Book review

Review of Finance for Normal People by Meir Statman, Oxford University Press, 2017

By Meir Statman
Finance for Normal People
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Meir Statman, a pioneer of behavioural finance, brings us an overview of behavioural finance, "finance for normal people, like you and me." Usually textbooks are written by good second-division researchers in the relevant subject, but this volume joins a small list of textbooks by those who founded their subdiscipline of our field (Fama and Miller, 1972; Watts and Zimmerman, 1986).

Statman interprets the behavioural perspective as extending standard finance, with its intense focus on the utilitarian benefits of investment, to a broader canvas including two additional factors. The first is the expressive benefits of investments that arise from being part of an elite group of hedgies, or angel investors in an arthouse film. The second is the emotional benefit of investing in a good cause, such as a wind farm or a charity like Amnesty International Company. The book then interprets observed investment behaviour as the product of an investor's utility function which sums these three elements of utility, utilitarian, expressive and emotional.

So, the book is both an attractive MBA textbook offering as well as a coherent research contribution bringing together much of Statman's previous research, often with Hersh Shefrin, over the past decade or so. In Statman's vision, the additional elements of investors' utility, the expressive and emotional parts, can enhance utility via shortcuts or diminish it via errors. The difference between shortcuts and error, a priori, is one of the ambiguities the book, and perhaps the field of behavioural finance, struggles with. I discuss this more at the end of this review, after providing more detail regarding its content.

The book is divided into parts, the first on financial markets and especially asset pricing, and the second on investment management using the same lens of the summed value of utilitarian, expressive and emotional costs and benefits to investors. Initial forays into behavioural finance simply bolted on "anomalous" elements of investor behaviour to the "rational" investor framework, but Statman seeks to expand that framework to embed investors' expressive and emotional needs and the shortcuts/errors they make in attaining them.

Thus, standard finance theory for Statman is "anorexic" finance (p. 4), reflecting a distorted view of our own "normal" needs as investors, for the joy of playing the game and solace of having someone else to blame (usually our broker) when we lose it. Statman's vision of finance thus fattens up standard theory to reflect our, at least, threefold elements of need, utilitarian, expressive and emotional. This results in a working version of a, behavioural, finance that is

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more messy and confusing than the standard model but, perhaps for that very reason, is more reflective of our lives as investors, savers and consumers of investment products.

Statman invokes compelling evidence that we do not use reasoned choice without emotion, but rather integrate affect into any well-functioning decision-making process. The only real question is then when do our emotional responses help or hinder our broader interests as investors and consumers of financial products? When are we invoking an emotional shortcut rather than simply making an emotional error? For Statman, a shortcut invokes "System 1"/blink response when it is appropriate, for example what is 2×2, and errors rely on a System 1 response when we should be thinking in a calculative, deliberate, System 2, manner (Kahneman, 2011).

Thus, for Statman, shortcuts to the cognitive process serve investors well, whereas errors mislead them. Much of the second part of the book shows how sellers of financial products seek to short-circuit our decision-making process to entice us into making costly errors. Statman points out that one response to the threat of expressive and emotional errors is the adoption of an explicitly calculative, data-driven form of decision-making, where intuition and "expert" judgement have previously prevailed, rather in the style of Billy Beane's resurrection of the Oakland A's in *Moneyball* (Lewis, 2003, p. 101). However, Statman also notes that simple models often work best, so "less is more" for financial decisions requiring forecasts of future outcomes.

An illuminating part of Statman's expansion of our understanding of investors' utility functions comes in Chapter 6, where he discusses what we have learned from studies of happiness, capabilities and a much broader conception of our life's purpose than the von-Neumann-Morgenstern expected utility framework allows. This gives colleagues in finance, and our students, an opportunity to benefit from ongoing advances in behavioural economics and neuroeconomics.

Chapter 7 sees Statman's enriched utility function, with its three elements in action, explaining some of the big puzzles/anomalies in finance, including the disposition effect, which can be barely mentioned without recalling his name. Statman argues that many of these puzzles are more easily reconciled to observed data and investment practice once the expressive and emotional aspects of investor utility are taken into account. So, as well as the usual prospect theory, loss-aversion, rationalisation of the disposition effect, Statman also invokes self-control issues to explain why we ride winners for too short a time. It is just hard to resist cash dangled in front of you, even if a bit of patience might yield more. Indeed in a broader society, one might feel that economics of self-control is one of the greatest, most policy-relevant, contributions of the behavioural perspective in fighting addiction, obesity and poor savings for retirement (Baumeister and Tierney, 2011). Here the strength of Statman's approach is its richness and ability to generate new testable hypotheses, or recast old ones. But this very fecundity may also be its weakness, as I will later argue.

In the final part of the book, Statman turns to investment management and personal finance, where the behavioural finance has always been taken far more seriously and the standard approach to finance distrusted – if not ridiculed. Here, Statman notes, concepts of portfolio pyramids, nudges and mechanisms for self-control are already embedded into professional practice, and the utilitarian view is often only honoured in the breach. Statman shows that often the standard, utilitarian, approach cannot motivate the sort of regulation that structures much of retirement planning and trade in personal finance products in general. This is a big loss because, as Statman points out, if the nudge agenda fails, it is hard to believe shoving of investors' choices will be long delayed, given the low esteem in which many finance professionals are now held. So here, perhaps, the classical liberalism to which most finance academics subscribe is best served by adopting a behavioural approach along the lines advanced by Statman in the second part of this book.

So, the book offers an innovative interpretation of our current understanding of financial decision-making and an agenda for new research on the application of models incorporating an investor utility function reflecting, utilitarian, expressive and expressive needs. What's not to love?

As I have hinted above, my concern is that such an enhanced utility function might explain too much, in too many different ways, to serve as a satisfying interpretative tool. A classic example of this comes in Statman's fascinating discussion of the attraction to investors of dollar-cost averaging. I quote (p. 159):

> Consider an investor with $2,000 in cash he has chosen to invest in stocks because stocks are likely to yield higher long-term wealth than cash, even though they impose higher variance of wealth. This choice is consistent with expected-utility theory if the investor's variance aversion is not too high. Yet loss aversion, a feature of prospect theory, might deter our investor from buying stocks altogether if his potential short-term losses imposed by stocks during the coming day or week exceeds his desire for long-term gains.

It appears almost any choice can be rationalised by selecting an appropriate frame and/or evaluation period. But do we have to see a non-utilitarian choice as an "error" at all? Could it just be the right choice for the particular, loss-making, context? Gerd Gigerenzer and his Adaptive Behaviour Cognition research group in Berlin have re-emphasised the importance of the evolution of decision-making to specific contexts, especially those where uncertainty prevails and standard risk-based calculations seem less relevant and a true uncertainty prevails (Gigerenzer and Brighton, 2009; Aikman *et al.*, 2014). Here, stylised "fast and frugal" reasoning can be useful precisely by limiting valid choices in ways that seem attractive when faced with some of the "any bias will do" discussion which seems to characterise so much of behavioural finance, including that in this book.

For some of us, such a heuristic revolution in finance constitutes the third, most challenging, but potentially most rewarding, phase of the behavioural finance project. But if Gigerenzer and his acolytes can see so far, it is only because they stand on the shoulders of giants such as Professor Statman and their frequent bête noire Kahneman and Tversky. In this book, he insightfully extends the current behavioural project rather than conducting the derailment some of us believe to be necessary.

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