

Independence ADVISORS, LLC

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Fear, Greed and Investment Decision Making

Fear and greed cause investors to make bad decisions. Meir Statman is a pioneer in behavioral finance, the branch of economics that considers the influence of emotions on investor decision making.

We had the opportunity to interview Meir after seeing his presentation at a recent conference. You'll find his answers below. Among other things, he discusses:

- How framing and hindsight can lead investors astray
- How advisors should help their clients—Professor Statman's views are in tune with the philosophy of Independence Advisors
- The benefits of diversified low-cost portfolios

We highly recommend *What Investors Really Want*, Professor Statman's recently published book. Professor Statman is the Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University and Visiting Professor at Tilburg University in the Netherlands.

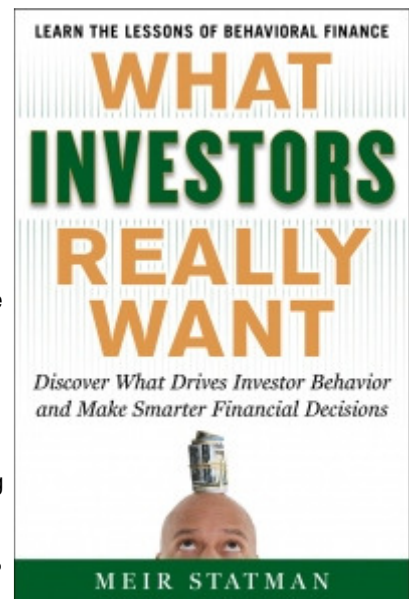
Charles Boinske: What behavioral finance traps most often snare investors?

Meir Statman: I begin with framing errors. We tend to frame trading stocks, mutual funds, and other investments as tennis played against a practice wall, where we see the ball hit the wall and place ourselves at the right spot to hit it back. But the correct frame of trading is real tennis against a player on the other side of the net. Would you play tennis when Roger Federer might be on the other side of the net if the loser pays \$100,000 to the winner? So why are you trading when Goldman Sachs might be on the other side of the net?

Whenever I am tempted to trade, I think about my position relative to that of a likely trader on the other side of the trade. Is my analysis of companies in my spare time better than the analysis of professional analysts who do their work full time? Do I have private information about demand and supply of stocks available to institutional investors? Is it possible that I'll be trading against insiders who are trading legally or illegally? I conclude that I have no likely advantage over other traders, so I do not trade.

Hindsight is another example of cognitive errors. Investors say, "I knew in 2007 that the market was going to tumble in 2008." Maybe so. But I would like to see their 2007 diary, written in permanent ink. My guess is that in 2007 they wrote something like this: "I've read that the housing market is in a bubble, and this seems to be true as I observe prices in my neighborhood. But are we really in a bubble? And when would the bubble pop?" But when we get to be 2008 and 2009 they remember that they have known with clear foresight not only that the housing market would collapse but also that the banking system and stock market would collapse. And did the people who were smart enough to sell their stocks at their top in 2007 smart enough to buy them back at their bottom in 2009?

Some months ago I was speaking to a group of very wealthy investors. One said, "I have a friend, who just *knew* in 2007 that the stock market was going to tank, and still he found it hard to pull the trigger. Why is that?" I tried to say, as gently as I could, "I don't think that your friend was as certain in 2007 as he is now. In 2007 he hemmed and hawed, with ifs and buts and on-the-other-hand. It is only in hindsight that all ifs and buts and on-the-other-hand disappear. Now he only remembers that he forgot to pull the trigger and vows not to forget to pull the trigger next time." These are only a few of the cognitive errors which stand in our way to good financial decisions.



Charles: What can investment advisors do to help their clients avoid the behavioral finance traps?

Meir: Advisors are fiduciaries to their clients, serving regularly as teachers and occasionally as parents. Advisors can teach clients to think as scientists, guided by logic and evidence. Advisors can teach clients to look not only at the similarities between the financial situation the United States today and sad situation of Japan in the 1990s, but also at the differences between them. Is the Japanese culture really similar to the American culture? Are Japanese institutions really similar to American institutions?

Advisors can take on parent-like roles as teachers and rule-makers when fear grips clients, as it did in early 2009. They can teach clients that fear prods all of us to sell our stocks to invest in Treasury bills. They can also set rules that delay major financial decisions during turbulent periods. This allows clients' emotions to cool off.

Charles: Shows like CNBC's Squawk Box and personalities like Jim Cramer are very popular. What is their appeal from a behavioral finance point of view?

Meir: Many media commentators appeal to the cognitive errors made by investors rather than educate investors to overcome these cognitive errors by science. Whenever you watch CNBC or Bloomberg, you see two professionals, both wearing suits so you know they are experts, yet one says that the market is sure to go up and the other says that it is sure to go down. They cannot both be right. The media regularly features money managers who have beaten the market recently, but not money managers who have been beaten by the market. This misleads investors into thinking that beating the market is easy.

Charles: In your book, you describe three benefits that investments give us. The benefits are utilitarian, emotional, and expressive. Can you define each benefit and discuss how a diversified, low cost portfolio delivers or does not deliver those benefits?

Meir: We want high returns from our investments, but we want much more. We want to nurture hope for riches and banish fear of poverty. We want to be #1 and beat the market. We want to feel pride when our investments bring gains and avoid the regret that comes with losses. We want the status and esteem of hedge funds and the warm glow and virtue of socially responsible funds. We want good advice from financial advisors, magazines, and the Internet. We want to be free from government regulations yet be protected by regulators.

We want financial markets to be fair but search for an edge that would let us win, sometimes fair and at other times not. We want to leave a legacy for our children when we are gone. And we want to leave nothing for the tax man. The sum of our wants and behaviors makes financial markets go up or down as we herd together or go our separate ways, sometimes inflating bubbles and at other times popping them.

Investments are like jobs. The benefits of jobs come in packages and we face trade-offs as we choose among them. A lawyer who wants to earn money but is also passionate about public advocacy can choose a public advocacy package with little money and much passion or a corporate law package with more money but less passion. The benefits of investments, like those of jobs, extend beyond money. Investments express parts of our identity, whether that of a trader, a gold accumulator, or a fan of hedge funds. Investments are a game to many of us, like tennis.

We may not admit it, and we may not even know it, but our actions show that we are willing to pay money for the investment game. This is money we pay in trading commissions, mutual fund fees, and software that promises to tell us where the stock market is headed. And investments are about what we would do with the money we make and how it makes us feel. Investments are about a sense of security in retirement, the hope of riches, joy and pride of raising our children, and paying for the college education of our grandchildren.

Investments, jobs, products and services have benefits that enhance wealth, well-being, or both. These include utilitarian benefits, expressive benefits, and emotional benefits. and the utilitarian benefit of investments is mostly wealth, enhanced by high investment returns. The utilitarian benefits of watches include time telling, the utilitarian benefits of restaurants include nutritious calories, and the utilitarian benefit of investments is mostly wealth, enhanced by high investment returns.

Expressive benefits convey to us and to others our values, tastes, and status. They answer the question, "What does it say about me to others and to me?" A stock picker says, "I am smart, able to pick winning stocks." A Goldman Sachs client says, "My status is high enough to be selected to invest \$2 million or more in Facebook shares."

Emotional benefits are the answer to the question, "How does it make me feel?" Insurance policies make us feel safe, lottery tickets give us hope, and an offer to be among the first to own Facebook shares makes us proud. A diversified low-cost portfolio delivers excellent utilitarian benefits of relatively high returns with relatively low risk, but it does not deliver expressive benefits to investors who want the pride of exclusive clubs of hedge funds, or the emotional benefits of the thrill that accompanies day trading. Still, investors in diversified low-cost portfolios can enjoy expressive and emotional benefits, taking pride in being smart enough to reach their financial goals and avoiding the emotional pitfalls of fear and exuberance.

Charles: Thank you.

Independence Advisors, LLC
620 Lee Road, Suite 100
Wayne, PA 19087-5636
www.independenceadvisors.com
(610) 695-8070
(800) 588-1732