

Book Review

What Investors Really Want

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Publisher: McGraw-Hill (2011)

ISBN: 978-0-07-174165-1

What Investors Really Want covers a broad swath of what motivates investors and how they can make better decisions. It is well researched and contains plenty of references for readers who wish to follow up on specific quotes or research topics. It is an excellent book and is well worth the effort to learn how to avoid saving and investment pitfalls. It should make readers better managers of their own money.

Meir Statman, the author, is an expert in the field of behavioral finance. He is the Glenn Klimek Professor of Finance at the Leavey School of Business at Santa Clara University. He consults with many investment companies and presents his work to academics and professionals in many forums.

Following is a chapter by chapter summary of some of the key content:

Introduction: What We Want

Statman states that investors want not only high returns with low risk, but other features as well such as self-esteem and status. However these human factors can get in the way of having a solid well-balanced investment portfolio. These factors include over-confidence, hindsight, and emotions. The problem, he says, is even more difficult because “The world of investments . . . offers no clear boundary between fact and fiction” (p. xii). In other words, it is not only a complex financial world out there, but we have internal needs that can derail our own best conscious efforts to invest wisely.

Chapter 1: We Want Profits Higher Than Risks

A Ponzi scheme by Bernard Madoff was uncovered in 2008, but why did so many people get taken in? Because investors

want high returns with low risk, when in truth it is not possible. “Enthusiasm, lust for gain, and gullibility are the real bases” (p. 4) for investors to go astray. Part of the reason is that many investors believe they are smarter than others and they alone can beat the market, which is not true. Some money managers’ quest for better returns turn to using insider information, which is illegal. For the average investor, Statman suggests that a good strategy is to invest in index funds (passive funds that invest in a broad market of stocks).

Chapter 2: We Have Thoughts, Some Erroneous

Unfortunately, human beings have built certain cognitive errors into our brains. One of these is framing errors. We see a chief executive interviewed on CNN and the stock of that company typically rises over the next days, to be proceeded by a downturn lower than the rise. Investors “frame” the company’s prospect by assuming that the executive would not be interviewed unless it was a good stock to buy. But that is no way to buy a stock. Another error is representativeness. When a mutual fund manager has a high rating, we take that manager as representing a successful manager, as opposed to a lucky manager, which is often the case. Another error is in seeing patterns and assuming they will continue. If a manager has a string of several years of successes, we assume they will continue, when they often do not. To overcome these errors, investors should deliberately assess all aspects of an investment and its advantages and disadvantages.

Chapter 3: We Have Emotions, Some Misleading

Investors sometimes let their emotions get in the way of making objective decisions. When we have a day of sunshine we feel better than on a gloomy day. It has been

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shown that stocks generally do better during such days. The stock market's phenomenal rise during the dot.com bubble in the 1990s was propelled in large part by people's emotional ties to new technology. Airplane accidents cause more than personal tragedies. On average they lose \$60 billion in stock losses.

Chapter 4: We Want to Play, and Win

We want to play the market, and of course, win. An anonymous writer (and one highly successful on Wall Street) said in an investment book in 1930 that what investors want, besides making money, is the thrill of winning. He continued, "That's why we . . . drink Bootleg whiskey, and kiss the girls, and take new jobs . . . but Wall Street is a poor place to look for thrills, for the simple reason that thrills in Wall Street are very expensive" (p. 55).

Chapter 5: We Join Herds and Inflate Bubbles

In December 1999, at the height of Amazon's stock price, investors still gushed at its prospects. Some analysts predicted that the price would be 50% to 100% higher. In late 2001, the stock was down by 80%. Our recent real estate bubble is just another example. Enthusiasm can cause a herd mentality where reality becomes blurred and when prices shoot up. But when the bubble bursts, as they all do, the herd gets slaughtered.

Chapter 6: We Want Self-Control and Mental Accounts

People in general want self-control. Further, we create mental accounts to help us in our need for control. This keeps money in separate accounts for specific purposes and can prevent us from spending all our money today and having nothing in the future. A research study is mentioned, called the two marshmallows. Four-year-olds were given one marshmallow but were told that if they waited to eat the marshmallow, they could have two. The kids who waited, were later in life found to be more successful. Why? They had better self-control. This is also seen in the ability to save money. Those with more self-control, as you would expect, had more savings later in life.

Chapter 7: We Want to Save for Tomorrow and Spend It Today

Surveys of people thinking about retirement indicate that many people worry about "the number." This is the total amount of money they will need to accumulate to have a comfortable retirement. But it is difficult to calculate, because we do not know how our investments will do or what the inflation rate will be. Some websites, however, can help

in this regard. There is another aspect of this calculation that the author discusses: when in retirement how do you convert capital into income? You can either have dividend paying stocks or you can dip into capital. They are really the same. Either way you convert capital into retirement income. Then there are mutual funds, at Fidelity and Vanguard, among others, that do this for you. They send you a certain percentage of your capital, which they take from either income or capital, but they do all the work.

Chapter 8: We Want Hope for Riches and Freedom from the Fear of Poverty

There are two desires that many people hope for, riches and freedoms. Some can get caught up striving after riches by taking great risks. But even winning the lottery is no guarantee of riches after a number of years. One in five winners ends up poor. Lotteries and lottery-like stocks attract people because they offer great riches. This concept was also in part behind the large number of people buying houses with a subprime mortgage. It was not greed that most people sought, it was hope and aspirations. Also, another animated feeling we have is fear of poverty. Thus, we are driven by different desires and different ideas of riches, but in all cases, freedom from poverty.

Chapter 9: We Have Similar Wants and Different Ones

A scam artist who cheated people out of \$34 million said that his promise of a 25% return in 90 days was impossible, but people wanted to believe it could happen. A survey of men and women found that men crave riches more than women, while women crave freedom from poverty more. In picking stocks, men are more confident than women and thus take more risks. Personality also plays into this, with some types more prone to naturally save money, while others want to spend it now. Culture can also determine how people think about saving or spending money. The high savings rate among the Chinese is attributed, in part, to Confucian ideas of harmony, honesty, and responsibility.

Chapter 10: We Want to Face No Losses

People are reluctant to face losses. But this works against people when they have losses in stocks. People are too reluctant to sell when they should. Rational investors, however, follow the maxim: "cut your losses and let your profits run." But this runs counter to our nature. Investors also sell stock gains too soon, because they want gains so badly. Statman says, "Anger joins regret and pride on the list of emotions that animate our attitudes towards investor gains and losses and our decisions to realize them"

(p. 147). Professionals are no better in avoiding cognitive errors based on emotions.

Chapter 11: We Want to Pay No Taxes

Senator Russell B. Long once said, “Don’t tax you, don’t tax me, tax that fellow behind the tree.” This succinctly sums up our attitude about taxes; we do not want to pay them. Anger over taxation was behind the 1773 Boston Tea Party. Sometimes people cheat or at least under-pay what they earn, because they can. Most Americans receive a salary and the IRS knows who they are and what they earn, and thus, there is little cheating. People who own businesses or investments in tax shelters, however, have more opportunity to under-report their income.

Chapter 12: We Want High Status and Proper Respect

Many people want high social status and proper respect. This leads some to invest in hedge funds, for example, because it brings status among their friends. One hedge fund manager stated it well, “It certifies one’s affluence while attesting to one’s astuteness” (p. 161). Status displays also include investments in wine or art, or even an expensive Gucci bag. H. L. Mencken, journalist and critic, defined a rich man as one earning \$100 more than his wife’s sister’s husband. Investors, however, should concentrate on realistic investments and focus on realistic returns.

Chapter 13: We Want to Stay True to Our Values

Some socially responsible investors are willing to sacrifice higher returns for expressive and emotional values. Some would like to invest in companies that protect the environment, avoid tobacco, alcohol, and gambling or promote their own political or religious causes. Two prominent mutual funds that specialize in these investments are Calvert and Domini. Statman further suggests that another approach is to invest in best-in-class companies that practice some form of socially responsible investing. Further, not everyone agrees on which companies are socially responsible. For instance, some investors might avoid oil companies all together, while others will pick the best of the oil companies.

Chapter 14: We Want Fairness

There is the game of fairness called “The Ultimate Game.” Imagine that I am holding \$1,000 and I am facing you and a person behind a curtain. You, nor the person, will never know each other. Now, I offer the person behind the curtain the chance to divide the \$1,000 between the two of you. Perhaps \$500 for each, or \$999 for the person and

\$1 for you. There is no negotiating, you simply accept or reject, that is, if you reject the offer then no one gets any money. Question: If the person behind the curtain offers you \$1, would you accept? After all, it’s \$1 more than you had a minute ago. In playing this game many times and in many countries, generally if the person behind the curtain offers anything less than \$200, it is rejected. Why? Because it does not seem fair. We are faced with fairness issues when credit card companies or banks charge us a fee that seems too high. The desire of fairness starts early in life as a child protests, “It’s not fair.”

Chapter 15: We Want to Invest in Our Children

Another need of an investor, Statman suggests, “Is to do well for their children. Rich parents buy \$6,500 Tiffany teapots not only for their children,” but as the advertisement says, “For Your Children’s Children.” Poor parents buy \$50 bonds for their children” (p. 210). Many parents, at all income levels, also try to instill good savings habits into their sons and daughters. Statman also notes that parents appear to be more effective in teaching good money habits than schools are. He says, “High school education in financial literacy had little effect on financial knowledge and even less on financial behavior” (p. 216). Further, stock market games taught in high school seem to teach trading more than smart investing.

Chapter 16: We Want Education, Advice, and Protection

Financial advisers are like physicians. You can find free advice on the Internet, but when a patient has a persistent pain in their chest, they go see their physician. So too, for financial advisers. Today, workers have to be financially literate, because they have to invest their own 401(k)s, versus the automatic pensions of yesterday. When we recently had a wave of mortgage defaults, the value of financial literacy was evident. Good financial advisers possess knowledge of finance, as good physicians have medical knowledge, and add good skills of asking, listening, empathizing, educating, and prescribing. Trust in financial advisers, however, has diminished in the wake of the recent financial crisis. But investors want it all: education, advice, and protection; and they especially want this for free.

Conclusion: What We Have

Statman says that the trouble is that most people do not know how to invest wisely. Further, investments offer three different kinds of benefits: utilitarian, expressive, and emotional. The first is what it does for our pocketbooks. The second is what it conveys to others and to ourselves about

our values, tastes, and status. The third is how our investments make us feel. To overcome cognitive errors, we need financial education and literacy.

This book, in the reviewer's eyes, is a good compilation of advice that financial planners have been giving people for many years. What makes this book valuable is explaining the underlying human factors that work against this good advice. Hopefully, by understanding these factors, investors can overcome them and better meet their savings and investment objectives. This book is also good for financial planners and other financial professionals who are not familiar with behavioral finance and would like to expand their knowledge of this field.