portfolio construction forum

Behavioural finance vs standard finance

Angela Ashton | PortfolioConstruction Forum | 26 July 2014

"Behavioural Finance vs Standard Finance", by Meir Statman, Santa Clara University

Meir Statman is a well-known figure in the world of behavioural finance. A Professor of Finance at Santa Clara University, I'd argue his work should be standard reading for all portfolio construction practitioners and others involved in the financial services industry.

The book he is most famous for is "What Investors Really Want" (2011). I've just bought a copy and recommend it. Even if you don't agree with everything he writes, you'd have to believe it might contain some nuggets that have the potential to give you some new insights into how your clients behave.

Statman and his co-collaborators (e.g. Hersh Shefrin and Kenneth Fisher) believe that the major flaw in standard finance theory (think MPT and CAPM) is the assumption that investors act rationally. They don't believe investors rationally seek out the best risk/return option on the efficient frontier for them, but rather that investors (and perhaps, the professionals who advise them) act in non-rational ways and some of those behaviours are carried out quite consistently. And that is the basis of behavioural finance.

This wouldn't be important if it didn't affect the outcome of CAPM theory. If everyone was forced back onto the efficient frontier anyway by some means, the fact that we do not act rationally would not be important. However, Statman et al would say that it does affect our portfolios. They would say it is so prevalent that it affects investment markets and often in consistent ways - meaning people hold portfolios with the same consistent biases. This makes markets systematically inefficient.

In this white paper, Statman illustrates the effect of behavioural biases on investment portfolios and markets by using a number of examples.

One is the three factor model of French and Fama fame. To recap, French and Fama found that stocks with low Price/Book ratios (or Price/Earnings ratios) and smaller stocks tended to outperformed in a fairly consistent manner. Of course, this makes no sense if markets were efficient and if people invested rationally.

Statman's explanation of this effect is based on the idea that investors prefer stocks of good companies to good stocks. So, investors are drawn to 'good companies' or, in our parlance, 'darlings of the market'. This is in contrast to good investments. *Fortune Magazine* runs a survey each year of fund managers and other professional investors, asking for their three top stocks picks for the following year. Those investors consistently pick 'good companies', with good management, earnings growth and so forth. Statman and Shefrin found those stocks also consistently and significantly underperform. They theorise that even professional investors confuse good companies and good investments.

An Australian example of this might be Domino's Pizza. Broker consensus is that the company is very well managed, has very good revenue growth prospects and does everything a 'good company' should do. Hence, it is generally considered a Buy by brokers who cover smaller stocks. It's also exactly the sort of company a conservative investor would like to own. As a result, its price has been bid up so that it now trades at a PE of 50. So it's a very expensive stock. Is it really likely that the stock will outperform from this point? Yet it remains a market darling and is on buy lists everywhere.

Because good companies get bid up, companies that might have weaker management and not-so-good fundamentals aren't as heavily pursued and their PE ratios fall more than they should. They often then go on to outperform.

Another example Statman discusses is investors' attraction to stocks with good dividend yields. Investors like dividends - indeed, many self-funded retirees see dividends as their pay cheque. Cutting dividends does severe damage to stock prices, even if it is in the best interests of the company and will lead to greater capital growth. Investors often don't see that selling a portion of their holding in those circumstances can amount to the same thing as a dividend. Statman attributes this to mental accounting. Many investors think about equity holdings as being in their capital account while dividends are in their income account. They are happy to spend dividends but it's a cardinal sin to dip into capital.

This paper is a great introduction to why behavioural finance is quickly becoming recognised as a field that can add real value to the wealth management industry. Not long and not a hard read, it's a good introduction to a very useful field.

Read "Behavioural Finance vs Standard Finance"