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ABFG November/December 2009 Newsletter

Upcoming Events

> Yaacov Trope. Leonard N. Stern School of Business, New York University, "The Psychology of Transcending the Here and Now". Friday, November 20th, 2009. UCLA Anderson School, D313-Cornell Hall.

> Leonard Mlodinow, PhD. Professor of physics, California Institute of Techology. December 2, 12 to 1:30 PM. Downtown Los Angeles, location TBD. "The Rules of Randomness". Watch the CFALA website for details and registration: www.cfala.org. For more information on Mlodinow click here.

> Andrew W. Lo. Watch for upcoming date for an LA program in the Spring of 2010.

> Academy of Behavioral Finance & Economics - 2010. Second Annual Meeting. September 22-24, 2010. Chicago Illinois. www.aobf.org

Observations

We were fortunate to connect with Arnold Wood of Martingale Asset Management in Boston recently who was in Los Angeles for meetings. We presented Arnie with a certificate of achievement to recognize his longstanding (and continuing) commitment to the field of behavioral finance and his extensive work in pursuing, organizing, hosting, and distributing information and events of interest in behavioral finance. Arnie is also in the process of working with the CFA Institute Research Foundation to publish a monograph of recent research in the field.

Several of us attended a recent presentation by Ed Peters of First Quadrant entitled "Method and Madness: Integrating Complexity, Behavioral Finance, and Efficient Markets". As a confirmed "deliberative" thinker, your newsletter editor found Ed's organization (and explanation) of methods of decision making by environment and process fascinating. I encourage you to explore his work (several

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 identify, evaluate, and disseminate information and activities in the field of behavioral finance. Our objective is to enhance collaboration between research and practitioners in books are cited below, and a paper published in the Journal of Behavioral Finance of interest).

As well, listening to a presentation by Roy Baumeister at UCLA recently provided some interesting insights into self control and how using it can be depleted (think of comparisons of how your energy levels can be higher or lower). Roy cited illustrations of the implications of his research findings on decision making. A review of a book containing some of Roy's work is provided below. You may also wish to review some of Roy's work by reviewing his website listings:

http://www.psy.fsu.edu/faculty/baumeister.dp.html

He also has an interesting presentation published that may either mitigate or fuel the fire of the battle of the sexes entitled "Is There Anything Good About Men".

Information of Interest

Magic Numbers: The following observations are contributed by Don Steinmann.

With the financial crisis slowly disappearing in the rear view mirror (we hope), we now come to the finger pointing phase. Who is at fault? Regulatory agencies? Wall Street? Main Street? Obviously someone was asleep at the wheel or this could never have happened. How can we have enough regulation or foresight so that this doesn't happen again?

The answer may be that we cannot prevent something similar from happening because of the inescapable problem of human behavior. People have an innate trust of authority; it's one of the heuristics of our existence. A recent and telling example came up during the recent Major League Baseball season.

During the run up to the end of the season, leaders of the six baseball divisions begin to track what is called the 'magic number'. It's the combination of the wins by the first place team and losses by the second place team that is needing for first place team to win the division. The countdown of the magic number is tracked by Major League Baseball, the teams involved, the local newspapers, and all the sports websites.

The race between the first place Los Angeles Dodgers and the second place Colorado Rockies was counted down with the magic number around 20. It was watched especially keenly at the end of the season as the Dodgers kept losing. The Dodgers were stuck at a magic number of two. Then a strange thing happened. Overnight the number became one without any games played. It turned out that the magic number was off by one. All of these sources had been dutifully reporting the magic number incorrectly and it was not discovered until the season was almost over.

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What happened? Major League Baseball (the authority) had told everyone what the magic number was. And the Dodgers, Rockies, Los Angeles Times, ESPN, and every other sports authority dutifully reported the wrong number. If you think this is a trivial error, you're not a baseball fan. How could a mistake be made about something so simple for so long? Shouldn't someone have caught this?

The problem is the trust of authority. Major League Baseball told everyone the magic number, and so no one bothered to check until the season was almost over. Likewise, when an authority like Goldman Sachs told everyone that a basket of mortgages could be turned into a AAA debt, no one bothered to check if that was really true, including the rating agencies. It's likely that our trust of authority will lead us to similar errors in the future, no matter how many regulations we pass.

So what can we do about it? Do we just throw up our hands? No, fortunately we are not slaves to our tendencies to trust authority. If it's important enough (and winning the division should have been important enough to the Dodgers) we can double check. We can do the math. We can check the background story. And if things don't add up then we can do the really hard thing. Stand our ground even though 'the authority' says we're wrong. It is hard to do sometimes, but our innate behaviors influence, they do not rule us.

Book Reviews

"Do Emotions Help or Hurt Decision-Making: A Hedgefoxian Perspective", Kathleen D. Vohs, Roy F. Baumeister, and George Loewenstein, Editors. Russell Sage Foundation, 2007.

by Cynthia Harrington, CFA, Cynthia Harrington Coaching LLC

In preparing this piece, it's quite tempting to go through a point by point review of the book and wait to reveal the book's answer to the question. But let's cut to the chase, get to whether emotions help or hurt decision making. The answer is -- it depends. Not only is that the answer among these leading scholars in the field, but it's also the answer within the findings of each chapter.

Each of the 14 chapters is contributed by a scholar doing prominent research into specific subtopics in the area of emotions and decisions. While mostly the work of psychologists, financial decision making is covered in chapters by a Federal Reserve economist and a smattering of business professors.

A good example of the parsing of helpful and hurtful conditions is in the chapter entitled "The Role of Personality in Decision Making". The author directly answers the titled question in the final section of the chapter. Authors found that emotions affect decision making differently for different personality types. Using the 5-point personality assessment test, they found that emotions help or hurt decision making depending on the type of personality but also on the context. For example, extraverts react more quickly when asked to decide when in positive moods, but people ranking high in emotionalism react more quickly when in negative moods. (You might note that this correlation to personality types supports the premise of Michael Pompian's work in *Behavioral Finance and Wealth Management* .)

Chapters on emotional measurement and self regulation, how affective states alter information seeking, and the effects of self esteem and ego threat on decision making reported similar individualistic and situation-specific conclusions.

Of particular relevance is the chapter on emotion and cognition. The common understanding is that emotion and cognition fight for dominance in decision making. But these authors concluded that the brain works not either in cognition or in emotion, but in both. Looking at the mind through an information-processing model, emotion acts as a "superordinate information-processing program". In this way, emotion is the program that coordinates the entire decision making process toward the ultimate human goals of increasing probability of survival and reproduction of the species. Emotions activate the fight or flight response, but bring in cognition to figure out which to do and what actions to take as a result. Emotions activate to attract and entice a mate but coordinated efforts of cognitive and psychological processes are necessary to navigate the tasks that ensue, like child rearing. In other words, the systems are not separate but interdependent. One is not effective without the other.

Still, in other chapters, this book is stuck like to many others in the model of conflict between emotion and cognition. The chapter entitled "Affect and Cognition as a Source of Motivation: A New Model and Evidence from Natural Experiments", presents the research in the context of the old paradigm, that being that cognition and emotion are inherently separate. The "new model" they suggest is simply a refinement of what they define as the standard model in economics, that is that economics are purely cognitive. The "new model" they suggest simply adds a purpose for emotion -- that emotion provides the motivation to act. With this, they feel they have updated the model, even though the "standard model" of economics being about cognition only, has soundly been discredited by the markets in the new Millennium. And, since one author of this chapter is s senior economist at the Federal Reserve Bank of Boston, it is illustrative of the problem faced by the finance world in general. Learning and operating within a new paradigm is impossible when the researchers are stuck in explaining findings in the context of the discredited premises of the old paradigm. Without seeing the irony in their statement, the authors admit their backward-looking work when they say about their model "It maintains the standard assumption in economics that the individual's cognitive processes are sophisticated and forward-looking, but it also allows for circumstances in which affective processes can override cognitive priorities and distort the individual's effort profile". Since this myopically regurgitates the assumption that the processes are separate and that an individual's "effort profile" is somehow set it stone, this statement should be quite familiar to students of behavioral finance. The authors provide this perfect example of a well-known cognitive bias. It's called "confirmation bias", or "I see what I already believe".

On balance, the book reveals that emotions play an important role in making decisions, whether we like it or not. Learning to understand and work with this fact will certainly be more profitable than continuing to work against it.

This book is a valuable contribution to the body of work on human decision making. Two conclusions come to mind for applications to investment decision making. First, since the simple answer to the question is -- It Depends --- any investment decisions that take a top-down approach, looking at the averages of human decisions, will veer wildly off course. The aggregate averages do not reflect reality. "It depends" suggests a bottom-up approach, looking at each human as an individual. Not only is the answer of helping or hurting different for each human being, but since humans change, today's answer may not follow through to tomorrow's results. Second, keep researching. There's more about this subject that we don't know, than what we do.

"Plight of the Fortune Tellers: Why We Need to Manage Financial Risk Differently". 2007. By Riccardo Rebonato, Princeton University Press. Review listed in the Financial Analysts Journal. Available at this link.

Recent CFALA speaker Ed Peters has three books of potential interest. They are specifically:

Complexity, Risk, and Financial Markets

Chaos and Order in the Capital Markets: A New View of Cycles, Prices, and Market Volatility (Wiley Finance)

Fractal Market Analysis: Applying Chaos Theory to Investment and Economics

Website Links of Interest

Shlomo Bernartzi, UCLA. Click here for a YouTube video.

Dan Gilbert, Harvard. Author of "Stumbling on Happiness". Click here for a YouTube video. There is also an additional video via iShares that requires registration. Click here.

Editor's Invitation

Please share items of interest with the group by sending to Mark Harbour, Editor, ABFG Newsletter at harboal@ca.rr.com.

We invite you to view our website, www.abfgla.com, and share reactions, ideas, or other information of interest.