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
Why do I pay $10,000 for an IWC 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 masculine*

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*
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 and high status

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

Meir Statman painted “Colors in Straight Lines” $50 canvass 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
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

To play the beat-the-market game and win
What Investors Really Want
What Institutional Investors Really Want

To get high alpha?

To play the beat-the-market game and win?

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*
First Lesson
Know Yourself
Know Your Clients
Know Your Competitors
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
Apply science to public policy

Knowledge through science distinguish institutional investors from individual investors
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
### Why do we behave as we do?

<table>
<thead>
<tr>
<th>Behavioral Finance version 1</th>
<th>Behavioral Finance version 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Because we are <em>irrational</em></td>
<td>Because we are <em>normal</em>, pursuing what normal investors want</td>
</tr>
<tr>
<td></td>
<td>We fall victim to cognitive errors and misleading emotions <em>on our way to what we want</em></td>
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</tbody>
</table>

### Foundation blocks of standard finance

1. Investors are rational

2. Investors should construct portfolios by the rules of mean-variance portfolio theory (and actually do so)
   Investors save and spend by life-cycle theory (Smoothing spending over the life-cycle)

3. Markets are efficient

4. Expected returns are determined only by risk (measured by beta)
   (Only utilitarian factors)
Foundation blocks of behavioral finance

1. Investors are normal

2. Investors construct portfolios by the rules of behavioral portfolio theory (and are wise to do so)
   Investors save and spend by behavioral life-cycle theory
   (Affected by framing, mental accounting and imperfect self-control)

3. Markets are not efficient (but are not as easy to beat as many normal investors think)

4. Expected returns are determined by more than risk
   (Utilitarian, expressive and emotional factors)

Know the science of human behavior
and teach it
Why do we behave as we do?
Fear is a normal emotion - Usually a useful emotion

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

BE AFRAID
The Economist
Know the science of human behavior and teach it
Fear can be a misleading emotion
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
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
Herding errors

Know the science of human behavior
and teach it

**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)
Know the science of human behavior and teach it

Overconfidence errors
On average, we are above average

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

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

Know the science of human behavior and teach it

Confirmation errors

Nouriel Roubini in February 2010, when the S&P 500 Index was at 1,063
Forecasting the level of the S&P 500 Index at the end of 2010

The S&P 500 Index ended 2010 at 1,258
Know Science
Confirmation errors

March 9, 2009
Jeff Kearns - Bloomberg

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

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

Question

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 you chances of improving your returns by taking more risk, would you:

<table>
<thead>
<tr>
<th>Risk</th>
<th>Money</th>
<th>=</th>
</tr>
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<tbody>
<tr>
<td>a. A little more risk</td>
<td>All of your money</td>
<td>= Addition to portfolio risk</td>
</tr>
<tr>
<td>b. A lot more risk</td>
<td>Some of your money</td>
<td>= Addition to portfolio risk</td>
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What do investors 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-portfolios are all on the mean variance efficient frontier
Question

Think about switching your portfolio

You have a 50-50 chance to increase your standard of living by 50% throughout your life

You have a 50-50 chance to decrease your standard of living by X% throughout your life

What is the maximum X% you are willing to accept?

1. 10% or less
2. 11-20%
3. 21-30%
4. More than 30%

Question

Who (on average) are more loss averse?

1. Dutch
2. Vietnamese
Loss Aversion

Countries where loss aversion is high tend to be countries where uncertainty avoidance is high.

Uncertainty Avoidance Index (UAI)
Question

Do you think that:

1. Incomes should be made more equal

or

2. We need larger income differences as incentives

Counties where uncertainty avoidance is high tend to be countries where preference for equal income is high

Preference for Equal Income

<table>
<thead>
<tr>
<th>Country</th>
<th>Preference for Equal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>4.94</td>
</tr>
<tr>
<td>France</td>
<td>5.92</td>
</tr>
<tr>
<td>Italy</td>
<td>5.06</td>
</tr>
<tr>
<td>Japan</td>
<td>5.24</td>
</tr>
<tr>
<td>Poland</td>
<td>4.41</td>
</tr>
<tr>
<td>US</td>
<td>4.94</td>
</tr>
</tbody>
</table>
Counties where uncertainty avoidance is high tend to be countries where social spending is high

<table>
<thead>
<tr>
<th>Country</th>
<th>Social Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>NA</td>
<td>29.7</td>
</tr>
<tr>
<td>China</td>
<td>29.7</td>
</tr>
<tr>
<td>France</td>
<td>24.7</td>
</tr>
<tr>
<td>Italy</td>
<td>18.7</td>
</tr>
<tr>
<td>Japan</td>
<td>19.7</td>
</tr>
<tr>
<td>Poland</td>
<td>16.3</td>
</tr>
<tr>
<td>US</td>
<td>16.3</td>
</tr>
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</table>

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
We want a dignified retirement life

Problem:
Many do not save enough for retirement

Reasons:
- Inability to earn enough for spending and savings
- Inability to properly allocate earnings to spending and savings

What Investors Really Want
We Want to Save for Tomorrow and Spend it Today
The Problem of Self-Control

Save for Tomorrow  Spend it Today
What Investors Really Want
We Want to Save for Tomorrow and Spend it Today

The benefits and difficulties of self-control
Genetics account for one-third of differences in saving behavior
Self-control is associated with conscientiousness (One of the Big-Five factors of personality)
Conscientious people tend to excel academically and at jobs, have stable marriages, and live long
Conscientious people do not buy things on impulse

What Investors really Want
We want retirement savings protected from weak self-control
Retirement savings in the old mandatory DB paternalistic days

Voluntary Savings (Libertarian)
Mandatory Defined Benefits (DB) Retirement Savings (Paternalistic)
Social Security (Paternalistic)
What Investors Really Want
We Want Fairness
Politics make defined-benefit pensions impossible
Detroit Spent Billions Extra on Pensions

What Investors Really Want
We Want Fairness
Insider Trading
(Raj Rajaratnam)  
Workers’ Rights
What Investors Really Want
We Want Fairness

What does fairness mean?

Fairness rights
Libertarian fairness right –
   Freedom from coercion
Liberal (socialist) fairness right –
   Equal power
Paternalistic fairness right –
   Freedom from cognitive errors and misleading emotions

Perceptions of fairness and choice of fairness rights
Motivated by ideology and self interest

Unions negotiating with corporations compare their salaries to salaries in higher-paying companies

Corporations compare the salaries they pay to salaries in lower-paying companies
What Investors Really Want
We Want Fairness

Perceptions of fairness and choice of fairness rights
Motivated by ideology and self interest

An elderly man complained about applying “chained Consumer Price Index” to Social Security benefits

“Why don’t you put that chain on Government spending?”

Social Security and Medicare make up 60% of Government spending

What Investors really Want
We want retirement savings protected from weak self-control
Retirement savings in the early voluntary libertarian DC days

Voluntary Savings (Libertarian)
Voluntary Defined Contribution (DC) Retirement Savings (Libertarian)
Social Security (Paternalistic)
What Investors really Want
We want retirement savings protected from weak self-control
Retirement savings in the more recent voluntary libertarian-paternalistic (Nudge) DC days

Voluntary Savings (Libertarian)

Voluntary Defined Contribution (DC)
Retirement Savings – With a Nudge (Libertarian - Paternalistic)

Social Security (Paternalistic)

What Investors really Want
We want retirement savings protected from weak self-control
Retirement savings in my proposed mandatory paternalistic (Shove) DC days

Voluntary Savings (Libertarian)

Mandatory Defined Contribution (DC)
Retirement Savings – With a Shove (Paternalistic)

Social Security (Paternalistic)
What Investors really Want
We want retirement savings protected from weak self-control
Retirement savings in my proposed
mandatory paternalistic (Shove) DC plan

1. Combined mandatory contributions by employers and employees amounting to a minimum of 12% of earnings

2. Administration by companies offering DC plans but with a central agency for employees whose companies do not provide DC plans

3. Default offerings of well-diversified target-date funds set in one-year intervals

4. Fees not exceeding 30 bps

5. No borrowing from retirement savings accounts and no cashing out of accounts before retirement age

6. Enhanced financial literacy through education at high schools and elsewhere
Conclusion

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

Second Lesson
Know Science
Teach science to your clients
Apply science to public policy

References

• S. Das, H. Markowitz, J. Scheid, and M. Statman, “Portfolios for investors who want to reach their goals while staying on the mean-variance efficient frontier,” Journal of Wealth Management, 2011
• M. Statman, “Culture in loss-aversion, income inequality, and safety nets
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