Finance for Normal People: 
How Investors and Markets Behave

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Normal Wants
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
Normal Wants
We want to nurture our children

Utilitarian benefits
*What does it do for my pocketbook?*
I have money to support my children

Expressive benefits
*What does it say about me?*
I am a responsible parent

Emotional benefits
*How does it make me feel?*
I am proud to support my children
Normal Wants
We want to stay true to our values

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*
Normal Wants
We want high social status

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 social status

Emotional benefit
* I feel proud as a member of an exclusive club
Normal wants

Why do people with billions want more billions? We want great beauty, high status, and proper respect

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

Meir Statman painted “Many Colors in Straight Lines” with a $50 canvas and $20 paint
Normal Wants
We want to make sense of the world
What makes stocks go up and down?

Utilitarian benefits
*By solving the puzzle I can make money*

Expressive benefits
*I am smart*

Emotional benefits
*I feel proud and accomplished*
Normal Wants
We want to play and win

Benefits of “active” investing

Utilitarian benefits

*It provides high returns*

Expressive benefits

*I am much smarter than mediocre index fund investors*

Emotional benefits

*I love the exhilaration of playing and winning*
Normal Wants
We want to play and win
Why doesn’t John Paulson retire?

Some people like playing chess, some like backgammon

This is like a game, and playing games is fun

It’s more fun when you win

Why do we behave as we do?
Rational, Irrational, and Normal Behavior

1\textsuperscript{st} generation
behavioral finance

Because we are \textit{irrational}

Our wants are the wants of the rational people of standard finance

We fall victim to cognitive and emotional errors on our way to our \textit{rational} wants

2\textsuperscript{nd} generation
behavioral finance

Because we are \textit{normal}

Our wants are the wants of normal people

We fall victim to cognitive and emotional errors on our way to our \textit{normal} wants
Rational, Irrational, and Normal People

2nd Generation Behavioral Finance

People are normal

Normal people buy lottery tickets because they want:

The *expressive benefits* of being “players” with a chance of winning

The *emotional benefits* of hope of winning

The *utilitarian benefits* of the miniscule chance of winning

Normal people are sometimes misled by cognitive and emotional errors
Normal wants, shortcuts, and errors underlie behavioral finance

We often hear that behavioral finance is nothing more than a collection of stories

That its lacks the rigorous structure of standard finance
Normal wants, shortcuts, and errors underlie behavioral finance

Foundation blocks of behavioral finance

1. People are normal
2. People construct portfolios as described by behavioral portfolio theory
3. People save and spend as described by behavioral life-cycle theory
4. Expected returns of investments are accounted for by behavioral asset pricing theory
5. Behavioral finance distinguishes price-equal-value markets from hard-to-beat markets
   And explains why many people believe that markets are easy to beat
Normal wants, shortcuts, and errors underlie behavioral finance

Foundation blocks of behavioral finance

5. Behavioral finance distinguishes price-equal-value markets from hard-to-beat markets
   And explains why many people believe that markets are easy to beat
Behavioral Market Efficiency

*Price-equals-value efficient markets*

Stock prices always equal intrinsic values

*Hard-to-beat efficient markets*

Some people are able to beat the market (but not necessarily every month)
Most people cannot beat the market (even if they succeed some months)
Behavioral Market Efficiency

The price-equals-value market hypothesis is false

The hard-to-beat market hypothesis is true

Yes, markets are crazy, but this does not make you a psychiatrist

Why do so many investors believe that markets are easy to beat?
Behavioral Market Efficiency

Price-equals-value and hard-to-beat markets

Warren Buffett received three bids from sellers of Citizens Insurance bonds, one at a price that would yield 11.33%, one at 9.87% and one at 6.00%

"It's the same bond, the same time, the same dealer. And a big issue"
Behavioral Market Efficiency

Price-equals-value and hard-to-beat markets

When asked “What advice would you give to someone who is not a professional investor,” Buffett said:

“Well, if they’re not going to be an active investor – and very few should try that – then they should just stay with index funds. Any low-cost index fund... They’re not going to be able to pick the right price and the right time”
Behavioral Market Efficiency

Who beats a hard-to-beat market?
Hard-to-beat markets are not impossible to beat

Investors with exclusively-available information find it easy to beat the market
A single insider

Investors with narrowly-available information find it hard but not impossible to beat the market
Professional investors, including hedge fund and “active” mutual fund managers, security analysts, groups of insiders

Yet, on average, amateur investors with nothing more than widely-available information find it impossible to beat the market
And professional investors keep all their market beating returns in fees
Normal Investors
The “market-sum” game
Fat and lean returns in a pot of stew
Behavioral Market Efficiency

**Bubbles in price-equals-value and hard-to-beat markets**

Bubbles cannot exist in price-equals-value markets

Bubbles, however, can persist in hard-to-beat markets
Can we detect bubbles in foresight?
Shiller says: Yes

“You can have a fairly high degree of confidence

That's what I felt in the stock market in late 1990s”
Can we detect bubbles in foresight?
Fama says: No

“The word "bubble" drives me nuts, frankly,
because I don't think there's anything in the
statistical evidence that says anybody can reliably
predict when prices go down”
Behavioral Market Efficiency
1926-2015

P/E (CAPE) Ratio

Behavioral Market Efficiency
1926-2015

Correlation = 0.71

Annualized return in the subsequent 10-years

P/E ratio (CAPE) in December of a year
Behavioral Market Efficiency
1926-2015

CAPE Ratios

<table>
<thead>
<tr>
<th>CAPE Ratio</th>
<th>Annualized 10-Year Return</th>
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<tr>
<td>35</td>
<td>10.23%</td>
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<tr>
<td>30</td>
<td>10.31%</td>
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<td>25</td>
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<td>20</td>
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<tr>
<td>Median</td>
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<td>12</td>
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Stock Buy and Hold
10.02%
Normal wants, shortcuts, and errors underlie behavioral finance

Foundation blocks of behavioral finance

1. People are *normal*
Normal Investors
Amateur investors have only widely-available information
Why do amateur investors play the market-sum game?

1. Ignorance
2. Cognitive errors
3. Wants for expressive and emotional benefits
Normal Investors
Why do amateur investors play the market-sum game?

1. Ignorance

Believe, wrongly, that they have narrowly-available information

Believe, wrongly, that they have to “play” if they want to win

Account for returns “in their heads” or neglect to exclude contributions when calculating returns

Do not compare their returns to market returns

Do not realize losses, counting them as no losses

Attribute to skill what properly belongs to luck (e.g. We can beat the market in the short run but not in the long run)
Normal Investors
Why do amateur investors play the market-sum game?

2. Cognitive and emotional errors

Framing errors

Overplacement errors

Hindsight errors

Availability errors
Normal Investors
Framing errors

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

Who is the idiot buying my stocks?

Framing the trading game as tennis
against a practice wall
Normal Investors
Framing errors

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

Who is the idiot buying my stocks?

Framing the trading game as tennis
against Roger Federer
(or high frequency traders, or insiders)
Question

Do you think that your skills at juggling 3 oranges place you above or below average among amateur jugglers of your age?

a. Above average
b. Below average
Question

Do you think that your skills at driving a car place you above or below average among drivers of your age?

a. Above average
b. Below average
Question

Do you think that your skills at selecting investments that beat the market place you above or below investors of your investment education and experience?

a. Above average
b. Below average
Normal people
Overconfidence (Overplacement) errors

Fidelity Traders Summit April 11, 2012

62% expect to beat the market during the next 12 months

29% expect to match the market

Do 9% expect to lag the market?
Normal People
Hindsight errors

The Bible Code
Published in 1997

Finding patterns in the letters of the Bible
Normal People
Hindsight errors

“Economic collapse” appears with
“Depression,”
“Stocks”
“1929”
Normal People
Hindsight errors

The Bible Code was published in 1997

Did it forecast the boom of 1999?

Did it forecast the bust of 2000?
Normal People
Hindsight errors

Wall Street Strategists’ predictions of S&P 500 Index at the end of 2008
(BusinessWeek December 20, 2007)

Strategist 1: 22% increase - recommends all-stock portfolio
Strategist 2: 16% increase - AIG’s stock is a good investment
Strategist 3: 15% increase - recommends stocks of financial institutions.

Most pessimistic strategist: 8% decline
Normal People
Availability errors

Judging probability by what is available to memory

Promoters of trading advertise winners
We exaggerate the probability of being winners
Normal Investors
Amateur investors have only widely-available information
Why do amateur investors play the market-sum game?

3. Wants for expressive and emotional benefits
Fidelity survey - 78% of traders trade for reasons beyond profits;

54% enjoy “the thrill of the hunt,”

53% enjoy learning new investment skills,

More than half enjoy engaging in social activities
Normal People

Normal Wants

Managers of “active” funds satisfy their investors’ wants for the utilitarian benefits of high returns

and the expressive and emotional benefits of playing games and winning
Normal People
Normal Wants

Mutual fund managers exploit availability errors by “window dressing,”

changing the composition of their portfolios to increase their appeal when disclosed to investors
Conclusion
Rational, Irrational, and Normal Behavior

Standard Finance
People are *rational*

1\(^{st}\) Generation Behavioral Finance
People are *irrational*

2\(^{nd}\) Generation Behavioral Finance
People are *normal*
Normal people have normal *wants*
Normal people use normal *cognitive and emotional shortcuts*
Normal people normal *cognitive and emotional errors*
Lessons

Know your wants

Know financial facts

Know human behavior
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