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ABFG July/August 2009 Newsletter



Events

- UCLA Marschak Colloquium speaker series begins in October. For more information on speakers and topics, www.anderson.ucla.edu/x23212.xml
- ABFG annual meeting on Tuesday, August 25th. Luncheon location to be announced soon.
- Joseph Engleberg is discussing his paper "In Search of Attention" at the Workshop in Psychology and Capital Markets at UC Irvine on July 20th.

Article

In the post-Bernie Madoff world, we are all reminded about the importance of thorough due diligence. In a brief article in the most recent edition of the Journal of Accountancy, Donald Deans, and William Nicholson provide guidance to those who are investing through a Qualified Intermediary (QI) to place funds. Specifically, they provide a handy checklist of specific information investors and/or advisors should review before transferring funds. The article is available at the following website:

www.journalofaccountancy.com/Issues/2009/Jul/20091620.htm

Book Review

The following review is contributed by Larry Brody.

MANIAS, PANICS & CRASHES; A History of Financial Crises, 5th edition, 2005, Author Charles Kindleberger & Robert Aliber; Kindleberger Deceased 2003. ISBN 0-471-46714-6

There are many reviews of this book available on the Internet. Many are critical, most appreciative. What follows is my impression based on my knowledge gain.

Here is a classic for all times. This is the 5th edition and posthumous

Newsletter

This is a bimonthly newsletter from the Applied Behavioral Finance Group (ABFG), An Associated Group of the CFA Society of Los Angeles, CA.

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Mission

To encourage active participation in research studies, educational opportunities, and the dissemination of behavioral finance concepts in order to enhance the quality of human decision making in practical applications.

publication of a book first written in 1978 and modified 4 times thereafter. For anyone who is astonished and blindsided by a financial crisis, this is an illuminating book, which chronicles all sorts of financial crises over the centuries with focus on modern times. The book pulls together the factors and sequences leading up to bubbles and the pinpricks that break the bubbles, and how time after time new bubbles appear, whether in housing, shipping, tulips, high tech stocks, Y2K or whatever.

One would think professional accrual of wisdom would protect the wise and experienced, but no. History repeats itself over and over. The thing I like about this book is not only the historical episodes and the lists of Panics, Crashes etc. but linking the similarities of all these events which build up over time, and illustrating the human nature underlying the whole investment process.

One would think that armed with these long-standing historical facts, many would be able to protect one's self and one's clients from getting wiped out. I guess it doesn't work that way. Kindleberger's thesis demonstrates that after one bubble bursts new bubbles start soon after. Eventually a nation, empire or country runs out of assets to inflate, and thence begins a descent downwards in the country's prominence as a financial leader. The government expansion of credit is consistent in adding fuel to the fire and insuring that the good intentions of avoiding a crisis evolved into a bubble, somewhere, in some asset class, as long as there is a place to go.

I had even forgotten about Japan in the 1980's and 90's and how their capital spread throughout the world and in the US, and what happened to them. As of 2009 are they still recovering? And low interest rates or capital availability as expansion of credit just led to the "carry trade," and not to a solution for Japan itself. Low interest rates and plentiful money, time and time again, provided no protection. The carry trade is working for financial institutions but not for citizen investors.

I can see the present tied to the future. Unfortunately, it is hard to foresee the future, but Kindleberger offers a good lesson. The book is contemporary up to the High Tech bubble of 2002-02, and you have to use your imagination from thereon. I can't imagine anyone interested in Behavioral Finance not being familiar with this book.

But after reading his putting together of the S & L crisis of the 1990's it is a short stretch of the imagination into the "sub-prime mortgage mess." "Sub Prime" will now henceforth be part of the financial vocabulary, and history of American and World finance, and the United States, the "Sub-Prime country."

This is a book I couldn't put down, and I almost think it's a bible to protect one from the sins of greed.

Book Review

The following review is contributed by Mark Harbour.

Going to Extremes: How Like Minds Unite and Divide by Cass R. Sunstein (Oxford University Press -- 2009)

"The economic crisis that began in 2008 was a product, in significant part, of a form of group polarization, in which skeptics about the real estate bubble, armed with statistical evidence, did not receive a fair hearing or were in a sense silenced."

The above quote from this new book by Cass Sunstein raises at least a couple of questions. How do group dynamics influence individual and group (i.e., market) decisions? What can astute investors or financial decision makers

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learn from this book to ensure the way they process information and make decisions is improved?

Cass Sunstein's book explains how group dynamics influence opinions and thus decisions. In a world that has recently experienced a seismic event of markets being affected by group dynamics -- and sometimes extremists, the information contained in this volume represent an excellent study of what to look for in environmental conditions that drive such events -- and clues that may help us recognize and react -- hopefully, in a more timely fashion in the future.

There are at least a couple of direct applications from this work. First, today perhaps more than ever, economic decisions are impacted by politics. Recall GM, Chrysler, Bank of America, Citibank, et al? Understanding political methods and influences can enable a more accurate assessment of the political environment conducive (or perhaps not) to investment decisions.

Second, understanding how the degree of risk taken in decisions made by groups or individuals is impacted by group composition is something that regulators and business organizations will find helpful in designing optimum team composition.

What follows is a sampling of the concepts, their implications, and actions that may be appropriate to counter potentially adverse implications.

The concept of **group polarization** arises from studies of what happens when people who are inclined to take risks talk to other people who share their opinions. Specifically, studies show that after group discussions, individuals became significantly more disposed to take risks than they were prior to such interaction.

Rhetorical advantage is a concept applied to jury awards, and decisions on altruism. Specifically, studies of juries suggest that after group discussions, punitive awards are more likely to be larger rather than smaller. Regardless of the facts of a case, it is easier to justify a larger award than defend a smaller one -- thus creating an artificial advantage for higher awards. In discussions of groups regarding how much money to "share" with others, individuals became more generous in a group than they were individually; apparently out of wanting to appear more altruistic.

To counter potential situations of encouraged group moves toward more extreme positions, three techniques are described. First, **traditionalism** refers to the thought that reasonable citizens, aware of their own limitations will effectively delegate a good deal of authority to their own traditions; deferring to the acceptance of the status quo as determined from historical decisions. I personally suspect that the "me" generation would have a relatively difficult time with this countermeasure.

Second, consequentialism suggests that group decisions may be influenced by a deliberative review of specifically what would happen if a decision were taken -- costs, scenarios, etc. The thought that such a reality check could potentially mitigate the possibility of too extreme a degree of risk taken or identify a possible adverse outcome that should be avoided.

Finally, **checks and balances** as a technique is also a reference to the benefits of "deliberative democracy". This is an attempt to combine deliberation and reason-giving with accountability. The concept has application not only to systems of government, but in establishing prudent practices for financial decisions. The wisdom of crowds has substantial statistical validity as explained in the book, particularly when there is substantial diversity in the composition of the crowd. Construction of teams that support the investment decision making would be well advised to consider including thinkers whose downside views are at least vetted in the process of formulating the final

choices made by the group.

I also found that the research studies summarized in an appendix (Findings of Group Polarization) particularly helpful in providing resources for exploration of those areas most applicable to the study of group dynamics on risk. (One in particular, Risk-taking among business students may be helpful to your thinking and is noted to be available at <http://dspace.mit.edu/handle/1721.1/11330>)

This book provides an excellent initial survey of research findings of value and a glimpse of practical applications aimed at improving decision making processes.

Article

A vast body of literature reports that people frequently violate rationality by allowing nonrecoverable investments (sunk costs) to influence their decisions, a phenomenon known as the sunk-cost effect. Although sunk-cost effects have been well documented for monetary investments, they have been demonstrated for behavioral investments only when those investments are linked to a monetary equivalent.

Marcus Cunha, Jr and Fabio Caldieraro of the University of Washington discuss this concept in a 2008 paper titled "Sunk-Cost Effects on Purely Behavioral Investments".

The full article can be found at:

<http://faculty.washington.edu/cunhamv/papers/sunkcost.pdf>

Thanks to Charlie Dolan for this submission.

Link

The following link goes to an American Public Media page focused on neuroeconomics. Toward the bottom of the page is an audio interview with Paul Zak. Approximately 78 minutes.

<http://speakingoffaith.publicradio.org/programs/2009/neuroeconomics/>

Website

Our website has been revamped. Please visit www.abfgla.com to investigate.

Recent postings include content from Richard Thaler, Russ Fuller, Brad Barber and many others. Archived ABFG Newsletters can also be found here.

We solicit your input. If you have suggestions for content additions or improvements, please contact [Mark Harbour](#) (President) or [Dan Pomerantz](#) (Webmaster).

Editor's Corner

We're a clearinghouse for Behavioral Finance applications, including news bits, reviews, opinions, and academic studies in the field. Share items of interest with the group by sending to John Weisickle, Editor, Applied Behavioral Finance Digest at editor@abfgla.com.

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