

# **What Investors Really Want**

## **Investor Psychology in Behavioral Finance**

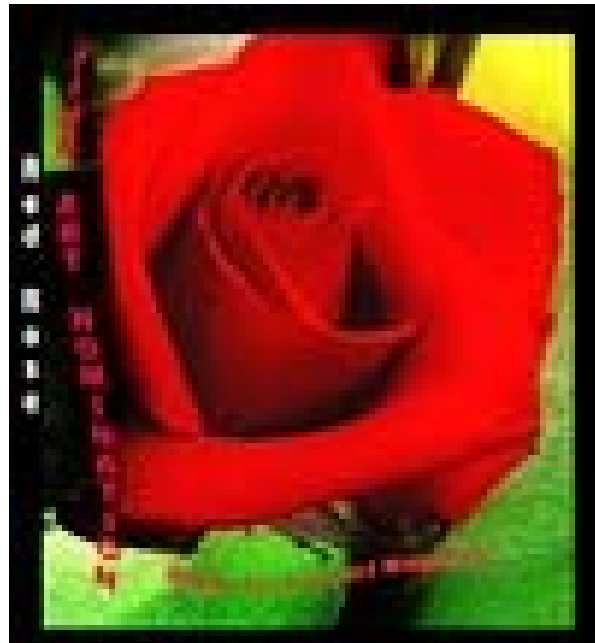
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**Tilburg University – The Netherlands**

# **What Investors Really Want**

## **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**



## What watch buyers really want Why do I pay \$10,000 for an IWC watch?

### Utilitarian benefits

*What does it do for me and my pocketbook?*

**It tells time and never breaks down**

### Expressive benefits

*What does it say about me (to me and to others)?*

**I am a successful man with high status and refined tastes**

### Emotional benefits

*How does it make me feel?*

**Accomplished and masculine**



# What Investors Really Want

## We want to stay true to our values

**Socially responsible  
investments**

**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 value**

Truth be told,  
I'm as financially  
ambitious as I am  
socially conscious.



# **What Investors Really Want**

## **What do we want?**

**Why do we play the beat-the-market game?**

**Why do we trade?**

**Why do we fail to diversify?**

**Why do we listen to TV gurus?**

**Why do we buy socially responsible funds?**

**Why do we buy hedge funds?**

# **What do investors want?**

**Why do we play the game?**

**Behavioral finance version 1 answer:**

***Because we are irrational***

**Behavioral finance version 2 answer:**

***Because we are normal, pursuing what normal investors want***

**Sometimes we are normal smart and sometimes stupid**

**We fall victim to cognitive errors and emotions on our way to what we want**

## **What do investors want? Wants and cognitive errors**

### **What do investors want?**

**To get high returns**

**To beat the market and feel like winners**

**To banish fear**

**To savor hope**

**To avoid regret**

**To be socially responsible**

**To gain status**

# **First Lesson**

## **Know yourself**

**Know your clients and competitors**

**Know what they really want**

**Know their cognitive errors**

**Know their emotions**

## **Second Lesson**

### **Know Science**

**Teach science to your clients**

**Teach the science of financial markets**

**Teach the science of human behavior**

**Second Lesson**  
**Know Science and teach science**  
**The tools of science**

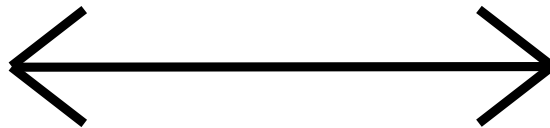


**Science makes us aware of our cognitive errors and emotions**

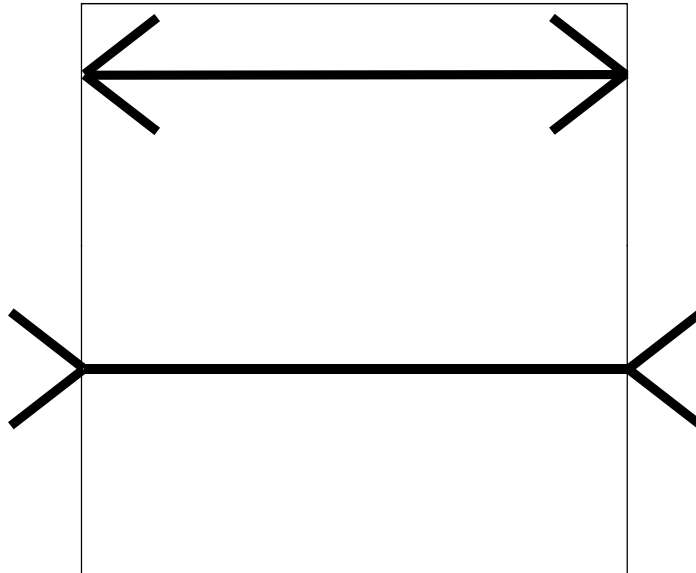
**Science gives us tools to correct them**

**Logic and empirical evidence**

**Second lesson**  
**Know science**  
**Examine intuition with the tools of science**



**Second lesson**  
**Know science**  
**Examine intuition with the tools of science**



**Know science and teach it**

**Replace ignorance with knowledge**

**Silence the noise of CNBC**

**Know science and teach it**

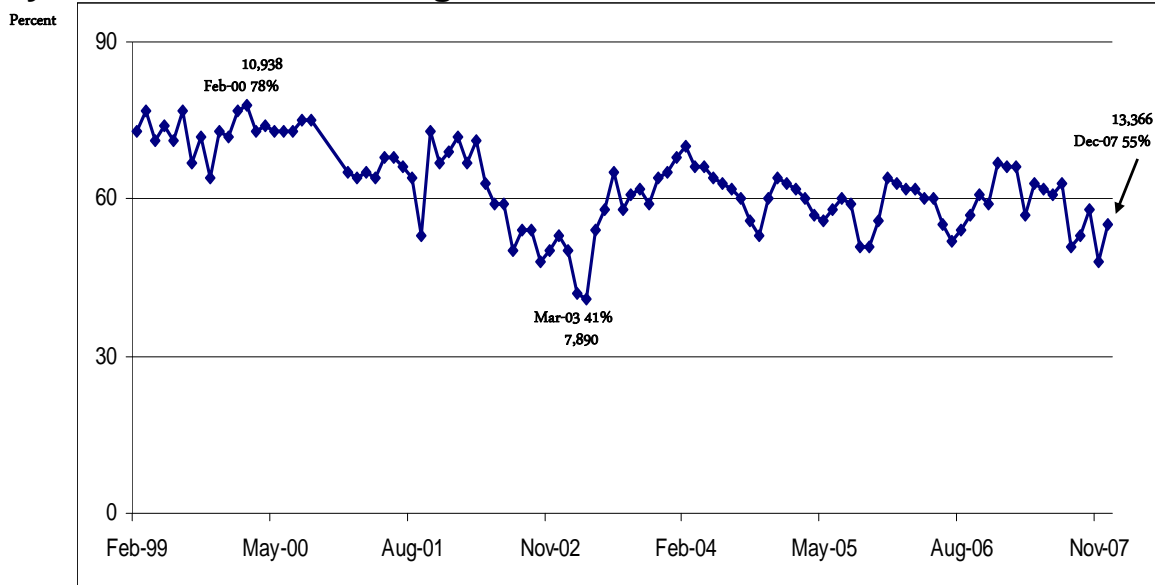
**Counter fear-mongers**

**Calm nerves**

# Know science and teach it

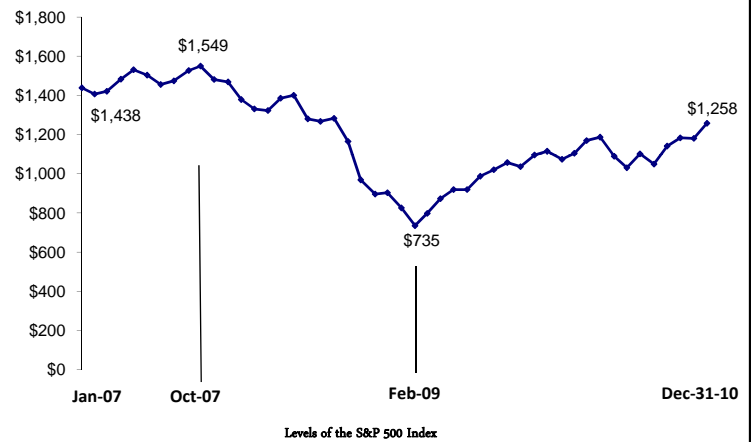
## Emotions: Fear and Exuberance

Do you think that now is a good time to invest in the financial markets?



Source: UBS Index of Investor Optimism

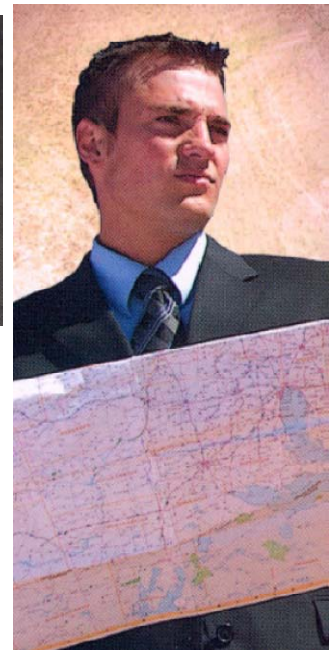
**We were afraid...**  
**We are still afraid**  
**Investors turn away from stocks**  
**Clients turn away from advisors**



**Investors turn away from what was  
accepted as scientific truth**



**Is Markowitz Wrong?**  
Market Turmoil Fuels Nontraditional Approaches  
to Managing Investment Risk



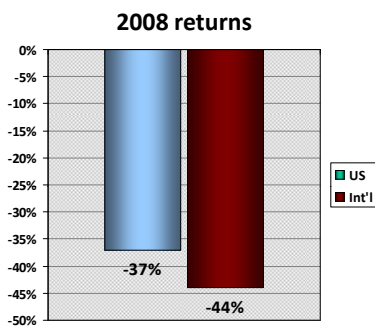
**Know the science of financial markets  
and teach it**

**Is Markowitz wrong?**

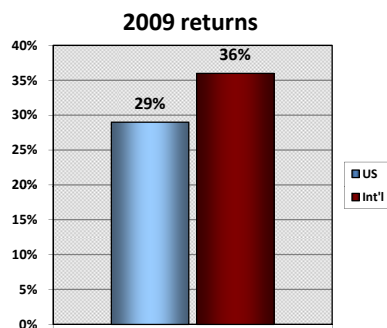
**Did diversification fail?**

# Know the science of financial markets and teach it

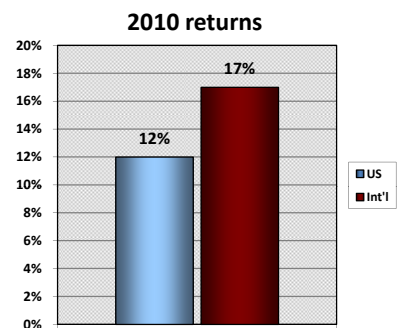
## Is Markowitz wrong?



Return gap 7 percentage points



Return gap 7 percentage points



Return gap 5 percentage points

## Know the science of financial markets and teach it

### Forecasted return gaps

Correlation	Standard Deviation		
	10.00%	15.00%	20.00%
0.99	1.41%	2.12%	2.83%
0.9	4.47%	6.71%	8.94%
0.8	6.32%	9.49%	12.65%
0.5	10.00%	15.00%	20.00%
0	14.14%	21.21%	28.28%

Forecasted return gap =  $2 * \text{Standard deviation} * [(1-\text{correlation})/2]^{1/2}$   
Standard deviation is the mean of the annualized standard deviations of the two assets.

Statman & Scheid (2008)

**Know the science of financial markets  
and teach it**

**Suppose that Markowitz is wrong  
What is the substitute for diversification?**

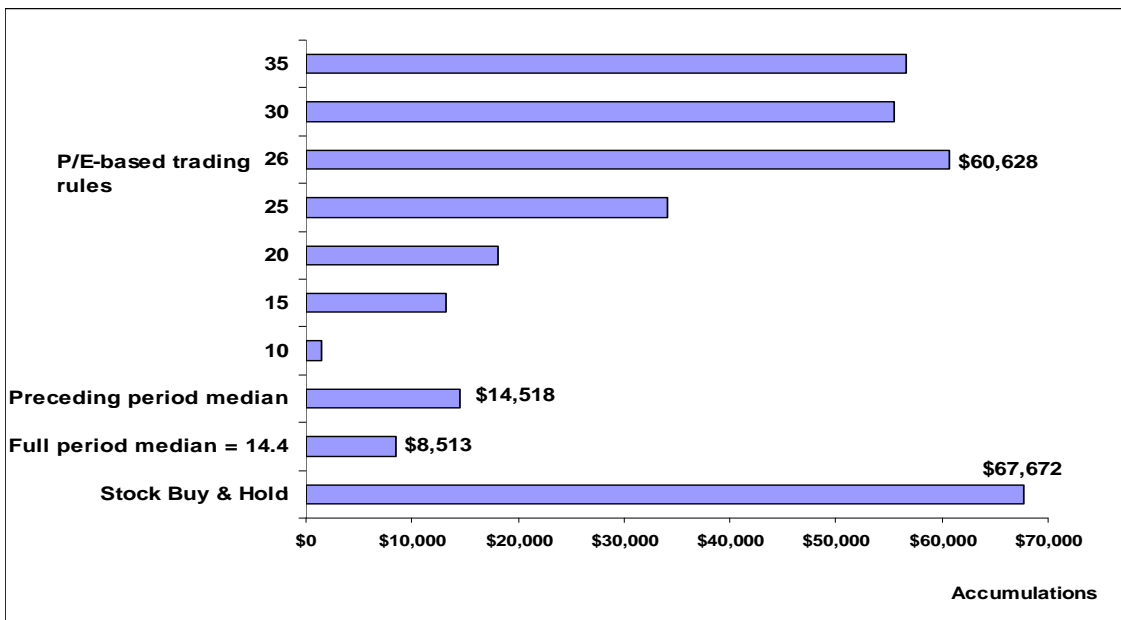
**Market Timing!**

**There is a negative correlation between P/E ratios and future  
stock returns**

**Sell stocks when P/E ratios are high**

# Know the science of financial markets and teach it

## Market timing with P/E trading rules<sup>1</sup>



1. Accumulation at the end of 2002 from \$1 invested at the beginning of 1871.

Fisher & Statman (2006)

**Know the science of human behavior  
and teach it**

**Cognitive errors in market timing**

**Why do we believe that we can time the  
market?**

**Two examples of cognitive errors**

**Hindsight error (and the emotion of regret)**

**Confirmation error**

**Know the science of human behavior and teach it**  
**Hindsight and regret**



**“If we’re being honest, it was your  
decision to follow my recommendation  
that cost you money”**

**Know the science of human behavior and teach it**

## **Confirmation errors**

**We look for evidence that  
confirms our claims and beliefs**

**We overlook evidence that  
disconfirms them**

**Know the science of human behavior  
and teach it**

**Confirmation errors**

**Claim: 'The severity of the current crisis was  
obvious to anyone who cared to look'**

**Confirming evidence: Nouriel Roubini saw it**

**Disconfirming evidence: Ben Bernanke and  
countless other equally good experts did not**

**Know the science of human behavior  
and teach it**

**Confirmation errors**

**Nouriel Roubini in February 2010,  
when the S&P 500 Index was at 1,063**

**Forecasting the level of the S&P 500  
Index at the end of 2010**

**The S&P 500 Index ended 2010 at 1,258**

**Know the science of human behavior  
and teach it**

**Why is it hard to resist intuition,  
even when it is wrong?**

**John Nash - A Beautiful Mind**

## **What Investors Really Want**

### **We want status**

**Hedge funds (and Facebook shares)**

**“Fifty million, sadly, leaves one flying commercial. Hedge-fund money can put you into exhilarating conversations about the virtues of Gulfstreams versus Falcons”**

**Utilitarian benefits**

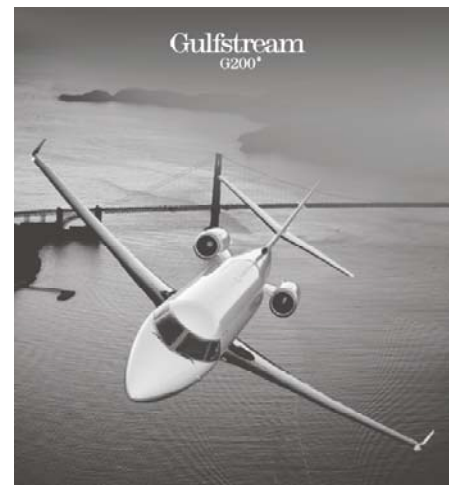
**I will have high returns with low risk**

**Expressive benefits**

**I have high status**

**Emotional benefit**

**I feel proud as a member of an exclusive club**



# What Investors Really Want

## We want to win

### Benefits to “active “ investors

Utilitarian benefits

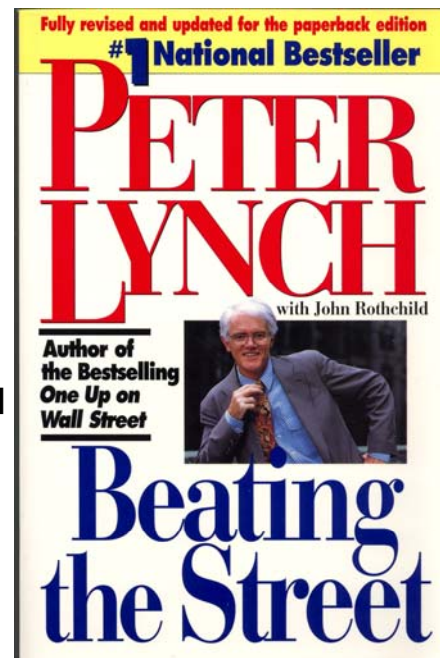
It provides high returns

Expressive benefits

I am much smarter than mediocre index fund investors

Emotional benefits

I love the exhilaration of winning



## **What investors really want**

**What do investor wants tell us about market efficiency and asset pricing models**

**The “joint hypothesis” problem  
If the CAPM is the right asset pricing model then the market is not efficient.**

### **Anomalies**

**The returns of small cap stocks exceed CAPM expected returns**

**The returns of value stocks exceed CAPM expected returns**

**Should we give up market efficiency or the CAPM as the asset pricing model?**

## What investors really want

**Market efficiency and asset pricing models  
in standard finance**

**Fama and French gave up the CAPM  
rather than give up market efficiency  
They introduced the 3-factor model.**

- 1. Market (beta)**
  - 2. Size**
  - 3. Book-to-market**
- } Measure Risk

## What investors really want

### Market efficiency and asset pricing models in standard finance

#### The number of factors keeps growing

1. **Market**
  2. **Size**
  3. **Book-to-market**
  4. **Momentum**
  5. **Liquidity**
  6. **Skewness of returns**
- } Measure Risk

## **What investors really want**

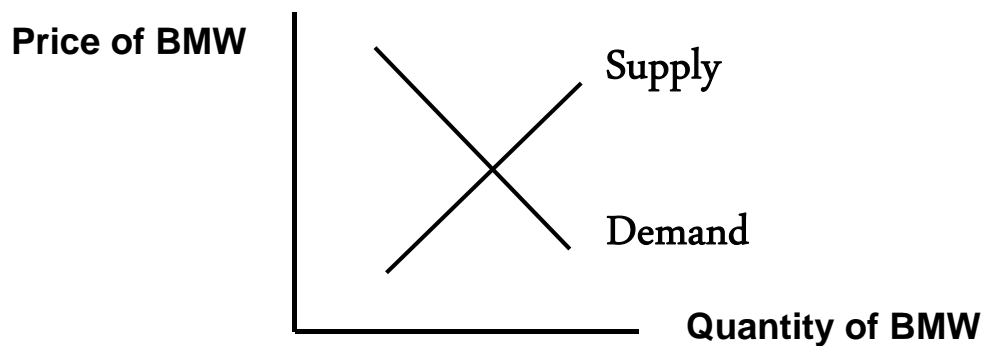
### **Market efficiency and asset pricing models in behavioral finance**

**What is the automobile pricing model?**

**What determines the demand for an automobile?**

**What determines the supply?**

**Think about a BMW 330i**







# Ratings

## upscale sedans

Excellent Very good Good Fair Poor

In performance order. Red check (✓) indicates a recommended model.  
Blue key number indicates a Quick Pick.

Make & model	In this issue	Overall score	Price as tested	Reliability
✓ <b>1</b> Acura TL	●		\$33,150	
✓ <b>2</b> BMW 330i	●		40,570	

**Why does the BMW 330i cost more than the Acura TL?**

- Is the automobiles market inefficient?
- Is the automobile pricing model mis-specified?

**Behavioral Finance**  
**Stocks are like automobiles**

**The automobile pricing model has:**

**Utilitarian factors:**

**Gas mileage**

**Safety**

**Physical Comfort**

**Expressive factors:**

**Status**

**Fidelity to my image of myself**

**Emotional Factors**

**Exhilaration**

**Emotional comfort**

## What investors really want

Market efficiency and asset pricing models  
in behavioral finance

Utilitarian, expressive and emotional factors

1. Market
  2. Size
  3. Book-to-market
  4. Momentum
  5. Liquidity
  6. Skewness of returns
  7. Social responsibility
  8. Status
- } Measure affect - expressive and emotional factor (and utilitarian risk?)

# What investors really want

Market efficiency and asset pricing models  
in behavioral finance

Cognitive errors or wants?

Spurned portfolio	Admired portfolio	Difference
16.12%	13.81%	2.31 pp.

## **What investors really want**

**Market efficiency and asset pricing models  
in behavioral finance  
Cognitive errors or wants?**

**Annualized alpha of the long-short value-weighted  
Spurned and Admired portfolios (1983-2007)**

**CAPM alpha 2.56% (p-value less than 0.05)**

**4-factor alpha -0.25% (Not statistically significant)**

**Tilt toward: Small and Value**

**Tilt away from: Momentum**

## **What investors really want**

### **Market efficiency and asset pricing models in behavioral finance**

**Cognitive errors or wants?**

**Market efficiency or asset pricing models?**

**Do you beat the market or get a fair return by an asset pricing model?**

**When you buy an Acura rather than a BMW?**

**When you buy value stocks rather than growth stocks?**

**When you buy spurned stocks rather than admired stocks?**

**When you buy sin stocks rather than virtuous stocks**

**When you buy lottery-like stocks rather than insurance-like  
stocks?**

# **Conclusion**

## **First Lesson**

**Know yourself, your clients, and your competitors**

**Know what they really want**

**Know their cognitive errors**

**Know their emotions**

## **Second Lesson**

**Know Science and teach it**

**Know and teach the science of markets**

**Know and teach the science of human behavior**

LEARN THE LESSONS OF BEHAVIORAL FINANCE

# WHAT INVESTORS REALLY WANT

*Discover What Drives Investor Behavior  
and Make Smarter Financial Decisions*



MEIR STATMAN