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"

$50 canvas and $20 paint

Why do we behave as we do?

Rational, Irrational, and Normal Behavior

1st generation behavioral finance

Because we are *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 *rational* wants

2nd generation behavioral finance

Because we are *normal*

Our wants are the wants of normal people

We fall victim to cognitive and emotional errors on our way to our *normal* wants

Rational, Irrational, and Normal People

Normal people in the 2nd generation of behavioral finance

***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 the 2nd generation of behavioral finance

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

That it lacks the rigorous structure of standard finance

Normal wants, shortcuts, and errors underlie the 2nd generation of 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 the 2nd generation of behavioral finance

Foundation blocks of behavioral finance

1. People are normal

Normal people have normal wants

Normal people use normal cognitive and emotional shortcuts

and commit normal cognitive and emotional errors

Normal People

Cognitive shortcuts and errors

Overconfidence (Over-placement) shortcuts and errors

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

Emotional shortcuts and errors

Hope and fear

October 6, 2008

We were afraid

Emotional wants are not always emotional errors

FED WEIGHS BID TO SPUR ECONOMY
AS MARKETS PLUMMET WORLDWIDE

Normal wants, shortcuts, and errors underlie the 2nd generation of behavioral finance

Foundation blocks of behavioral finance

2. People construct portfolios as described by behavioral portfolio theory

Question

If you could increase your chances of having a more comfortable retirement by taking more risk, would you:

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

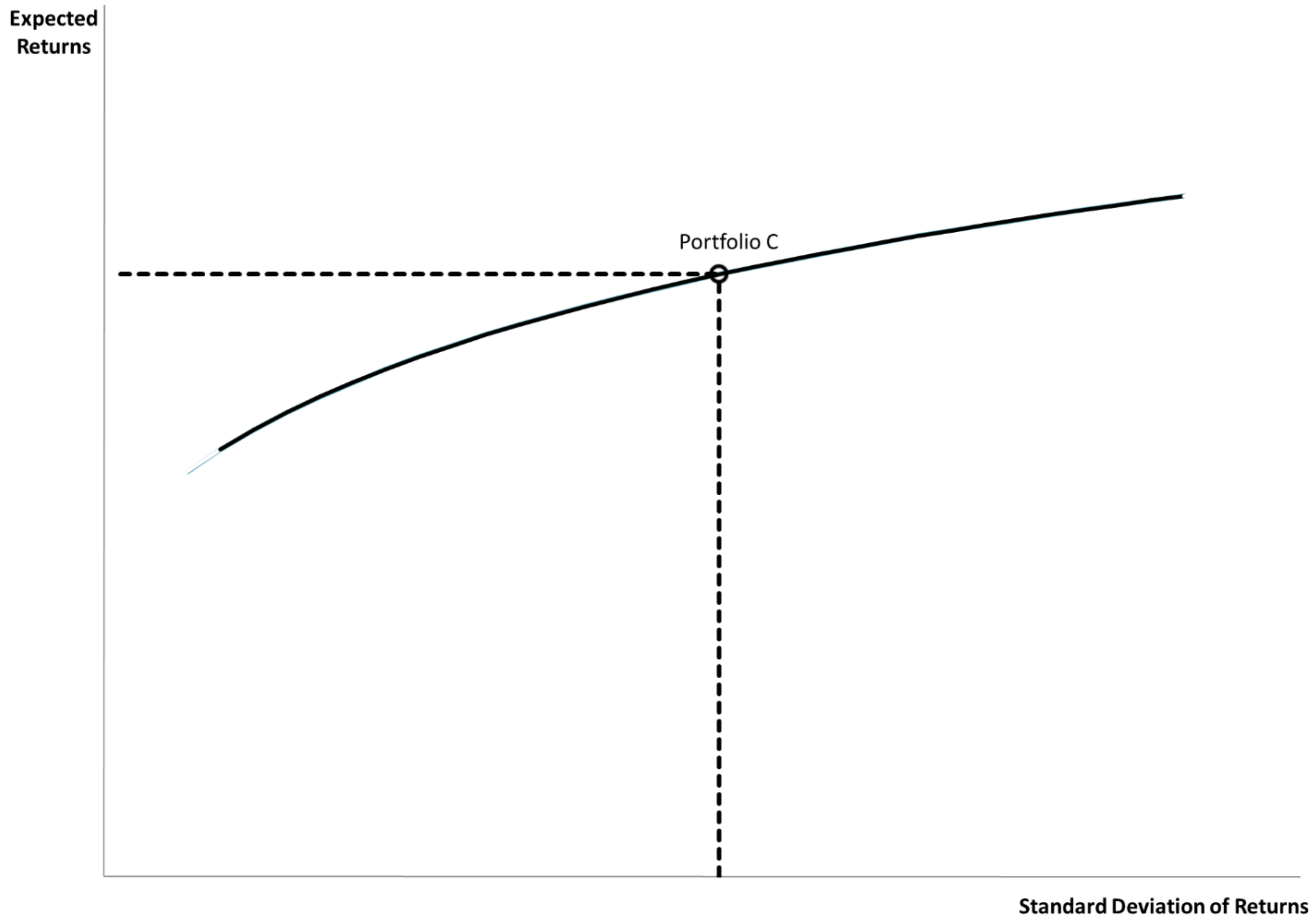
b. Be willing to take a *lot* more *risk* with *some* of your money?

Question:

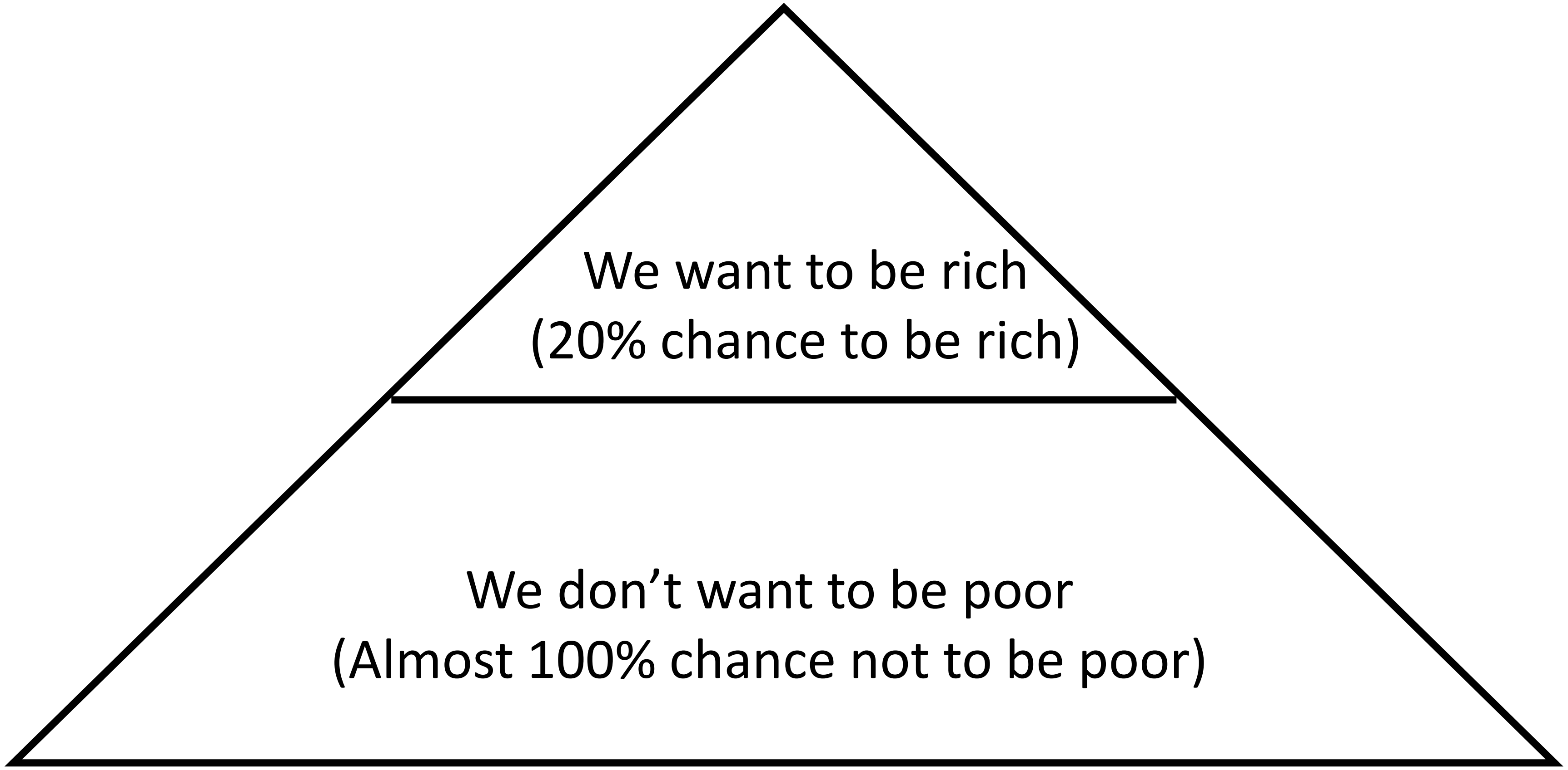
If you could increase your chances of improving your returns by taking more risk, would you:

	Risk		Money		
a.	A little more risk	x	All of your money	=	Addition to portfolio risk
b.	A lot more risk	x	Some of your money	=	Addition to portfolio risk

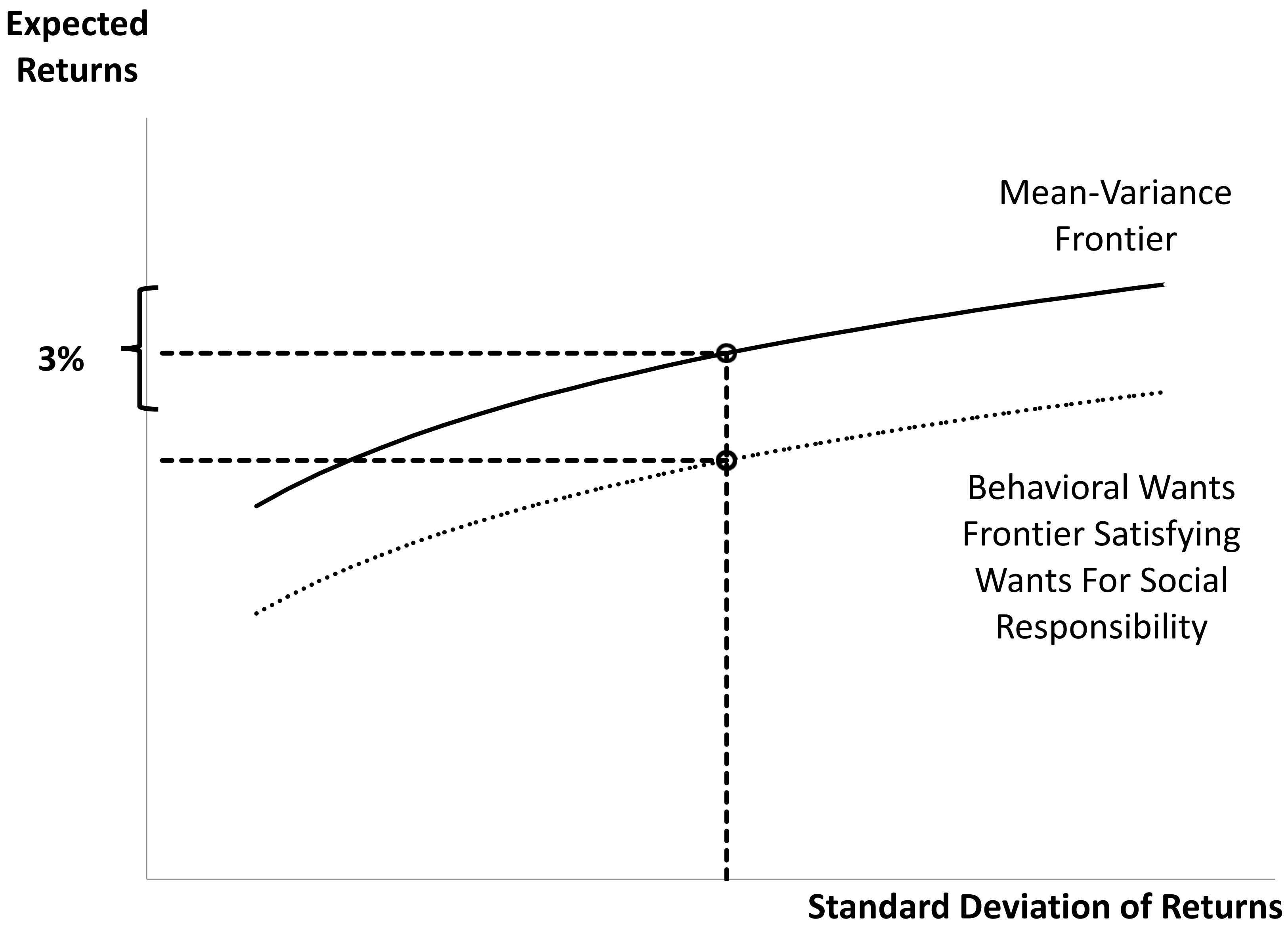
Mean-Variance Portfolios
We want to be on the mean-variance efficient frontier



Behavioral portfolios
We want to reach our goals



Behavioral portfolios
We want to be on the behavioral-wants frontier



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3. People save and spend as described by behavioral life-cycle theory

Question

Imagine you must schedule two weekend outings in a city where you once lived

You do not plan on visiting the city after these two outings

You must spend one of these weekends with an irritating, abrasive aunt who is a horrendous cook

The other weekend will be spent visiting former work associates whom you like a lot

Question

Suppose one outing will take place this coming weekend, the other the weekend after

Do you prefer, A or B?

A. This weekend with friends and next weekend with abrasive aunt

B. This weekend with abrasive aunt and next weekend with friends

From Accumulation to Decumulation

Mental tools that help us in accumulation can hinder us in decumulation

Mental tools that helped us save make it difficult for us to spend

Self-control

From Accumulation to Decumulation

Mental tools that help us in accumulation can hinder us in decumulation

Mental tools that helped us save make it difficult for us to spend

Framing and Mental accounting

From Accumulation to Decumulation

You are your clients' good financial physician

Good physicians promote both *health* and *well-being*

Good financial physicians promote both *wealth* and *well-being*

Wealth* is only a way station to *well-being
Good financial advisers are *well-being advisers*
Good *well-being advisers* manage *investments and investors*

Good financial physicians:

Ask, Listen, Empathize, Diagnose, Educate, Treat

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4. Expected returns of investments are accounted for by behavioral asset pricing theory

What is the asset pricing model of restaurant meals?

Meals at Per Se restaurant

Dinner starts at $295

Lunch starts at $185

Wine starts at $295

Behavioral pricing of restaurant meals

The expected price of a meal is a function of:

1. **Wants for utilitarian benefits such as high nutrition**

2. **Wants for expressive and emotional benefits such as great prestige**

3. **Cognitive and emotional errors such as inferring food quality from its price**

Behavioral Asset Pricing

The expected return of a stock is a function of:

1. Wants for utilitarian benefits such as low risk

2. Wants for expressive and emotional benefits such as hope of winning

3. Cognitive and emotional errors such as a belief that stocks of admired companies are likely to yield higher returns than stocks of spurned companies

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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

Bubbles cannot exist in price-equals-value markets

Bubbles can persist in hard-to-beat markets

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

Behavioral Market Efficiency

Price-equals-value efficient markets

Hard-to-beat efficient markets

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

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

Normal Investors
The “market-sum” game
Fat and lean returns in a pot of stew

Normal Investors

Correcting cognitive and emotional errors

Framing

Confidence and overconfidence

Hindsight

Availability

Confirmation

Hope and fear

Pride and regret

Normal Investors

Distinguishing wants from errors

Gaining hope and avoiding fear

Gaining pride and avoiding regret

Gaining social responsibility

Gaining social status

Playing and winning

Conclusion

Rational, Irrational, and Normal Behavior

Standard Finance

People are *rational*

1st Generation Behavioral Finance

People are *irrational*

2nd 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*

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What Investors really Want, McGraw-Hill, 2011