beyond greed & fear

By Hersch Shefrin
Harvard Business School
Press 368 pages

review rating

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This book is about “Understanding Behavioural Finance and the Psychology of Investing”. Hersh Shefrin holds the Chair in Finance at the Leavey School of Business at Santa Clara University, USA, and has been studying this discipline for many years. He has written this book for practitioners: portfolio managers, analysts, and financial advisers; and has tried for a level of detail suited to the middle segment of this group. He rates the level as being appropriate for an MBA course in behavioural finance.

There is a wealth of material, data, analysis and references in this book. It could well be used as a starting point for more detailed reading of the many papers referenced throughout the text – there are eight pages of credits, 27 pages of references and 21 pages of foot notes before the index. Thus, this is a work of scholarly magnitude and authority.

The overall impact and quality of the book is spoilt by one ubiquitous issue that keeps popping up in the text, and which – in one sense – lies at the heart of behavioural finance: the debate over efficiency of markets. As with many debates of principle, the proponents in each corner have tended to adopt extreme positions, and the text and tone of this book, clearly illustrates how reputations and pride have been at risk during the debate. The way Shefrin presents the debate, there is a cohesive behavioural band in one corner (eg, Richard Thaler, Werner De Bondt and Robert Shiller), with the market efficiency believers in the other corner (notably the Chicago School of Merton Miller, Fama and French etc). One does wonder if it really is that clear cut, as Shiller’s book, Irrational Exuberance (reviewed this web site) does not overtly support or propound behavioural finance. However, many daggers have been drawn over the years, for example Eugene Fama is quoted as describing behavioural finance as “anomalies dredging”.

The fundamental question and doubt

As the author has applied so much focus and so many observations on the market efficiency debate, it is reasonable for this review to highlight what I see as being the Achilles Heel of the Shefrin analysis. His thesis is that behavioural finance has three themes, to support the contention that psychological phenomenon pervade the entire landscape of finance. Firstly, there is heuristic-driven bias – the holding of entrenched biased beliefs that predispose the holder to errors in decision making. This first theme has several sub-routes into: representativeness, regression to the mean, gambler’s fallacy, overconfidence, anchoring and aversion to ambiguity. Secondly, there is the prevalence of frame dependence - perceptions of risk and return and consequential decision making that are influenced by how problems are “framed”. Here we learn more of such matters as: loss aversion, regret, self-control and the significance of dividend income.

Thirdly, there is the contention that the culmination and practical effect of the first two themes (above), leads to mispricing of securities and deviation from fundamental value – ie, the inefficient market. In some respects, it is a shame that the book does not just focus on the first two themes, as the third theme/theory of marker inefficiency does encounter heavy water – perhaps unnecessarily heavy water, due to framing. In Chapter 4 there is an interesting and revealing overview of market pricing issues, and how investor errors can cause mispricing – note in this regard that the book was written in 1999 and published in 2000. The latest reference I can see is to mid 1999, and hence the text is clearly pre the Dow/NASDAQ collapse of March 2000.

There is coverage of the early work of Thaler on pessimism about past losers and optimism about past winners, and how mispricing is corrected over time – leading to out-performance of “loser portfolios”. There is an excellent overview of Shiller’s work on valuation and of how, long term, the return from stocks is swamped by the compounding of dividends – the US historical mean return from dividends is 4.73%. (Note: “The Dow Jones Industrial Average closed 1998 at 9,181. As a price index, the Dow does not include reinvested dividends. If the Dow were redefined to reflect the reinvestment of all dividends since May 1896, when it commenced at a value of 40” it would have had a value of 652,230 in 1998). And, by reference to the crash of 1987, Shiller is again drawn on for his analysis, which found that the crash occurred in the absence of any major news about changing fundamentals. All of this, plus the examples of overconfidence, mount a convincing case (even without the collapse of the NASDAQ, which had then not occurred) of overall macro mispricing of the market, and of how market valuation can stray from fundamental value – only to be drawn back, over time, to the inevitable reversion to mean.

The problem comes when he reaches Chapter 7 “Picking stocks to Beat the Market” as there the market inefficiency debate has to be approached at the micro stock level, where it is observed that “some managers have beaten the market consistently”. He then polarises the debate by contending that: “There are two sides to the market efficiency debate, and one side is wrong. Either money managers such as Dreman are subject to the illusion of mispricing, or the efficient market school is subject to the illusion of market efficiency. I argue that the evidence goes against market efficiency.” Then follows an unconvincing analysis of the impact of broker recommendations and post research stock performance. Importantly, he gives very short shift to the work of Fama and French (FF), and he seems to not appreciate their thesis. For example, on pp 76 and 77 he uses a single quarter performance review of two research firms, as an illustration of how stock recommendations can out-perform the market when not based on size and low price-to-book ratios.

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FF are renowned for their work on factor models (which is addressed in more detail in pp 85-87) and they show that, over long time periods, small cap and value stocks out-perform large/growth stocks – but they would never contend that this effect can be relied upon for one quarter of performance data. Small caps can under-perform large caps for a decade or more before they will predominate. This critical representation of FF is disquieting, especially when it must be know, but not mentioned by the author, that FF have proved their theories in the final investment court of appeal. Through Dimensional Fund Advisors Inc. (not mentioned in the book) they have applied their size/value factor models to wining (ie, out-performing) effect, and have made themselves multimillionaires in the process!

Finally, in the enthusiastic demolition of market efficiency, the early chapters seem not to mesh with later chapters, eg, one dealing with "The Money Management Industry: Framing Effects, Style 'Diversification' and Regret" – Chapter 15. Here the active funds management industry is castigated for under-performance: "Placing funds with an active money manager is typically a bad bet. Yet institutions continue to hire active money managers. Why?" – and the real-world rationale is addressed frankly and convincingly; but the underlying message is equally as clear: active managers seldom deliver. How this fits the prior tirade on the efficient market hypothesis is not easy to discern, in fact it is plainly contradictory. In the dust cover to this book, this fair and revealing insight (eg, in Chapter 15) into the fund management industry is unsurprisingly appreciated by John Bogle, founder of Vanguard, who is quoted as saying: "I particularly enjoyed the reference to the emperor's clothes worn by the mutual funds industry. Shefrin's clear reaffirmation of the fallibility of professional investors will lead even to the most impressionable investor to consider, yet again, the advantages of market indexing strategies" – hardly a ringing endorsement of inefficient markets and successful exploitation of misprising by active equity management.

This key shortcoming is a pity, as there is so much in this work which is of value to practitioners and individual investors. Even Chapter 15 (above), contains a revealing outline of how US pension funds work with asset consultants (the so called industry "gatekeepers"), and select active managers in specific asset classes and sub-classes – eg, value/growth, small cap etc. The industry folklore is exposed for what it is, and the perceived benefits of sticking to the tried and tested (ie, the known, if under-performing) is explained, as against the risk of trying new and innovative managers.

Many lessons and examples of human infallibility – psychological and otherwise

Throughout this book there are numerous examples of how investors can act to their detriment, with the best of motives at the time. Although these failings are squeezed into the lexicon and categorisation of "behavioural finance", and are sprinkled throughout the book, they provide insightful instances of irrational behaviour. Some examples:

1. Past stock losers are not liked but are generally good investments – plenty of examples of this in Australia for the brave and informed investor
2. Few people understand the law of averages and suffer from gambler's fallacy – thinking that a reversion to mean should occur in the short term, when it can still have plenty of time to run
3. Most investors, including institutional, suffer from expensive levels of overconfidence in areas where they should appreciate that they know very little; eg, direction of the market. Two key manifestations of overconfidence: taking bets when failing to appreciate that you are at an information disadvantage; and trading more frequently than is justified or prudent – part of the illusion of control
4. Inexperienced investors expect higher returns than do long term investors and they are more confident in their ability to beat the market
5. People have an aversion to ambiguity, and therefore will always prefer the familiar to the unfamiliar investment
6. When stakes are smaller, people become more tolerant of risk – hardly surprising, as this is why people buy lottery tickets
7. Behavioural finance explains why markets are more volatile than they, theoretically, should be, based on fundamentals
8. Although investors understand inflation and the difference between real and nominal returns, most find it difficult to think in terms of real returns and remain anchored to nominal numbers
9. Bullishness appears to have a backward-looking time horizon of around 12 months, and supports irrational "trend" following/belief
10. When it comes to fund selection and other matters, past performance may be a guide to future results, but "it's a mighty tough guide to read" – although dog managers generally stay dogs.

As well as these practical observations (with examples in the text), which the honest, self-critical investor would do well to ponder, there are excellent expositions of fixed interest markets, currency management, and the risk of corporate executives paying unjustified takeover premiums. Chapter 14 contains the best explanation that I have seen of the yield curve – and of why bond funds generally under-perform the relevant fixed interest index/benchmark after fees. It is basically impossible to outguess future actual/spot rates, and believing that one can outguess the yield curve is the ultimate in overconfidence.

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Naturally, there are some areas where events subsequent to 1999 have overtaken the text, eg the work of Eliott Spitzer has simply amplified the observations made in Chapter 18 on stock recommendations and the un-impartiality of equity research.

However, after making due allowance for the market efficiency conundrum and the tricky inconsistencies in this area mentioned above, this book holds true value to the Australian investor who is prepared to think outside of the fundamental square, and for this reason is rated 7. “If you are playing to win, you have to understand how the other players are thinking. … The real point of this game, is that playing sensibly requires you to have a sense of the magnitude of the other players’ errors.” It seems, that ignoring human infallibility has its downside, as investors in 1929 might now agree.

MARTIN EARP
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