CHAPTER 1

# What Is Behavioral Finance?

*People in standard finance are rational. People in behavioral finance are normal.*

—Meir Statman, PhD, Santa Clara University

At its core, behavioral finance attempts to understand and explain actual investor and market behaviors versus theories of investor behavior. This idea differs from traditional (or standard) finance, which is based on assumptions of how investors and markets should behave. Wealth managers from around the world who want to better serve their clients have begun to realize that they cannot rely solely on theories or mathematical models to explain individual investor and market behavior. As Meir Statman's quote puts it, standard finance people are modeled as "rational," whereas behavioral finance people are modeled as "normal." This can be interpreted to mean that "normal" people may behave irrationally—but the reality is that almost no one (actually, I will go so far as to say absolutely no one) behaves perfectly rationally, and dealing with normal people is what this book is all about. We will delve into the topic of the irrational behaviors of markets at times; however, the focus of the book is on individual investor behavior.

Fundamentally, behavioral finance is about understanding how people make financial decisions, both individually and collectively. By understanding how investors and markets behave, it may be possible to modify or adapt to these behaviors in order to improve financial outcomes. In many instances, knowledge of and integration of behavioral finance may lead to better than expected results for both advisors and their clients. But advisors cannot view behavioral finance as a panacea or "the answer" to problems with clients. Working with clients is as much an art as it is a science. Behavioral finance can add many arrows to the art quiver.

We will begin this chapter with a review of the prominent researchers in the field of behavioral finance, all of whom promote a deeper understanding of the benefits of the behavioral finance discipline. We will then review the key differences debate between standard finance and behavioral finance. By doing so, we can establish a common understanding of what we mean when we say *behavioral finance,* which will in turn permit us to understand the use of this term as it applies directly to the practice of wealth management. This chapter will finish with a summary of the role of behavioral finance in dealing with private clients and how the practical application of behavioral finance can enhance an advisory relationship.

## BEHAVIORAL FINANCE: THE BIG PICTURE

Behavioral finance, commonly defined as the application of psychology to finance, has become a very hot topic, generating credence with the rupture of the tech-stock bubble in March of 2000, and has been pushed to the forefront of both investors' and advisors' minds with the financial market meltdown of 2008–2009. While the term *behavioral finance* is bandied about in books, magazine articles, and investment papers, many people lack a firm understanding of the concepts behind behavioral finance. Additional confusion may arise from a proliferation of topics resembling behavioral finance, at least in name, including: behavioral science, investor psychology, cognitive psychology, behavioral economics, experimental economics, and cognitive science, to name a few. Furthermore, many investor psychology books that have entered the market recently refer to various aspects of behavioral finance but fail to fully define it. This section will try to communicate a more detailed understanding of the term *behavioral finance.* First, we will discuss some of the popular authors in the field and review the outstanding work they have done (not an exhaustive list), which will provide a broad overview of the subject. We will then examine the two primary subtopics in behavioral finance: behavioral finance micro and behavioral finance macro. Finally, we will observe the ways in which behavioral finance applies specifically to wealth management, the focus of this book.

### Key Figures in the Field

In Chapter 2 we will review a history of behavioral finance. In this section, we will review some key figures in the field who have more recently contributed exceptionally brilliant work to the field of behavioral finance. Most of the people we will review here are active academics, but many of them have also

**FIGURE 1.1** Robert Shiller, former president of the Eastern Economic Association and best-selling author.

been applying their work to the "real world," which makes them especially worthy of our attention. While this is clearly not an exhaustive list, the names of the people we will review are: Professor Robert Shiller, Professor Richard Thaler, Professor Meir Statman, Professor Daniel Kahnemann, and Professor Vernon Smith.

The first prominent figure we will discuss is Professor Robert Shiller (Figure 1.1). Some readers may be familiar with the work *Irrational Exuberance,* by Yale University professor Robert Shiller, PhD. Certainly, the title resonates; it's a reference to a now-famous admonition by Federal Reserve Chairman Alan Greenspan during his remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research in Washington, D.C., on December 5, 1996. In his speech, Greenspan acknowledged that the ongoing economic growth spurt had been accompanied by low inflation, generally an indicator of stability. "But," he posed, "how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"[1] In Shiller's *Irrational Exuberance,* which hit bookstores only days before the 1990s' market peaked, Professor Shiller warns investors that stock prices, by various historical measures, have climbed too high. He cautions that the "public may be very disappointed with the performance of the stock market in coming years."[2] It was reported that Shiller's editor at Princeton University Press rushed the book to print, perhaps fearing a market crash and wanting to

**FIGURE 1.2** Richard Thaler, PhD, renowned behavioral finance theorist.

warn investors. Sadly, few heeded the alarm. Mr. Greenspan's prediction came true, and the bubble burst. Though the correction came earlier than the Fed Chairman had foreseen, the damage did not match the aftermath of the collapse of the Japanese asset price bubble (the specter Greenspan raised in his speech).

More recently, Professor Shiller has been active in indentifying the next bubble—in the U.S. housing market. Together with researcher Karl E. Case, Shiller has been collecting data on housing, which is now known as the S&P/Case-Shiller U.S. National Home Price Index. This is a composite of single-family home price indices for the nine U.S. Census divisions. As early as 2004, Shiller and Case asked, "Is there a bubble in the housing market?" They were early, but they were also quite correct. Mr. Shiller is an active commentator on news programs and is someone to whom, in my opinion, we should listen closely.

Another high-profile behavioral finance researcher, Professor Richard Thaler, PhD (Figure 1.2), of the University of Chicago Graduate School of Business, penned a classic commentary with Owen Lamont entitled "Can the Market Add and Subtract? Mispricing in Tech Stock Carve-Outs,"[3] also on the general topic of irrational investor behavior set amid the tech bubble. The work relates to 3Com Corporation's 1999 spin-off of Palm, Inc., and argues that if investor behavior was indeed rational, then 3Com would have sustained a positive market value for a few months after the Palm Pilot spin-off. In actuality, after 3Com distributed shares of Palm

Pilot to shareholders in March 2000, Palm Pilot traded at levels exceeding the inherent value of the shares of the original company. "This would not happen in a rational world," Thaler notes. Professor Thaler is also the author of the book *Advances in Behavioral Finance,* which was published in 1993.

More recently, Professor Thaler, in conjunction with Professor Cass Sunstein, wrote *Nudge: Improving Decisions About Health, Wealth, and Happiness*. In this work, Thaler and Sunstein support the idea that by "tilting" people's decision making in a positive direction, everyone can make society a better place. The following is an interesting and insightful excerpt from an interview Amazon.com did with Thaler and Sunstein.[4] I particularly like the reference to choice architecture.

**Amazon.com:** What do you mean by "nudge" and why do people sometimes need to be nudged?

**Thaler and Sunstein:** By a nudge we mean anything that influences our choices. A school cafeteria might try to nudge kids toward good diets by putting the healthiest foods at front. We think that it's time for institutions, including government, to become much more user-friendly by enlisting the science of choice to make life easier for people and by gentling nudging them in directions that will make their lives better.

**Amazon.com:** Can you describe a nudge that is now being used successfully?

**Thaler and Sunstein:** One example is the *Save More Tomorrow* program. Firms offer employees who are not saving very much the option of joining a program in which their saving rates are automatically increased whenever the employee gets a raise. This plan has more than tripled saving rates in some firms, and is now offered by thousands of employers.

**Amazon.com:** What is "choice architecture" and how does it affect the average person's daily life?

**Thaler and Sunstein:** Choice architecture is the context in which you make your choice. Suppose you go into a cafeteria. What do you see first, the salad bar or the burger and fries stand? Where's the chocolate cake? Where's the fruit? These features influence what you will choose to eat, so the person who decides how to display the food is the choice architect of the cafeteria. All of our choices are similarly influenced by choice architects. The architecture includes rules deciding what happens if you do nothing; what's said and what isn't said; what you see and what you don't. Doctors, employers, credit card companies, banks, and even parents are choice architects.

We show that by carefully designing the choice architecture, we can make dramatic improvements in the decisions people make, without

forcing anyone to do anything. For example, we can help people save more and invest better in their retirement plans, make better choices when picking a mortgage, save on their utility bills, and improve the environment simultaneously. Good choice architecture can even improve the process of getting a divorce—or (a happier thought) getting married in the first place!

**Amazon.com:** You point out that most people spend more time picking out a new TV or audio device than they do choosing their health plan or retirement investment strategy? Why do most people go into what you describe as "auto-pilot mode" even when it comes to making important long-term decisions?

**Thaler and Sunstein:** There are three factors at work. First, people procrastinate, especially when a decision is hard. And having too many choices can create an information overload. Research shows that in many situations people will just delay making a choice altogether if they can (say by not joining their 401(k) plan), or will just take the easy way out by selecting the default option, or the one that is being suggested by a pushy salesman.

Second, our world has gotten a lot more complicated. Thirty years ago, most mortgages were of the 30-year fixed-rate variety, making them easy to compare. Now mortgages come in dozens of varieties, and even finance professors can have trouble figuring out which one is best. Since the cost of figuring out which one is best is so hard, an unscrupulous mortgage broker can easily push unsophisticated borrowers into taking a bad deal.

Third, although one might think that high stakes would make people pay more attention, instead it can just make people tense. In such situations some people react by curling into a ball and thinking, well, err, I'll do something else instead, like stare at the television or think about baseball. So, much of our lives is lived on auto-pilot, just because weighing complicated decisions is not so easy, and sometimes not so fun. Nudges can help ensure that even when we're on auto-pilot, or unwilling to make a hard choice, the deck is stacked in our favor.

Another prolific contributor to behavioral finance is Meir Statman, PhD, of the Leavey School of Business, Santa Clara University (Figure 1.3).

Statman has authored many significant works in the field of behavioral finance, including an early paper entitled "Behavioral Finance: Past Battles and Future Engagements,"[5] which is regarded as another classic in behavioral finance research. His research posed decisive questions: What are the cognitive errors and emotions that influence investors? What are investor aspirations? How can financial advisors and plan sponsors help investors?

**FIGURE 1.3** Meir Statman, PhD, Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University.

What is the nature of risk and regret? How do investors form portfolios? How important are tactical asset allocation and strategic asset allocation? What determines stock returns? What are the effects of sentiment? Statman produces insightful answers to all of these points. Professor Statman has won the William F. Sharpe Best Paper Award, a Bernstein Fabozzi/Jacobs Levy Outstanding Article Award, and two Graham and Dodd Awards of Excellence.

More recently, Professor Statman has written a book entitled *What Investors Really Want*.[6] According to Statman, what investors really want is three kinds of benefits from their investments: utilitarian, expressive, and emotional. Utilitarian benefits are those investment benefits that drop to the bottom line: what money can buy. Expressive benefits convey to us and to others an investor's values, tastes, and status. For example, Statman contends that hedge funds express status, and socially responsible funds express virtue. Emotional benefits of investments express how people feel. His examples are: insurance policies make people feel safe, lottery tickets and speculative stocks give hope, and stock trading gives people excitement.

Perhaps the greatest realization of behavioral finance as a unique academic and professional discipline is found in the work of Daniel Kahneman and Vernon Smith, who shared the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel in 2002. The Nobel Prize organization honored Kahneman for "having integrated insights from

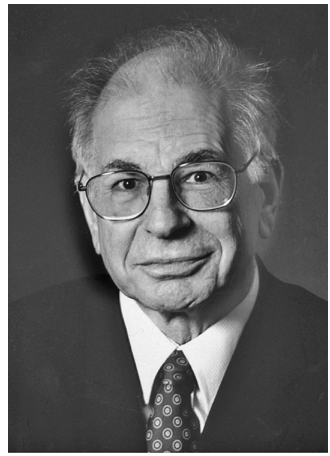

**FIGURE 1.4** Daniel Kahneman, Prize winner in Economic Sciences 2002. *Source:* Jon Roemer. © The Nobel Foundation.

psychological research into economic science, especially concerning human judgment and decision-making under uncertainty." Smith similarly "established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms," garnering the recognition of the committee.[7]

Professor Kahneman (Figure 1.4) found that under conditions of uncertainty, human decisions systematically depart from those predicted by standard economic theory. Kahneman, together with Amos Tversky (deceased in 1996), formulated prospect theory. An alternative to standard models, prospect theory provides a better account for observed behavior and is discussed at length in later chapters. Kahneman also discovered that human judgment may take heuristic shortcuts that systematically diverge from basic principles of probability. His work has inspired a new generation of research, employing insights from cognitive psychology to enrich financial and economic models.

Vernon Smith (Figure 1.5) is known for developing standards for laboratory methodology that constitute the foundation for experimental economics. In his own experimental work, he demonstrated the importance of alternative market institutions, for example, the rationale by which a seller's expected revenue depends on the auction technique in use. Smith also performed "wind-tunnel tests" to estimate the implications of alternative market configurations before such conditions are implemented in practice. The deregulation of electricity markets, for example, was one scenario

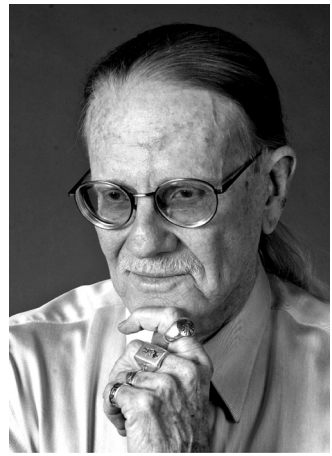

**FIGURE 1.5** Vernon L. Smith, Prize winner in Economic Sciences 2002. © The Nobel Foundation.

that Smith was able to model in advance. Smith's work has been instrumental in establishing experiments as an essential tool in empirical economic analysis.

## Behavioral Finance Micro versus Behavioral Finance Macro

As we have observed, behavioral finance models and interprets phenomena ranging from individual investor conduct to market-level outcomes. Therefore, it is a difficult subject to define. For practitioners and investors reading this book, this is a major problem, because our goal is to develop a common vocabulary so that we can apply to our benefit the very valuable body of behavioral finance knowledge. For purposes of this book, we adopt an approach favored by traditional economics textbooks; we break our topic down into two subtopics: behavioral finance micro and behavioral finance macro.

1. Behavioral finance micro (BFMI) examines *behaviors or biases of individual investors* that distinguish them from the rational actors envisioned in classical economic theory.
2. Behavioral finance macro (BFMA) detects and describe *anomalies* in the efficient market hypothesis that behavioral models may explain.

As wealth management practitioners and investors, our primary focus will be BFMI, the study of individual investor behavior. Specifically, we want to identify relevant psychological biases and investigate their influence on asset allocation decisions so that we can manage the effects of those biases on the investment process.

Each of the two subtopics of behavioral finance corresponds to a distinct set of issues within the standard finance versus behavioral finance discussion. With regard to BFMA, the debate asks: Are markets "efficient," or are they subject to behavioral effects? With regard to BFMI, the debate asks: Are individual investors perfectly rational, or can cognitive and emotional errors impact their financial decisions? These questions are examined in the next section of this chapter; but to set the stage for the discussion, it is critical to understand that much of economic and financial theory is based on the notion that individuals act rationally and consider all available information in the decision-making process. In academic studies, researchers have documented abundant evidence of irrational behavior and repeated errors in judgment by adult human subjects.

Finally, one last thought before moving on. It should be noted that there is an entire body of information available on what the popular press has termed the *psychology of money*. This subject involves individuals' relationship with money—how they spend it, how they feel about it, and how they use it. There are many useful books in this area; however, this book will not focus on these topics.

## STANDARD FINANCE VERSUS BEHAVIORAL FINANCE

This section reviews two basic concepts in standard finance that behavioral finance disputes: rational markets and the rational economic man. It also covers the basis on which behavioral finance proponents challenge each tenet and discusses some evidence that has emerged in favor of the behavioral approach.

### Overview

On Monday, October 18, 2004, a significant but mostly unnoticed article appeared in the *Wall Street Journal*. Eugene Fama, one of the pillars of the efficient market school of financial thought, was cited admitting that stock prices could become "somewhat irrational."[8] Imagine a renowned and rabid Boston Red Sox fan proposing that Fenway Park be renamed Yogi Berra Stadium (after the colorful New York Yankees catcher), and you may begin to grasp the gravity of Fama's concession. The development raised eyebrows

and pleased many behavioralists. (Fama's paper, "Market Efficiency, Long-Term Returns, and Behavioral Finance," noting this concession at the Social Science Research Network, is one of the most popular investment downloads on the web site.) The *Journal* article also featured remarks by Roger Ibbotson, founder of Ibboston Associates: "There is a shift taking place," Ibbotson observed. "People are recognizing that markets are less efficient than we thought."[9]

As Meir Statman eloquently put it, "Standard finance is the body of knowledge built on the pillars of the arbitrage principles of Miller and Modigliani, the portfolio principles of Markowitz, the capital asset pricing theory of Sharpe, Lintner, and Black, and the option-pricing theory of Black, Scholes, and Merton."[10] Standard finance theory is designed to provide mathematically elegant explanations for financial questions that, when posed in real life, are often complicated by imprecise, inelegant conditions. The standard finance approach relies on a set of assumptions that oversimplify reality. For example, embedded within standard finance is the notion of *Homo economicus,* or rational economic man. It prescribes that humans make perfectly rational economic decisions at all times. Standard finance, basically, is built on rules about how investors "should" behave, rather than on principles describing how they actually behave. Behavioral finance attempts to identify and learn from the human psychological phenomena at work in financial markets and within individual investors. Behavioral finance, like standard finance, is ultimately governed by basic precepts and assumptions. However, standard finance grounds its assumptions in idealized financial behavior; behavioral finance grounds its assumptions in observed financial behavior.

## Efficient Markets versus Irrational Markets

During the 1970s, the standard finance theory of market efficiency became the model of market behavior accepted by the majority of academics and a good number of professionals. The efficient market hypothesis had matured in the previous decade, stemming from the doctoral dissertation of Eugene Fama. Fama persuasively demonstrated that in a securities market populated by many well-informed investors, investments will be appropriately priced and will reflect all available information. There are three forms of the efficient market hypothesis:

1. The "Weak" form contends that all past market prices and data are fully reflected in securities prices; that is, technical analysis is of little or no value.

2. The "Semistrong" form contends that all publicly available information is fully reflected in securities prices; that is, fundamental analysis is of no value.
3. The "Strong" form contends that all information is fully reflected in securities prices; that is, insider information is of no value.

If a market is efficient, then no amount of information or rigorous analysis can be expected to result in outperformance of a selected benchmark. An efficient market can basically be defined as a market wherein large numbers of rational investors act to maximize profits in the direction of individual securities. A key assumption is that relevant information is freely available to all participants. This competition among market participants results in a market wherein, at any given time, prices of individual investments reflect the total effects of all information, including information about events that have already happened, and events that the market expects to take place in the future. In sum, at any given time in an efficient market, the price of a security will match that security's intrinsic value.

At the center of this market efficiency debate are the actual portfolio managers who manage investments. Some of these managers are fervently passive, believing that the market is too efficient to "beat"; some are active managers, believing that the right strategies can consistently generate alpha (alpha is performance above a selected benchmark). In reality, active managers beat their benchmarks only roughly one-third of the time on average. This may explain why the popularity of exchange-traded funds (ETFs) has exploded in the past five years and why venture capitalists are now supporting new ETF companies, many of which are offering variations on the basic ETF theme.

The implications of the efficient market hypothesis are far-reaching. Most individuals who trade stocks and bonds do so under the assumption that the securities they are buying (selling) are worth more (less) than the prices that they are paying. If markets are truly efficient and current prices fully reflect all pertinent information, then trading securities in an attempt to surpass a benchmark is a game of luck, not skill.

The market efficiency debate has inspired literally thousands of studies attempting to determine whether specific markets are in fact "efficient." Many studies do indeed point to evidence that supports the efficient market hypothesis. Researchers have documented numerous, persistent anomalies, however, that contradict the efficient market hypothesis. There are three main types of market anomalies: Fundamental Anomalies, Technical Anomalies, and Calendar Anomalies.

## Fundamental Anomalies

Irregularities that emerge when a stock's performance is considered in light of a fundamental assessment of the stock's value are known as fundamental anomalies. Many people, for example, are unaware that value investing—one of the most popular and effective investment methods—is based on fundamental anomalies in the efficient market hypothesis. There is a large body of evidence documenting that investors consistently overestimate the prospects of growth companies and underestimate the value of out-of-favor companies.

One example concerns stocks with low price-to-book-value (P/B) ratios. Eugene Fama and Kenneth French performed a study of low price-to-book-value ratios that covered the period between 1963 and 1990.[11] The study considered all equities listed on the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the Nasdaq. The stocks were divided into 10 groups by book/market and were reranked annually. The lowest book/market stocks outperformed the highest book/market stocks 21.4 percent to 8 percent, with each decile performing more poorly than the previously ranked, higher-ratio decile. Fama and French also ranked the deciles by beta and found that the value stocks posed lower risk and that the growth stocks had the highest risk. Another famous value investor, David Dreman, found that for the 25-year period ending in 1994, the lowest 20 percent P/B stocks (quarterly adjustments) significantly outperformed the market; the market, in turn, outperformed the 20 percent highest P/B of the largest 1,500 stocks on Compustat.[12]

Securities with low price-to-sales ratios also often exhibit performance that is fundamentally anomalous. Numerous studies have shown that low P/B is a consistent predictor of future value. In *What Works on Wall Street,* however, James P. O'Shaughnessy demonstrated that stocks with low price-to-sales ratios outperform markets in general and also outperform stocks with high price-to-sales ratios. He believes that the price/sales ratio is the strongest single determinant of excess return.[13]

Low price-to-earnings ratio (P/E) is another attribute that tends to anomalously correlate with outperformance. Numerous studies, including David Dreman's work, have shown that low P/E stocks tend to outperform both high P/E stocks and the market in general.[14]

Ample evidence also indicates that stocks with high dividend yields tend to outperform others. The Dow Dividend Strategy, which has received a great deal of attention recently, counsels purchasing the 10 highest-yielding Dow stocks.

## Technical Anomalies

Another major debate in the investing world revolves around whether past securities prices can be used to predict future securities prices. "Technical analysis" encompasses a number of techniques that attempt to forecast securities prices by studying past prices. Sometimes, technical analysis reveals inconsistencies with respect to the efficient market hypothesis; these are technical anomalies. Common technical analysis strategies are based on relative strength and moving averages, as well as on support and resistance. While a full discussion of these strategies would prove too intricate for our purposes, there are many excellent books on the subject of technical analysis. In general, the majority of research-focused technical analysis trading methods (and, therefore, by extension, the weak-form efficient market hypothesis) finds that prices adjust rapidly in response to new stock market information and that technical analysis techniques are not likely to provide any advantage to investors who use them. However, proponents continue to argue the validity of certain technical strategies.

## Calendar Anomalies

One calendar anomaly is known as "The January Effect." Historically, stocks in general and small stocks in particular have delivered abnormally high returns during the month of January. Robert Haugen and Philippe Jorion, two researchers on the subject, note that "the January Effect is, perhaps, the best-known example of anomalous behavior in security markets throughout the world."[15] The January Effect is particularly illuminating because it hasn't disappeared, despite being well known for 25 years (according to arbitrage theory, anomalies should disappear as traders attempt to exploit them in advance).

The January Effect is attributed to stocks rebounding following year-end tax selling. Individual stocks depressed near year-end are more likely to be sold for tax-loss harvesting. Some researchers have also begun to identify a "December Effect," which stems both from the requirement that many mutual funds report holdings as well as from investors buying in advance of potential January increases.

Additionally, there is a Turn-of-the-Month Effect. Studies have shown that stocks show higher returns on the last and on the first four days of each month relative to the other days. Frank Russell Company examined returns of the Standard & Poor's (S&P) 500 over a 65-year period and found that U.S. large-cap stocks consistently generate higher returns at the turn of the month.[16] Some believe that this effect is due to end-of-month cash flows (salaries, mortgages, credit cards, etc.). Chris Hensel and William Ziemba

found that returns for the turn of the month consistently and significantly exceeded averages during the interval from 1928 through 1993 and "that the total return from the S&P 500 over this sixty-five-year period was received mostly during the turn of the month."[17] The study implies that investors making regular purchases may benefit by scheduling those purchases prior to the turn of the month.

Finally, as of this writing, during the course of its existence, the Dow Jones Industrial Average (DJIA) has never posted a net decline over any year ending in a "5." Of course, this may be purely coincidental.

Validity exists in both the efficient market and the anomalous market theories. In reality, markets are neither perfectly efficient nor completely anomalous. Market efficiency is not black or white but rather, varies by degrees of gray, depending on the market in question. In markets exhibiting substantial inefficiency, savvy investors can strive to outperform less savvy investors. Many believe that large-capitalization stocks, such as GE and Microsoft, tend to be very informative and efficient stocks but that small-capitalization stocks and international stocks are less efficient, creating opportunities for outperformance. Real estate, while traditionally an inefficient market, has become more transparent and, during the time of this writing, could be entering a bubble phase. Finally, the venture capital market, lacking fluid and continuous prices, is considered to be less efficient due to information asymmetries between players.

## Rational Economic Man versus Behaviorally Biased Man

Stemming from neoclassical economics, Homo economicus is a simple model of human economic behavior, which assumes that principles of perfect self-interest, perfect rationality, and perfect information govern economic decisions by individuals. Like the efficient market hypothesis, Homo economicus is a tenet that economists uphold with varying degrees of stringency. Some have adopted it in a semistrong form; this version does not see rational economic behavior as perfectly predominant but still assumes an abnormally high occurrence of rational economic traits. Other economists support a weak form of Homo economicus, in which the corresponding traits exist but are not strong. All of these versions share the core assumption that humans are "rational maximizers" who are purely self-interested and make perfectly rational economic decisions. Economists like to use the concept of rational economic man for two primary reasons:

1. Homo economicus makes economic analysis relatively simple. Naturally, one might question how useful such a simple model can be.

2. Homo economicus allows economists to quantify their findings, making their work more elegant and easier to digest. If humans are perfectly rational, possessing perfect information and perfect self-interest, then perhaps their behavior can be quantified.

Most criticisms of Homo economicus proceed by challenging the bases for these three underlying assumptions—perfect rationality, perfect self-interest, and perfect information.

1. *Perfect rationality.* When humans are rational, they have the ability to reason and to make beneficial judgments. However, rationality is not the sole driver of human behavior. In fact, it may not even be the primary driver, as many psychologists believe that the human intellect is actually subservient to human emotion. They contend, therefore, that human behavior is less the product of logic than of subjective impulses, such as fear, love, hate, pleasure, and pain. Humans use their intellect only to achieve or to avoid these emotional outcomes.
2. *Perfect self-interest.* Many studies have shown that people are not perfectly self-interested. If they were, philanthropy would not exist. Religions prizing selflessness, sacrifice, and kindness to strangers would also be unlikely to prevail as they have over centuries. Perfect self-interest would preclude people from performing such unselfish deeds as volunteering, helping the needy, or serving in the military. It would also rule out self-destructive behavior, such as suicide, alcoholism, and substance abuse.
3. *Perfect information.* Some people may possess perfect or near-perfect information on certain subjects; a doctor or a dentist, one would hope, is impeccably versed in his or her field. It is impossible, however, for every person to enjoy perfect knowledge of every subject. In the world of investing, there is nearly an infinite amount to know and learn; and even the most successful investors don't master all disciplines.

Many economic decisions are made in the absence of perfect information. For instance, some economic theories assume that people adjust their buying habits based on the Federal Reserve's monetary policy. Naturally, some people know exactly where to find the Fed data, how to interpret it, and how to apply it; but many people don't know or care who or what the Federal Reserve is. Considering that this inefficiency affects millions of people, the idea that all financial actors possess perfect information becomes implausible.

Again, as with market efficiency, human rationality rarely manifests in black or white absolutes. It is better modeled across a spectrum of gray.

People are neither perfectly rational nor perfectly irrational; they possess diverse combinations of rational and irrational characteristics, and benefit from different degrees of enlightenment with respect to different issues.

## THE ROLE OF BEHAVIORAL FINANCE WITH PRIVATE CLIENTS

Private clients can greatly benefit from the application of behavioral finance to their unique situations. Because behavioral finance is a relatively new concept in application to individual investors, investment advisors may feel reluctant to accept its validity. Moreover, advisors may not feel comfortable asking their clients psychological or behavioral questions to ascertain biases, especially at the beginning of the advisory relationship.

One of the objectives of this book is to position behavioral finance as a more mainstream aspect of the wealth management relationship, for both advisors and clients.

As behavioral finance is increasingly adopted by practitioners, clients will begin to see the benefits. There is no doubt that an understanding of how investor psychology impacts investment outcomes will generate insights that benefit the advisory relationship. The key result of a behavioral finance–enhanced relationship will be a portfolio to which the advisor can comfortably adhere while fulfilling the client's long-term goals. This result has obvious advantages—advantages that suggest that behavioral finance will continue to play an increasing role in portfolio structure.

## HOW PRACTICAL APPLICATION OF BEHAVIORAL FINANCE CAN CREATE A SUCCESSFUL ADVISORY RELATIONSHIP

Wealth management practitioners have different ways of measuring the success of an advisory relationship. Few could argue that every successful relationship shares some fundamental characteristics:

- The advisor understands the client's financial goals.
- The advisor maintains a systematic (consistent) approach to advising the client.
- The advisor delivers what the client expects.
- The relationship benefits both client and advisor.

So, how can behavioral finance help?

### Formulating Financial Goals

Experienced financial advisors know that defining financial goals is critical to creating an investment program appropriate for the client. To best define financial goals, it is helpful to understand the psychology and the emotions underlying the decisions behind creating the goals. Upcoming chapters in this book will suggest ways in which advisors can use behavioral finance to discern why investors are setting the goals that they are. Such insights equip the advisor in deepening the bond with the client, producing a better investment outcome and achieving a better advisory relationship.

### Maintaining a Consistent Approach

Most successful advisors exercise a consistent approach to delivering wealth management services. Incorporating the benefits of behavioral finance can become part of that discipline and would not mandate large-scale changes in the advisor's methods. Behavioral finance can also add more professionalism and structure to the relationship because advisors can use it in the process for getting to know the client, which precedes the delivery of any actual investment advice. This step will be appreciated by clients, and it will make the relationship more successful.

### Delivering What the Client Expects

Perhaps there is no other aspect of the advisory relationship that could benefit more from behavioral finance. Addressing client expectations is essential to a successful relationship; in many unfortunate instances, the advisor doesn't deliver the client's expectations because the advisor doesn't understand the needs of the client. Behavioral finance provides a context in which the advisor can take a step back and attempt to really understand the motivations of the client. Having gotten to the root of the client's expectations, the advisor is then more equipped to help realize them.

### Ensuring Mutual Benefits

There is no question that measures taken that result in happier, more satisfied clients will also improve the advisor's practice and work life. Incorporating insights from behavioral finance into the advisory relationship will enhance that relationship, and it will lead to more fruitful results.

It is well known by those in the individual investor advisory business that investment results are not the primary reason that a client seeks a new advisor. The number-one reason that practitioners lose clients is that clients do not feel as though their advisors understand, or attempt to understand,

the clients' financial objectives—resulting in poor relationships. The primary benefit that behavioral finance offers is the ability to develop a strong bond between client and advisor. By getting inside the head of the client and developing a comprehensive grasp of his or her motives and fears, the advisor can help the client to better understand why a portfolio is designed the way it is and why it is the "right" portfolio for him or her—regardless of what happens from day to day in the markets.

## NOTES

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