Interview with professor Meir Statman about Behavioral Finance

Meir Statman is the Glenn Klimek Professor of Finance at Santa Clara University, and Visiting Professor at Tilburg University in the Netherlands. His research focuses on behavioral finance. He attempts to understand how investors and managers make financial decisions and how these decisions are reflected in financial markets. Meir's award-winning book, "What Investors Really Want," has recently been published by McGraw-Hill. The book's subtitles are "Know What Drives Investor Behavior and Make Better Financial Decisions," and "Learn the Lessons of Behavioral Finance." Meir Statman received his Ph.D. from Columbia University and his B.A. and M.B.A. from the Hebrew University of Jerusalem. Michal Stupavský, Newsletter Manager, carried out the interview with professor Statman during ACCA&CFA Business Mixer in Prague on 15 October.

Stupavský: Dear professor, you are among the biggest economic stars in the behavioral finance area. How did it actually happen that you began to focus your research in this field of finance theory?

Statman: For as long as I remember, I tried to make sense of people, how people behave. Since I am interested in economics and finance, [my interest] is in how people behave in the world of finance. For example, I learned, as everybody else did in school, Miller-Modigliani and the proof that dividends do not matter. But, when I came to New York in 1973, it was just before the energy crisis, and then the war, the Vietnam War. Con Edison, the utility company of New York, stopped its dividend. [Con Edison] could not pay because it had to pay more for oil to generate electricity, but they could not raise the rates of electricity. Then, there was an Annual Meeting of shareholders in 1975 and people wanted to do physical harm to the Chairman of the Board. [Shareholders] had to be restrained, really, physically restrained from him. They asked why did you cut the dividend. Now here is the theory that they should not care. If they do not get the dividend they can make their own dividend by selling a few shares. Here is reality. The entire motivation is when you have theory that is contradicted by evidence, it is not the evidence that goes; it is the theory that goes.

When I came to Santa Clara [University], I met Hersh Shefrin. [He] was working with Richard Thaler on issues that have to do with self-control and mental-accounting. What people do is that they keep their money is separate pockets. It struck me and I said, I know that the standard advice really is that a dollar is a dollar and if you don't get the dividend you just dip into the capital and sell a few shares. Well that is a 'no-no' because people, for self-control reasons, keep separate income and capital. Spend from income but don't dip into capital. So I say 'aha'. We added to that issues that have to do with cognitive errors and issues of regret and mental-accounting and so on. So what started [my interest] is the drive to make sense of the world. So we say, is there something systematic about it or do people behave in a way that is random. Of course not, [people] behave in particular ways, but that is not described by Miller and Modigliani. So how can we describe it in a way that fits the evidence?

Stupavský: Yes. That is actually leading to my next question. In 1995 you published my favourite paper Behavioral Finance versus Standard Finance. So could you tell us three major differentiation points between behavioral finance and standard traditional finance?

Statman: There are four building blocks of standard finance, and they have equivalents in behavioral finance.

1) In standard finance, people are rational. In behavioural finance, people are normal.
2) In standard finance, people build their portfolios by mean-variance portfolio theory. In behavioral finance, they [build portfolios] by behavioral portfolio theory.
3) In standard finance, markets are efficient. In behavioural finance, they are not efficient and any idiot can beat the market also.
4) In standard finance, the asset pricing model is the CAPM and now the Three-Factor Model. In behavioral finance, we have the behavioral asset pricing model that takes into account cognitive errors and emotions as well as people's wants.

In summary, these are the four building blocks of standard finance on one side and behavioral finance on the other side.

Professor Meir Statman

Stupavský: We, as the CFA charterholders within the CFA Curriculum, are learning about portfolio management and currently there is only the Modern Portfolio Theory by Harry Markowitz being the main part of the course. But actually in 2000 you published another very interesting article with Hersh Shefrin "Behavioral Portfolio Theory". So how do these two portfolio theories differ from each other?

Statman: What is different in Behavioral Portfolio Theory [than] standard portfolio theory? There are two elements. First, you begin by dividing the whole of the portfolio into mental accounts by goals. There is the retirement goal, the helping the children goal, and the leaving money for charity goal. So that is one difference, there are goals and

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mental accounts. Mean-variance does not ask what is the money for. [Mean-variance] says it will put you on the efficient frontier. But for what, why am I saving? That is nothing. So, one [thing] is the mental-accounting structure.

The other [thing] is that risk is not measured by standard deviation but rather by the probability of not getting to your goal. For example, nobody who is a mean-variance investor would by a lottery ticket, even if it is a fair lottery ticket. The behavioral investor would buy a lottery ticket if it gives him the only chance to get to his goal. Because, if you have a dollar and your goal is a million dollars, you know not even the best bet portfolio would get you from a dollar to a million dollars in a year. But a lottery has some chance to get you there.

Let me just mention that there is an article that was published in 2011 by Markowitz and me, and two of our colleagues Das and Scheid. We combine some elements from mean-variance and behavioral, in that we begin by dividing the portfolio into mental accounts by goals. So it is not that you have those two rigid oppositions. Harry Markowitz understands investors, he understands that people save for something, that they begin with goals and they think in mental accounts.

[Ed note: The article was titled "Portfolios for Investors Who Want to Reach Their Goals While Staying on the Mean-Variance Efficient Frontier"]

So when you sell it, it is 110. You close it at a gain. You both made money, and you feel proud. You feel the pride. Now, if the stock instead of going from 100 to 110 went from 100 to 60, then closing the account at a loss is going to be something that is going to impose regret. It will also have hindsight. In hindsight, you are going to say I just knew I should not buy this stock: the management was bad. So when you close [the position] at a loss, you are going to have regret. People postpone realization and they say it will come back. That is really one part of it. Even though there are tax benefits to realizing losses. I do not know how the Czech law is, but in the United States, you can count your investment losses against investment gains and some against your current income. So that should make sense for you to do the opposite, to realize losses but don't realize gains. But people do that the other way round, and that is really quite fascinating. We developed a theory, and it has some elements of Prospect Theory and so on but we did not really have the evidence. We had some evidence from really macro data, from flows of funds and so on. So it was really an honest hypothesis we did not really know if the evidence [would show] that in China people realize their losses fast. That would have been evidence against the hypothesis. But it works in China, it works everywhere. I haven't seen a study about the Czech Republic but I imagine [the hypothesis] works in the Czech Republic as well.

Professor Meir Statman

Michal Stupavský, CFA and David Havlíček

Stupavský: Mental-accounting is actually strongly connected to the so-called disposition effect which you are actually the author of with Hersh Shefrin from 1985 which is actually connected to the Prospect Theory of Kahneman and Tversky, a key building block of behavioral economics. In my view the disposition effect is among the greatest fears of investors. Could you tell us more about it? Why is it so important to be aware of this effect?

Statman: One is because it is systematic evidence. We want to understand people's behavior. This is a very important feature of people's behavior, and we are trying to make sense of it. So what we said in it is one way of describing equity is that when you buy a stock you open a mental account. In it is written "100 dollars". Now, what you like is to be able to close that account at a gain.

Stupavský: You recently published your new book What Investors Really Want. What are the main implications which a reader should take out of your book?

Statman: Well, I think that too much in finance is about this game: did you beat the market, did you not beat the market. But eventually, we save and we invest not to beat the market. We save and invest so that we can help ourselves, help our families, help other people, achieve our goals and get to our dreams. So that really is what the book is about. Some investors, for example, are socially responsible investors. They care not just about risk and return; they care also about whether it is socially responsible.

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Lots of investors, they like the game, they like the trading game. When you ask somebody who plays a video game, "Why do you do that?" He says, "Because it's fun." You ask a trader why he does that– "Because I'm making money." If you check his books, he is losing money. So the difference really is that when it comes to investing, when it comes to trading, people will not admit they do it because it is fun.

If I buy a Rolls-Royce, it is because it's a high-quality, comfortable car. If my neighbor buys it, he is stupid and arrogant and status seeking, and so on. So people just don't have very much insight into themselves. If you look into what people really want, [they] say we want two things. One is not to be poor. And the other is to be rich. So we buy both insurance and we buy lottery tickets.

Professor Meir Statman, Michal Stupavský, CFA and David Havlíček

We want fairness. If you think about insider trading and why it is that we have laws against insider trading, people say, you know, it should be fair. And fairness means we should have kind of a level playing field. We want education. We want help from professionals, we want help from the government, somebody to help us. So if we begin to look at all the things that people want you get to beyond the question of risk and return, you really get to the question, "What is the money for?" Some people say for example that you should invest your money in any company that will make you a lot of money. And then use the extra money to support your socially responsible cause. People are really passionate about social responsibility. This makes no sense. I liken it to telling an Orthodox Jew to eat pork because it costs less then kosher beef and donate the savings to the synagogue. [Laughs] And people say, oh yeah, that is absurd. Well, for people who really are passionate about the environment, investing in a company that pollutes the environment and then using the money to clean the environment, you know, this is absurd. So you really have to ask yourself what is the money for. What is it that investors really want because money is just a station on the way to what it is you really want.

Stupavský: My next question is regarding the latest developments in the academic sphere. The Nobel Prize in Economic Science for 2013 has been awarded this Monday two days ago to Eugene Fama, Peter Hansen and Robert Shiller. What do say on that? Because, in my view it is quite interesting, because Fama is the founder of efficient market hypothesis and Shiller on the other hand, a critic of it who says that volatility of asset prices is much higher than the volatility of the fundamentals which is actually caused by the behavioral and irrational characteristics of market participants. So really like day and night these two very distinct, different kind of personalities.

Statman: They are not day and night at all. I think that it is made this way. There are several things. First, market efficiency has at least two definitions. One is that price is equal to value. That is better described as rational markets. In rational markets, price is always equal to value, intrinsic value.

[Next,] there is another one that is called unbeatable market that says you cannot beat the market. Now, if the price is always equals to value, then you cannot beat the market. But if you cannot beat the market, it does not mean that the market is rational, that the price equals to value. For example, imagine that you know that we have a bubble. By bubble, we mean when prices do not equal to value. So the bubble is that prices are high relatively to value. Let's say that I know that there is a bubble. Why would not I be able to beat the market? Because, I do not know when [the bubble] will stop. So even though I know that price isn't equal to value, being able to beat the market requires something else. It requires that I will know when [the bubble] will stop, is it really a bubble, and so on. In other words, let's say that you have a market where generally the price equals value except that on every day God chooses a letter and companies whose name begins with this letter, lets say A for Apple, they get a 5 percent bonus. So price deviates from value. But can you beat the market? No. Because you cannot guess what God is going to choose today. So what Shiller showed is that the markets are not rational. That prices move. That it is not only fundamentals that determine prices but also, he called it mass psychology, called it sentiment, called it…

Stupavský: Stories…

Statman: Stories, exactly. So that does not mean that you can beat the market.

Now, there is another part to him that says that actually you can beat the market. If you look at P/E ratios, and P/E ratios are really very high, this means value exceeds book – there is a big gap. If you are going to use P/E ratio as a guide, when to buy and when to sell? You are going to be wrong lets say in 45 percent of the cases and you are going to be right 55, so the odds are [favorable]. Fine, but are you going to put your portfolio on those kinds of odds? In this, I stand with Fama, and I say you don't really know. The notion that ahead of time it's absolutely clear we are in a bubble. So we were in a bubble in 2007, And, we were in negative bubble in 2009. Are we in a bubble now do you think?

Stupavský: In hindsight we can say but not in foresight.

Statman: So that is what Fama says, and I agree with him,

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that maybe there is no such as a bubble. In other words, with a bubble, we are talking about a bubble in foresight. But people look back and say it might be just a manifestation of these cognitive errors which we know as hindsight. People look back and say, "God it was clear, it was clear." I show[ed] in my presentation forecasts that Wall Street strategists gave at the end of 2007 and throughout 2008, and you look at them and say, "Really?" [Laughs]

Another thing is that you have to look at the full record. That there is another thing: availability. Shiller, well he was right about the stock market in 2000, and he was right with real estate market. But, is that a full sample of his predictions? Well, he said that the market is overvalued in 1996. He was wrong for a long time, and then he was right. If you believed him in 1996, would you be better off than if you didn't believe him and just stayed in the market? Probably not. He said that real estate markets are high. In effect, they went down. But did he say anything about the bank problems? Nothing. He had no insight about that. Not to knock Bob Shiller, who I admired even before he got the Nobel Prize, he is just superb, but you have to be really careful. I think that he is. He is joking about the fact that just by luck the book came out in early 2000 and, boy, was it just the right time.

Stupavský: [Shiller's book] Irrational Exuberence

Statman: Exactly. So what we have is that Fama invests in index funds and I invest in index funds. And, I wouldn't be surprised if Bob Shiller invests in index funds.

Stupavský: Good point.

Statman: I tilt a bit towards value and small [cap]. Bob Shiller probably does the same. I doubt that Bob Shiller is really playing those games himself trying to beat the market. So if you get to the issue of why is it that there are so many people who try to beat the market that's an interesting question – and I think it is probably something that you deal with in the book – because people are stupid. [Laughs] Which is an impolite way of saying that, but they are subject to all of those emotions and cognitive errors, and they are not even aware that they are. It's kind of like somebody who does not know that he needs glasses and says, "Gee, you know, people are kind of blurry." No, people are not blurry, you need glasses. [Laughs]

Stupavský: Professor, my last question regards the current status of behavioral finance in academia, in the finance theory in general. Do you think that currently behavioral finance is already an inseparable part of the mainstream finance theory or still they are kind of complement or seperate?

Statman: I think that behavioral finance is finance. People do not fully know that. But what is happening is this: when people think about standard finance, they think, "Wow, this is a structure that is rigorous." We have rational people, we have mean-variance, we have efficient markets, we have asset pricing model. What does behavioral finance have? Their stories you know. But if you look at it, are people rational? Of course not. Do people actually use mean-variance? Of course not. You are trying to optimize.

Stupavský: I used to work as portfolio manager of an equity fund, never ever [used mean variance].

Statman: Yeah. And people use it, like I describe, just pretend. They put in parameters [to a mean variance model] that make sense. [The model] says put 90 percent into Hungarian stocks. No, no. So they put in constraints: no more than 2 percent of Hungarian stocks. And they give it another run and so on until they get what they wanted in the first place. Now it is the Nobel Prize winning. So, people don't use mean-variance. Asset pricing model – you know CAPM is bad. Three-factor model, Fama would tell you it has no basis in theory. It is just something that they've concocted and they tell a story about risk, but there is no evidence. So, market efficiency is a mess. So, what we have is something that I think is better, at least in terms of being closer to reality with normal people that behave in particular ways, like disposition effect. You have people who will construct portfolios by rules of Behavioral Portfolio Theory, by goals. You have notions of market efficiency that make sense. You have an asset pricing model that I talked about [in the presentation], that kind of shows the asset pricing model for automobiles. It includes utilitarian things: expressive, emotional. Like why you buy a BMW.

The difference, really, is that people still think about standard finance as being very solid, but it is not. It is really apart, and Fama would say that. He says that you know, and I quote him. Standard finance is broken. Behavioral finance, we will never have, we will never have…

Stupavský: Such rigorousness…

Statman: Exactly. You will never have a model like CAPM that is built directly on the asset pricing model, but that was an illusion. Okay, that was an illusion, you cannot have that. We have to think about finance more as physics, because [it is like] biology, kind of like the human body. That is, we are not built optimally. We were built by evolution. If you ask an engineer to design people from scratch – I once saw a picture what people would look like if they would have been designed from scratch. They are going to be much shorter, even shorter than me [Laughs]. And if you think about the part that gives troubles to many people, it is the back. Okay, why? Because, we were not built to stand up. So you have all of those peculiarities. And so you are going to describe it, but it's not an optimal adapt[ation]. You will not have this kind of highly mathematical [framework]. You want to have something that is like a science. It will have testable hypotheses, it will have theory, that you can explain in words. You will have tests to reject them or not reject them. You will have an asset pricing model that kind of makes sense. You know to me, that is good enough. But it will take time for people to do that. You know, they say that in science it is very hard for people to give up on old theories. And it is even hard for me. So, you have to kind of get a generation that will retire and move on. And you will see that behavioral finance is the next.

Stupavský: Thanks much professor for very interesting interview.