What Investors Really Want
Lessons from Behavioral Finance

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What Investors Really Want
Utilitarian, Expressive, and Emotional Benefits

The difference between:
1. Giving a rose to a woman you court
2. Giving her $10, the price of a rose
What Watch-buyers Really Want
We Want High Status and Great Respect
Why would anyone pay $380,000 for a Richard Mille watch?

Utilitarian benefits
What does it do for me and my pocketbook?
*It tells time and never breaks down*

Expressive benefits
What does it say about me (to me and to others)?
*I am a successful man with high status and refined tastes*

Emotional benefits
How does it make me feel?
*Accomplished and proud*
What Investors Really Want

We want to stay true to our values

Socially responsible investments

Utilitarian benefits

I’ll get high returns

Expressive benefits

I am socially responsible

Emotional benefits

I have peace of mind because my finances are true to my values

Truth be told, I’m as financially ambitious as I am socially conscious.
What Investors Really Want
We want to be homeowners

House of our own

Utilitarian benefits

I’ll enjoy tax benefits and equity appreciation

Expressive benefits

I am an owner, not a renter

Emotional benefits

I have peace of mind because no landlord can raise my rent or kick me out
What Investors Really Want
We want high status and proper respect

Hedge funds

Hedge-fund money can put you into exhilarating conversations about the virtues of Gulfstreams versus Falcons

Utilitarian benefits

I will have high returns with low risk

Expressive benefits

I have high status

Emotional benefit

I feel proud as a member of an exclusive club
What Investors Really Want
We want great beauty, high status, and proper respect

Why do people with billions want more billions?

Kenneth Griffin of Citadel bought Jasper Jones’ “False Start” for $80 million

Meir Statman painted “Many Colors in Straight Lines” $50 canvas and $20 paint
What Investors Really Want
What do we want?

Why do we invest in socially responsible funds?

Why do we invest in hedge funds?

Why do we listen to TV gurus?
What Investors Really Want

Why do we put money in our portfolios?
What will we do with it?

Utilitarian benefits
I have money for retirement

Expressive benefits
I am financially independent

Emotional benefits
I have freedom from fear
(Downside protection)
I have hope for riches
(Upside potential)
What Investors Really Want

Wants and cognitive errors

What do we want?

To get high returns (What is the money for?)

To nurture our families

To banish fear of poverty

To savor hope for riches
What Investors Really Want

Why is wealth important to you? (SEI survey)

- 94%—Financial security
- 50%—Help children become successful
- 45%—Educate children
- 35%—Help the less fortunate
- 31%—Buy the things I really want
- 29%—Open new opportunities/experiences
- 24%—Have an impact on personal causes I care about
- 19%—Leaving a legacy
- 11%—As a barometer of my success
- 2%—Allow me to meet interesting people
- 1%—Increase my social status
- 3%—Other
If you could increase your chances of having a more comfortable retirement by taking more risk, would you:

a. Be willing to take a little more risk with all your money?

b. Be willing to take a lot more risk with some of your money?
If you could increase your chances of improving your returns by taking more risk, would you:

- A little more risk
- All of your money
- Addition to portfolio risk

- A lot more risk
- Some of your money
- Addition to portfolio risk
What Investors Really Want

Freedom from fear – Downside protection
Hope – Upside potential
Goal-based portfolios

We want to be rich
(10% chance to be rich)

We don’t want to be poor
(Almost 100% chance not to be poor)
Combining elements of mean-variance portfolio theory and behavioral portfolio theory into a mental-accounting portfolio framework

Portfolio Optimization With Mental Accounts, *Journal of Financial and Quantitative Analysis*, 2010

Portfolios for investors who want to reach their goals while staying on the mean-variance efficient frontier

*Journal of Wealth Management*, 2011

Das, Markowitz, Scheid, and Statman
The overall portfolio and mental account (goals) sub-portfolio are all on the mean variance efficient frontier.
## What Investors Really Want
Standard Finance and Behavioral Finance

<table>
<thead>
<tr>
<th>Standard Finance</th>
<th>Behavioral Finance</th>
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</thead>
<tbody>
<tr>
<td><strong>Finance with rational people</strong></td>
<td><strong>Finance with normal people</strong></td>
</tr>
<tr>
<td>Computer-like people</td>
<td>Sometimes normal-smart</td>
</tr>
<tr>
<td>Immune to cognitive errors and misleading emotions</td>
<td>Sometimes normal-stupid</td>
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<tr>
<td></td>
<td>Normal-ignorant</td>
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<tr>
<td></td>
<td>Normal-knowledgeable</td>
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First Lesson

Know yourself

Know Your Clients

Know their wants

Know their goals

Know their cognitive errors

Know their emotions
Second Lesson
Know Science

Teach science to your clients

Teach the science of financial markets

Teach the science of human behavior

Knowledge of science distinguishes investment professionals from individual investors
Third Lesson

Be your clients’ financial physician

Good financial professionals are like good physicians

Good financial professionals promote both wealth and well-being

Good financial professionals ask, listen, empathize, educate, prescribe, and treat
Second Lesson
Know Science and teach science
The tools of science

Science makes us aware of our cognitive errors and misleading emotions

Science gives us tools to correct them

Logic and empirical evidence
Second Lesson
Know Science and teach science
The tools of science

“System 1” is the *Intuitive (Blink)* system

System 1 is automatic, effortless, rapid, and skilled
(An American in the US, driving on the right)

“System 2” is the *Scientific (Think)* system

System 2 is controlled, effortful, slow, and rule-following
(An American in the UK, driving on the left)
Know the science of human behavior and teach it

“Why is it hard to resist intuition, even when it is wrong?”

John Nash – A Beautiful Mind
Know the science of human behavior and teach it
Fear is a normal emotion
Exuberance is a normal emotion
Emotions are generally useful

Until politicians actually do something about the world economy...

BE AFRAID

The Economist
Do you think that now is a good time to invest in the financial markets?

Percentage of investors who said Yes

Source: UBS Index of Investor Optimism
What Investors Really Want
We want to play and win

Benefits to ‘active’ investors

Utilitarian benefits
It provides high returns

Expressive benefits
I am much smarter than mediocre index fund investors

Emotional benefits
I love the exhilaration of winning
Know the Science of Human Behavior and Teach It

Why do we behave as we do? Why do we believe that it is easy to beat the market?

Cognitive errors
Framing errors
Overconfidence errors
Confirmation errors
Hindsight (and regret) errors
Herding errors
Framing Errors

I sell my stocks because stocks are sure to go down!

Who is the idiot who is buying my stocks?

Framing the trading game as tennis against Roger Federer
(or Goldman Sachs, or high frequency traders, or Raj Rajaratnam)
Overconfidence Errors
On average, we are above average

Return investors expect from their own portfolio
Return investors expect from the stock market

End of 6-month moving average

Source: UBS Index of Investor Optimism
Know the science of human behavior and teach it

**Confirmation Errors**

We look for evidence that confirms our claims and beliefs

We overlook evidence that disconfirms them
Know the science of human behavior and teach it

Confirmation Errors

Claim: ‘The severity of the current crisis was obvious to anyone who cared to look’

Confirming evidence: Nouriel Roubini saw it

Disconfirming evidence: Ben Bernanke and countless other equally good experts did not
The S&P 500 was at 677

Roubini said:
“My main scenario is that it’s highly likely it goes to 600 or below”

A level of “500 is less likely, but there is some possibility you get there”
Know the science of human behavior and teach it
Hindsight, regret, and responsibility

“If we’re being honest, it was your decision to follow my recommendation that cost you money”
Know the science of human behavior and teach it

Hindsight, regret, and responsibility

All in the Family
Know the science of human behavior and teach it

**Herding Errors**

Herding can be beneficial
Herding can be harmful

How can we tell the difference?

What information drives this herd?
What benefit or harm can come from joining this herd?
Know the science of human behavior and teach it

Restaurant Herd
Conclusion

First Lesson
  Know yourself
  Know your clients
  Utilitarian, expressive and emotional benefits

Second Lesson
  Know Science
  Teach science to your clients

Third Lesson
  Be your clients’ financial physician
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Thank You

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