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## “What Investors Really Want”

By Kerry Pechter    Tue, Sep 7, 2010

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*That's the name of behavioral economist Meir Statman's new book. We all yearn for upside potential and downside protection—and maybe a weekly Lotto ticket, he says.*

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When managing his own savings, the behavioral economist Meir Statman practices what he teaches. If his emerging markets equities fund loses value, for instance, he doesn't panic and go to cash. Nor does he “rebalance” by shifting assets from bond to stocks.

More likely, he would move the depreciated stock fund into a similar stock fund to capture the tax-deductible loss (without engaging in a wash sale). He wouldn't touch his bond money, which he regards as protection against future poverty.

“I'm very risk-averse with downside money,” he told RIJ recently. “I think that the idea of looking at the portfolio as a whole, and having the same risk tolerance for all of your money, is wrong. I wouldn't recommend any change based on a prediction of what stocks will do, or on the belief that stocks were cheap.”

The Glenn Klimek professor of finance at Santa Clara University's Leavey School of Business in Silicon Valley, Statman has just published *What Investors Really Want* (McGraw Hill, 2010). His book combines personal anecdotes and academic research in an amiable narrative that emanates tolerance for our all-too-human financial foibles.

Most investors want at least a glimmer of hope for future riches and they want to avoid falling into poverty, Statman believes. In the jargon of the Street, they want upside potential and downside protection. Evidence of this is easy to find, he says.

It can be seen in the universal popularity of lottery tickets. It can also be seen in the way investors buy hybrid investments, like balanced funds, equity-indexed annuities and variable annuities with lifetime income guarantees. It can also be seen in the chronically low sales of fixed income annuities, which offer no opportunity for growth.

At the same time, people struggle with self-control as they seek to balance the desire to spend now with the desire to save for the future. “We deal with this by creating rules,” he said. “One rule is to spend in income but never dip into capital. Another rule is to spend only four percent of wealth in retirement. Payout mutual funds serve a psychological purpose, he said, by make dips into capital “invisible” to the owner.

“People are aware of their problem with self-control and look for ways to deal with it,” said Statman, who was born in Germany in 1947 to Polish parents who had fled the Nazis in 1939. After five years on a collective farm in Siberia, followed by the limbo of a Displaced Persons camp, they emigrated to Israel, where Statman grew up. He came to the U.S. for graduate study in the early 70s.

"The desire not to be poor and to become rich still exist when people are retired," Statman told RIJ, "and that is the bane of immediate annuities, which are presented as 'We are going to take all your money and give you a few thousand dollars a month.'

"But that deprives me of any chance of becoming rich. Advisors and annuity designers should be saying, 'Let's put a portion of your money into an annuity to supplement Social Security. You'll be protected from the downside and still have money to put into growth stocks.' That really is the ideal scenario."

Most people aren't as rational about money as economists once assumed or as hopelessly innumerate as some behavioralists paint them, he says. "Ninety-eight percent of us are normal. Sometimes we are stupid and sometimes we are smart. The question is, how can we raise the ratio of smart behavior to stupid?"

While the financial services industry has a pretty good grip on the public's desire for upside potential and downside protection, it lags behind other industries in understanding that people often think of mutual funds or wealth management services the same way they think of automobiles or watches—as expression of themselves.

"Money is just a way station to what you do with that money. Both standard and behavioral finance seem to regard investing as neutral or unique. Investment products and services are like other products and services.

"You might describe Vanguard, for instance, as a company that sells good merchandise at a good price. But investing at Vanguard also makes me proud that I'm smart enough not to waste my money. Vanguard is an expression of me just the way my Toyota is an expression of me. I could buy a Lamborghini, but I'd feel like a phony."

People invest in active funds instead of index funds for a good reason, Statman said. "Only 20% of stock investors invest in index funds. Knowing what we know about performance, you might say that people who invest in actively managed funds are stupid. But you wouldn't call people who buy Rolex watches stupid just because Rolexes don't tell time any better than Timex watches.

"If you ask people in the watch business, they won't deny that they're appealing to a sense of status or beauty. But money managers wouldn't admit that that's what they do," he said.

"People invest in active funds because active funds give them the hope of being rich. Some say you shouldn't pay for hope. But people pay for hope all the time. Look at lottery tickets. An advisor might tell you not to buy lottery tickets. But I'd say, go ahead and buy one once a week. You'll lose your money, but for \$52 you'll have hope for an entire year," he said.

But to take advantage of the craving for hope—i.e., greed—is foul play, Statman claims. If active fund managers were more candid, he says, they'd drop the pretense that they merely seek alpha through securities analysis. They make bets in order to outperform their peers. They advertise their good quarters, but bury the results of their bad bets, fostering an impression that active funds are consistent outperformers.

To counteract such stealth, Advisors should act as financial physicians for their clients, Statman said. An advisor should help people make smart, practicable choices, he said, creating a plan that accommodates their hope for upside and fear of ruin without over-indulging them.

"A good advisor will let people spend five percent of your money on frivolity, but make sure they don't spend their serious money on lottery tickets," he said. "I am passionate about the need for advisors to be their as financial physicians, because people do stupid things when they're on their own."

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