

What Investors Really Want

By Meir Statman, Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University

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This book will be published by McGraw-Hill in November 2010. It is available by advance orders at Amazon, Barnes and Nobles, and Borders.

What Investors Really Want is about what we want from our investments. It is about how we think about our investments, how we feel about them, and how investments drive us crazy as we try to cajole them into giving us what we want. This book is about normal investors like you and me. We are intelligent people, neither irrational nor insane. We are normal-smart at times and normal-stupid at other times. We should increase the ratio of smart behavior to stupid behavior, but we do not have computers for brains and we want benefits computers cannot comprehend.

As you read this book, you will recognize the cognitive errors and emotions that stand in your way to smart financial decisions. And you will learn to overcome them. You will also reflect on what you want from your investments, beyond money. We care about how we make our money. Socially responsible investors avoid tobacco stocks even if they offer high returns. Hedge fund investors get a dose of status in addition to money. Stock pickers seek the challenge of stock puzzles just as their spouses seek the challenge of crossword puzzles. We also care about what we do with our money. We invest in our children our love, energy, and hopes (and our money).

What Investors Really Want combines knowledge from rigorous academic studies with anecdotes illustrating that knowledge. It is written in plain language, full of fun and free of jargon. Studies and anecdotes in the book extend much beyond finance, yet they serve to highlight what we must know about finance. Studies and anecdotes also extend much beyond the United States to Australia, China, Japan, Mexico, Italy, Germany, Argentina, and elsewhere.

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Introduction: What we want

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 number one and beat the market. We want to feel pride when our investments bring gains and avoid regret when they bring losses. We want the sophistication of hedge funds and the virtue of socially responsible funds. We want to leave a legacy for our children when we are gone. And we want to leave nothing for the tax collector.

We want three kinds of benefits from our investments: utilitarian, expressive, and emotional. Utilitarian benefits are the answer to the question, “What does it do for me and my pocketbook?” The utilitarian benefits of investments are 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?” Hedge funds express status, and

socially responsible funds express virtue. A stock picker says, “I am smart; I am able to pick winning stocks” Emotional benefits are the answer to the question, “How does it make me feel?” Insurance policies make us feel safe, lottery tickets and speculative stocks give us hope, and stock trading is exciting.

Chapter 1: We want profits higher than risks

Investments with returns equal to their risk are as easy to find as good lunches at fair prices. But we want free lunches, not fair ones, and we are always searching for investments with returns higher than risks. “Why should I invest money at four and a half percent when I can get six percent . . . ?” asked an investor a century ago. Because the six percent bond is likely to be riskier than the four and a half percent bond, answered a wise advisor. Yet old lessons need to be taught again because we fail to learn.

Chapter 2: We have thoughts, some erroneous

Cognitive errors mislead us into thinking that investments with profits higher than risk are easy to find. Availability errors are one example. Investment companies increase the availability of winning investments in our minds by highlighting them in their advertisements while obscuring losing investments. This leaves us with the impression that winning is easy. Other cognitive errors include hindsight errors, which mislead us into thinking that we have seen winners and losers in foresight when, in truth, we have seen them only in hindsight, and framing errors, which mislead us into believing that all traders can be winners.

Chapter 3: We have emotions, some misleading

Emotions draw us into a search for investments with returns higher than risk and give us false confidence in our ability to find them. Emotions include sentiment, which misleads us into believing that some investments combine high returns with low risk; exuberance, which highlights returns and obscures risk; fear, which highlights risks and obscures returns; and unrealistic optimism, which leads us to exaggerate our skills and chances of finding investment with returns higher than risks.

Chapter 4: We want to play and win

The game of finding investments with returns higher than risks is tempting, even when we know that it is difficult to win. Playing the game makes us feel alive, in the groove, in control, and in the flow. This is the experience of athletes in the zone, car drivers going fast and changing lanes decisively, or day-traders enthralled by the flickering colors of their monitors. The challenge of a difficult game only enhances the joy of winning it. We like to play the game alone and we like to play it in communities, such as in investment clubs, where the benefits of playing the game extended to friendship and camaraderie.

Chapter 5: We stampede in herds and inflate bubbles

Herds of bullish investors stampede into investments and herds of bearish investors stampede out. We join herds because we think that bulls or bears in the herds know where they are charging. And we dread being left behind. Investors rush into stocks fearing that they would be left behind their friends and neighbors. Executives of hot companies rush to issue stocks to eager investors and entice them with wildly optimistic forecasts. In time, investors see the truth, and stock prices plunge as investors stampede out. Our herding instinct also opens the door to frauds, where fooled members pull in other members and all turn into losers.

Chapter 6: We want strong self-control and clear mental accounts

We care whether our aunt labeled money she left to us as “inheritance” or “legacy.” We do not spend “hard-earned” dollars as easily as we spend dollars we won in a lottery. We often place monies in distinctly labeled mental accounts and treat them accordingly. We spend inheritance money but we are likely to keep legacy money for our children and grandchildren. Simplified accounting is one benefit of mental accounting. But the benefits of mental accounting as a tool of self-control are even greater. Self-control stops us from buying a shiny new car today when we need the money for tomorrow’s rent. And self-control stops us from going on a vacation today so we might enter a nursing home in old age.

Chapter 7: We want to save for tomorrow and spend it today

How much money should we save for a comfortable retirement and how much can we spend today? Some are calculating how much to save today. Others are calculating how much to spend each month in retirement. But most of us just muddle our way through the years in an uncertain world, trying to strike a balance between saving too little and saving too much. Our capacities for mental accounting and self-control help us sometimes and stand in our way at other times. Mental accounting helps us distinguish what we are permitted to spend from what we must save. Self-control helps us manage our conflicting desires to save and spend.

Chapter 8: We want hope for riches and freedom from the fear of poverty

People who hate risk buy insurance policies, while people who love risk buy lottery tickets. Yet most of us buy both, just as most of us buy both safe bonds and risky stocks. We are motivated by our twin desires of hope for riches and freedom from the fear of poverty. We build our investment portfolios as layered pyramids of mental accounts. We place bonds in a mental accounting layer at the bottom of the pyramid, designed to free us from the fear of poverty, while we place stocks in a mental accounting layer closer to the top of the pyramid, intended to give us hope of riches. In practice, pyramid portfolios include many layers, each associated with a goal: retirement income at the bottom of the pyramid, college education in the middle, and at the top perhaps being rich enough to tell our boss we’re quitting our jobs to spend our lives on cruise ships.

Chapter 9: We have similar wants and different ones

We all hope for riches and freedom from the fear of poverty, but some of us are more passionate about hope, while others care more about freedom from fear. The balance each of us strikes

between hope and freedom from fear is shaped by our personalities, circumstances, life experiences, and cultures. Personality matters. Extroverts care about hope for riches more than introverts. Culture matters. People crave freedom from fear in countries where uncertainty avoidance is high. People crave it less in countries where uncertainty avoidance is low.

Chapter 10: We want to face no losses

Profits bring pride as well as money, while losses inflict regret. We check our investment accounts often when we know that they would show gains but we leave envelopes unopened when we know that statements would show losses. Realizing gains by selling investments at a profit intensifies pride because it brings profits into our hands. Realizing losses is especially painful because we give up hope of recouping our losses. This is why we tend to realize gains in haste and procrastinate in the realization of losses. Investors who do not make peace with their losses often dig themselves into deeper losses and throw good money after bad.

Chapter 11: We want to pay no taxes

High returns are the utilitarian benefits of tax-free funds; investors who send less to the IRS keep more for themselves. But tax-free funds and other tax-saving investments have expressive and emotional benefits as well. We express ourselves as high-income investors, with status as high as our tax brackets. We express ourselves as smart, savvy, wily, and crafty, which is what it takes to avoid taxes. Pride at avoiding taxes is emotionally satisfying, but the emotions accompanying taxes extend to anger and hatred. We are angry when taxes rob us of personal freedom or when they are wasted by politicians and bureaucrats. Indeed, we are often willing to spend an extra \$5,000 to save \$4,000 in taxes.

Chapter 12: We want high status and proper respect

While wealth is absolute, status is relative. The rich accumulate more wealth than they or their heirs can reasonably consume, in part because accumulated wealth brings status. Hedge funds open their doors only to the rich, making it easy for investors to brag about their riches without appearing to brag. Hedge funds are a status investment, and so are investments in art, wine, and movies. Wealth boosts self-confidence and applies balm when slighted by others, but even wealth does not always bring respect. Women investors resented disrespect a century ago, and they resent condescending attitudes today.

Chapter 13: We want to keep true to our values

Socially responsible investors are prominent among those willing to sacrifice money for values. Some social responsibility communities express a single value, such as protection of the environment, while others express several values, such as avoidance of tobacco, alcohol, and gambling. The Ave Maria Catholic Values fund eliminates from its portfolio stocks of companies associated with contraceptives and abortions. The Amana funds avoid bonds and other interest-paying investments because they violate the Islamic prohibition on interest payments or receipts. Values extend beyond social responsibility to patriotism, ideology, and philanthropy.

Chapter 14: We want fairness

We want to play on level playing fields in sports, investments, and every other field. We want fair stock markets where our chances at winning depend on our skills, savvy, or even luck, not ones where our chances are diminished by those who have fast computers or inside information. We want to be treated fairly by financial advisors and money managers. And we are willing to sacrifice money for the expressive and emotional benefits of fairness. We boycott stores that treat their employees unfairly even when we pay higher prices at other stores, and we forego profits to avoid financial advisors whose fairness we suspect.

Chapter 15: We want to invest in our children and families

Parents have always invested in their children. A 1929 advertisement by a bank says: “Invest today for their tomorrow.” Education tops the list of concerns of many parents, expressed in prodding children to do well in school and in savings accounts for college expenses. And while middle-class parents worry that they might not have enough for their children’s college education, rich parents worry that their children would feel entitled to spend what they do not earn. “Leaving children wealth is like leaving them a case of psychological cancer,” said one rich father. Sometimes we as children help our parents, as when we care for them in old age, and sometimes we help poorer members of our families, as when we send money we earn in developed countries to our families in developing countries.

Chapter 16: We want education, advice, and protection

We are increasingly responsible for our financial futures as company pensions disappear. Yet many old investors lack financial literacy, failing to understand even the basics of stocks and bonds and the importance of investment fees. Financial literacy among the young is no better. Less than one-third of young adults possess basic knowledge of interest rates, inflation, and the risk-reduction benefits of diversification. We seek information, protection, and advice from financial advisors, governments, television, the Internet, and other investors. Some of the advice we receive is good and some is bad. Some delivers what we want and some does not. Some sticks with us and some washes away. We want protection from others who might urge us into poor investments or defraud us, and we want protection from ourselves when greed and gullibility urge us into poor or fraudulent investments.

Conclusion: What we have

One of the many challenges facing us is the challenge of distinguishing truth from wants and from the cognitive errors we commit as we try to reach our wants. We might choose to trade stocks because we have a true advantage over other traders or because cognitive errors mislead us into thinking that we have an advantage. Moreover, we might choose to trade even when we know that other traders have an advantage simply because we want to enjoy the thrill of trading. Yet it is important that we distinguish truth from wants and from cognitive errors.

It is even more important to remember that investments are about life beyond money. We can enjoy the benefits of investments ourselves, indulging in a few luxuries, or we might enjoy them

with family, friends, and people in our neighborhoods and faraway continents. But, in the end, we cannot take our investments with us.