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## ABFG May/June 2010 Newsletter



### Upcoming Events

- **2010 CFA Institute Annual Conference**, will include presentations by Dan Ariely of Duke University and Richard Peterson, author of *Inside the Investor's Brain*, May 16 -- 19 in Boston Massachusetts. For information and registration -- <http://www.cfainstitute.org/memresources/conferences/100516/index.html>
- **The Interdisciplinary Group in Behavioral Decision Making at UCLA** is winding to a close this academic year. To view speakers and their topics -- <http://www.anderson.ucla.edu/x9484.xml>
- **Fairness, Trust and Emotions in Finance**: A conference sponsored by the Behavioural Finance Working Group, Cass Business School, London, UK. Robert Olsen, keynote speaker [http://www.cass.city.ac.uk/conferences/BFWG\\_Meeting2/index.html](http://www.cass.city.ac.uk/conferences/BFWG_Meeting2/index.html)
- Second Annual Meeting of the **Academy of Behavioral Finance & Economics- 2010**, September 15-17, 2010, Chicago, Illinois <http://www.aobf.org/>

### Observations

I have just finished reading Daniel Pink's new book, *Drive*. He does an admirable job of identifying the fundamentals of what motivates us and presenting ideas about how to incorporate them more effectively in our lives. He also has a website (listed below) that you may wish to peruse (be sure to note the ironic visual on his homepage with a sign pointing out a camera monitoring activity in the street placed just in front of the George Orwell placard).

We are continually confronted with the decision of what or whom to believe -- and why. This assumes greater significance in our world of growing volumes of information. Included are a timely book review by Larry Brody for a volume that you may wish to read and some musings

### 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

by Jim Altenbach on point.

As always, we encourage your contributions to our newsletter or research that you believe would be valuable to our efforts.

Your editor

between research and practitioners in order to produce practical applications of value for investors and professionals who serve them.

### **Websites of Interest**

PBS show NOVA segment entitled "Mind Over Money"

<http://video.pbs.org/video/1479100777>

Daniel Pink - website and publication links

<http://www.danpink.com/>

Various bits of information

<http://www.behaviouralfinance.net/>

The Journal from the Society for Judgment and Decision Making

<http://journal.sjdm.org/>

CFA Institute Life Long Learning (behavioral finance)

<http://www.cfainstitute.org/memresources/education/behavior.html>

Series by PBS on behavioral finance

[http://www.pbs.org/nbr/site/features/special/mind\\_and\\_money/](http://www.pbs.org/nbr/site/features/special/mind_and_money/)

Forthcoming book on behavioral finance edited by Baker and

Nofsinger (including a chapter from longtime content contributor to ABFGA, Victor Ricciardi)

<http://www.wiley.com/WileyCDA/WileyTitle/productCd-0470499117.html>

### **Website**

[www.abfgla.com](http://www.abfgla.com)

### **Book Review**

***Deception in Markets: An Economic Analysis*** Edited by Caroline Gershlager (published by Palgrave Macmillan, March 2005)

This review was contributed by **Dr. Laurence Brody**, ABFG Board member.

The jacket says that deception is a relatively new concern of economists, but fraud, major fraud continues to be uncovered. This book was published in 2005. Markets involve all sorts of human transactions; television markets, produce markets, etc. as does human deception and self-deception. We have a presentation that focuses on financial markets. Do we in 2010, have an issue with deception from both government and financial institutions?

We have lived through an era of puffed up financial recommendations by brokers in the high tech bubble, and Enron, World Com, Tyco et al. If you look at it that way, deception really has not stopped; it has accelerated! The Austrian Federal Ministry of Education Science and Culture financed this book. The list of contributors is international in scope. Deception may have historically been more the province of the military and criminology, but is now firmly and irrevocably immersed in finance. It was assumed cheats and liars disappear with more disclosure, but no, a new generation emerges. It probably never stopped.

In her introduction, Gershlager names Americans guilty of financial deception and fraud. She can do that safely from Austria without the

repercussions that an American author might incur. She quotes Nobelate Oliver Williamson as saying in his papers that when markets fail to see deception; institutions arise to deal with liars and cheats! This reference book was researched 5 years ago and published 4 years before this writing, but it is extremely timely. The financial markets have collapsed and partially rebounded, and fraudulent activity in markets abounds. What are we to think and do? Markets need credibility for investors to invest and plan for their future and the future of their families. Gershlager continues in her introduction that credulous investors are likely to be exploited. Moreover, I note, by the captains of the financial industry. "Because of the 'cheat-able' and 'lie-able' individuals, inefficiencies in the workings of the market mechanism may arise."

The views of an excellent variety of economic market watchers are well presented in this book. There are ideas and concepts to be gleaned in every chapter, which is written by a different group of individuals with thoughtful experience in aspects of deception and self-deception. The issue of trust versus deception is brought to light. How can trust be fostered with such deception going on?

One author points out that institutions cannot create trust. This is an aspect of interpersonal relations between two parties.

The chapter titles can be found on line, as well as the chapter authors. The authors are knowledgeable and take a wide swath of examples from Anthropology, History, and Politics. Government lying and deception is described since the beginning of time.

Gershlager herself undertakes a chapter on the Enron deception and collapse. Many of the theories of economics and psychology are based on experiments in which the subjects are treated with deceptions in order to gain information on their misperceptions.

Coval, Hirshleifer and Hong Teoh tackle the chapter on Self Deception and Deception in Capital Markets. Indeed Self-Deception may be a matter of naiveté or the bias of overconfidence: But definitely a chapter worth reading. They expound on how overconfident [self-deceptive] investors become prey for predatory financial institutions.

Overconfidence can set one up for large disappointments, similar to believing an investor has a "hot hand" [Gilovich]. They also point out the costs of time and energy to process information.

To me, the beauty of this book is that it takes so much information, previously known and published, and organizes it into one text with comprehensive chapters so that the concept of Deception and Self-Deception become so palpable that the reader may never be in a position of being deceived in financial markets. Although there is a superabundance of reference articles to the subject matter, I have not yet seen a publication that pulls the subject matter together in a more timely method and creates a textbook and reference book for all times.

Or at least as long as fraud and deception exist in financial markets.

The discussion of "sellers' knowledge" in transactions is illuminating.

The seller of a car knows its defects; the buyer may naïve in this transaction, or maybe not.

The topic of "Deception in Economic Anthropology" in Chapter 11 indicates that deception exists in all cultures and differs. Many cultures use barter methods during their transactions, and these may involve deceptions.

Reading carefully, there is an exposition of how political planners have used deception/ Self-Deception to implement their political plans; Communism, socialism, democracy all defined by the body politic.

This is a book review that can never come close to doing justice to the book. The book is so well put together and so poignant that it leaves no doubt that the best of us and the most astute of us can be, at times, deceivable in financial markets or in dealings with government. So, let the buyer beware, especially in this era of information, misinformation, and dis-information or intentional distortion of information. Your retirement and economic viability depends on it.

*" Life is either a daring adventure or nothing. Security does not exist in nature, nor do the children of men as a whole experience it. Avoiding danger is no safer in the long run than exposure ."*

**Helen Keller**

## **Observations**

### **Who are the Behavioral Finance Practitioners?**

By Jim Altenbach, CFA

Like many things behavioral finance gets commercialized and categorized, just so it can be "studied" or "marketed". One important issue is a definition of behavioral finance and who practices it, as well as the limitations of using the standard tools such as Alpha, Sharp Ratio, etc., to measure its success. These are ironically part of MPT and EMT which are the established theories that behavioral finance reviles. Also, as behavioral finance grows in popularity, it attracts lesser capable firms and individuals that are only in it to *sell something* under the behavioral finance umbrella, as the fee can be higher. One strict definition of what a behavioral finance professional is asks, "Does the professional actually consider themselves to be a behaviorist?" Do they speak and write the language of behavioral finance using terms like calibration paradigm, anchoring, etc? But there is a large amount of grey area. Maybe we should explain who is not a behavioral finance professional instead. Then we may be able to add back ones that didn't quite fit the mold, but their process of thought would place them in the category by default.

I submit that in part academic writers, Wall Street and the professional pension consultants that serve the profession have been too stringent (out of necessity) in defining what behavioral finance is and therefore who actually practices it. Before it was institutionalized in order to be studied in a "scientific" manner it had to be adequately defined by those who were to debate the merits and demerits of the challenging theory to EMH. As far as "recognized practitioners" you have the usually cast like Richard Thaler, Arnold Wood, David Dreman etc. They talk the behavioral finance talk and consider themselves behavioral finance pros, nothing ambiguous. But, they are successful portfolio managers that make decisions in a way that makes them behavioral finance pros but they don't always talk and write the rigorous walk.

How about explaining who is not a behavioral finance pro? That might include pure "quants" who abuse over optimizing without any understanding of the underlying human action. It also might include many but not all chartists and technicians. Also perhaps it would include pure number crunchers of fundamental data. Ben Graham would be out, as he was a pure quant, unlike his famous student

Warren Buffett.

Who would be a "behavioralist" but not consider them self a behavioral finance pro? Buffett himself... as there is no doubt he only used Graham's methods as screens to start, but used some amount of application of a disciplinary paradigm he and "Charlie" worked out over the decades. Reading their material in my view places them as behavioral finance pros...they practice it! They make billions. Michael Milken stated years ago that a great investor must in part be a social scientist. I would place him in that camp himself, and would consider him to be in the behavioral finance and behavioral economics areas, not EMH and MPT which he denounced on a panel with Harry Markowitz, the father of MPT. Milken has been known to make billions....on occasion. George Soros is another who considers himself a social scientist and would fall in the behavioral finance camp. Some scarier practitioners of behavior finance were Bernie Madoff and his gang. Madoff fully understood human nature and how to exploit it. The element of trust and the over-reliance many less sophisticated investors place in name brands -- as well as belonging to the "right" country clubs. He knew how to attract naïve investors and appear inviting to the right social circles.

Try adding to the record all the great professionals who should be in the behavioral finance or behavioral economics camp. You find a great cottage community that sheds more light on human economics and finance. Economic analysts, to be good social scientists, need wisdom of human nature. It is my view that precious few have this trait. This truth would, in part, explain lack luster results for many investment professionals

I believe that "lazy boy" portfolios will continue underperform over time. It is a naïve approach; replicating someone else's work and hoping for superior results. ***It is analysis of human action and wisdom of human nature that defines the real practitioners of behavioral finance, whether they call themselves behavioralists.... or not.***

### **Editor's Invitation**

Please share items of interest with the group by sending to Mark Harbour, Editor, Applied Behavioral Finance Digest at [harboal@ca.rr.com](mailto:harboal@ca.rr.com).

We invite you to view our website, [www.abfgla.com](http://www.abfgla.com), and share reactions, ideas, or other information of interest.

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