**InvestorLit Research: Behavioral Finance and Investment Management**

*InvestorLit is a subscription service providing reviews of institutional investment literature. The reviews cover a wide range of investment topics and are published at www.investorlit.com. Bruce Grantier, founder of InvestorLit, is a member of the Brandes Institute Advisory Board. Members of the InvestorLit Advisory Board include Zev Frishman (Brandes Institute Advisory Board member) William Raver (Brandes Institute Advisory Board member) and Bob Schmidt (Manager, Brandes Institute). This is the first article in what the Brandes Institute envisions as an ongoing series highlighting select InvestorLit research pieces. The opinions expressed here are those of InvestorLit.*

**Executive Summary**

*Behavioral Finance and Investment Management*¹, a 180-page book edited by Arnold S. Wood and published by the Research Foundation of the CFA Institute, is a collection of behavioral finance research written by different authors. The book features leading academic and practitioner views and discusses this topic from several vantages:

1. Behavioral finance in the context of modern portfolio theory (MPT) (Meir Statman and Richard Thaler),
2. Fear and irrationality (Jason Zweig and Robert Shiller),
3. Lessons from neuro-economics and brain function (Steven Sapra and Paul Zak),
4. The sociology of markets (Michael Mauboussin).

Summing the book up, it provides an excellent perspective on the field and shows how to incorporate behavioral finance into your investment framework. The book also suggests investors should be quite careful about modern portfolio theory (MPT) as it relies on so many unrealistic assumptions that it doesn’t always accurately model reality. As Statman and Thaler point out, people are irrational, markets are not efficient, investors usually think well beyond mean-variance, and beta is a very limited measure of risk.

**1. Behavioral Finance in the Context of Modern Portfolio Theory (Statman and Thaler)**

Statman describes the four building blocks of modern portfolio theory (MPT) and the behavioral finance theory (BFT) alternatives:

1. In MPT, investors are rational, but in BFT, they are “normal.” Loss aversion and hindsight bias are two of the more important behavioral traits which distort rationality.

2. In MPT, markets are efficient, but not in BFT. Efficiency means a stock’s price is always equal to its fundamental value. However, one study they cite found only 20% of changes in stock prices are due to fundamental value and another found many changes in indices occur with no change in fundamentals at all.

3. In MPT, investors build portfolios using mean-variance analysis, but in BFT, portfolio construction is goal-oriented and involves quite different risk orientations for different types of investment objectives.

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4. In MPT, return is entirely determined by “beta” (a measure of risk), but in BFT return is a function of a wide array of factors, including market cap, value, and momentum.

Statman states that while mean-variance and the related notion of the capital asset pricing model (CAPM) are very elegant models, they are not very realistic in their assumptions and have declined in usage.

Thaler discusses the evidence legitimizing BFT and concludes that the term will, in the future, become a redundant phrase as in, “What other kind of finance is there?” His important findings include:

- BFT has led to models which explain aggregation of individual behavior, grounded in both psychology and economics (important because opponents of BFT often argue that individual actions are irrelevant in aggregate).
- BFT theory on loss aversion (the emotional effect of losses weighing more heavily on investors than comparable gains) explains the long-standing puzzle of why the long-term equity risk premium is so high.
- BFT empirical research has uncovered frequent and widespread anomalies which question market efficiency.

2. Fear and Irrationality (Zweig and Shiller)

Zweig and Shiller discuss fear and irrationality, respectively. Zweig has written and spoken extensively on fear as an impediment to rational actions. A number of his webcasts are available on the CFA Institute website. His chapter discusses how fears often are mistaken or inflated, causing investors to react reflexively, often to their detriment.

Shiller, author of *Irrational Exuberance*, discusses irrationality in the stock and housing markets. He points out that while psychology is very important, it alone does not cause bubbles. Rather, bubbles result from a series of elements, including participating factors, amplification and cultural factors.

3. Lessons From Neuro-Economics And Brain Function (Sapra and Zak)

Sapra and Zak are professors at the University of Southern California and Claremont Graduate University, respectively. In their chapter on neuro-economics, they prescribe lessons for money managers. Neuro-economics, the study of which brain regions make decisions, offers an explanation of behavioral anomalies.

One lesson from this chapter concerns “anticipation of rewards.” The brain (in different places) encodes reward data, motivates effort to seek rewards and engages emotions for positive results in a rush typically associated with drug use. The lesson to investors is to be aware of how our brains influence our actions. Without discussing all the lessons contained in the chapter, even a brief understanding of the operation of the brain would very likely improve our investment decisions.

4. The Sociology Of Markets (Mauboussin)

Mauboussin’s article is more about the sociology of markets (who invests and what they invest in) than behavior of individuals. It gives several valuable examples that explain some large-scale anomalies in market performance. For example, Mauboussin examines the significant outperformance of U.S. small caps over large caps from 1926 to 1979, followed by the opposite in the 1980s and 1990s. He also explores the reemergence of small-cap outperformance due to the growth in hedge funds from 2000 to date, with their propensity (vs. mutual funds) for small- and mid-cap stocks.

In addition, Mauboussin tackles the Alan Greenspan fixed income “conundrum” in 2003-4, during which Fed tightening strangely led to declining long-term rates. The article concludes that financial institutions and agents have great influence on asset pricing.

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Recommendations for Two More Behavioral Finance Books

James Montier, author of *Behavioural Investing: A Practitioner’s Guide to Applying Behavioural Finance*, is a value investor with a strong behavioral psychology background. In this book, Montier summarizes an immense body of research on behavioral investing and adds many insights of his own, all of which make this book a valuable reference on this topic.3

The book discusses how the brain works, identifies 22 types of biases and the most common behavioral investment mistakes. Regarding the book’s contribution to the theoretical issues facing behavioral finance, the lack of a unified theory of asset pricing by the behaviorists is understandable; it is simply due to the breadth and complexity of the mind, which defies being captured in a neat equation.

Montier frequently quotes Daniel Gilbert on happiness, leading to a final note on readings on the topic of behavioral psychology. Gilbert, professor of psychology at Harvard University, is the author of *Stumbling on Happiness*, a fascinating book that seeks to identify what makes people happy. The essence of Gilbert’s premise? Of all living creatures, humans have the ability to contemplate the future. This allows us to calculate the utility of future scenarios, assess multiple outcomes and include what we have learned from past mistakes. Despite this unique gift, we happily fill in details we can’t recall, we often make up what we want to believe and we are heavily influenced by more recent events, giving less weight to the distant past. Ultimately, using this unique gift effectively requires conscious effort to overcome our natural biases.

Conclusion

The Brandes Institute talked with Bruce Grantier, InvestorLit founder, to gain additional insights on behavioral finance he has gained from more than 40 years in the investment industry. He shared his first-hand experience with the effects of biases on decision-making—and how to counter those emotional tendencies.

“In one instance,” he said of an investment committee’s decision, “we fell in love with two presenters who impressed us. After they left, we went around the table one by one and we all gave our opinion—8-0 in favor.

“At a later meeting addressing a follow-up question, we voted again. This time, I attempted to address potential groupthink. I suggested everyone write down his or her vote. It turned out to be 5-3 and not 8-0.” Grantier noted having committee members vote independently and anonymously can reduce the effects of at least two biases: “cascading,” where the first people voting can influence the whole group and “herding,” a social phenomenon where people simply want to fit in.

When asked about other practical steps individual and institutional investors could take to minimize behavioral influences, Grantier suggested, “Read everything you can on the topic and try and incorporate what you have read.” He acknowledged that it’s difficult to retrain our thinking. “During evolution, the ‘System 1’ part of our brains developed to judge quickly and respond automatically—often without our even being aware of it. This is very hard to change, but there is ‘System 2,’ the rational part of the brain, which requires time and effort to engage, but can be used to overcome System 1 reflexes.”

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3 A review of this book is available on the Brandes Institute website at: www.brandes.com/Institute/
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