Financial Physicians

Meir Statman
Glenn Klimek Professor of Finance
Santa Clara University
Santa Clara, California

Financial advisors should think of themselves—and present themselves—as financial physicians. Investors bring to financial advisors their stresses, fears, aspirations, and biases. Advisors can help investors balance wealth and well-being by using the tools of wise physicians: asking, listening, diagnosing, educating, and treating.

The findings and insights of behavioral finance can be useful to financial advisors. As an educator, I often speak with financial advisors. "Imagine that you are meeting with an investor," I say, "tell me what frustrates you most about the client's expectations." Advisors' answers are not surprising: Investors want the highest returns, with no risk, no taxes, and no fees, and the really rich investors want even more.

What can advisors offer? They can offer potentially greater wealth, improved well-being, and a good balance between the two. Several years ago, I attended a meeting between a financial advisor and a potential client, a well-educated man who had just received more than $30 million from the sale of his father's business. His brothers and sisters had each received the same amount. The advisor was trying to help the man build a well-diversified portfolio composed of domestic and international stocks and bonds—a balanced portfolio with low risk that would deliver good returns over the long run. But the man was distressed. Confident they could pick winning stocks, his brothers and sisters had chosen concentrated portfolios. They ridiculed his ideas about well-diversified portfolios and were sure to laugh at him when they came out ahead. As I listened, I realized I was happier than this much wealthier man. I had much less wealth but much greater well-being.

Wealth and well-being, what makes people happy, what investors want, and what advisors can offer—these are the themes of my presentation.

The Financial Physician

Many investors want more than a balance of risk and return or more than simply enough money for a secure retirement and college education for the children. Many investors want to be "number one," to win the race, and to outperform neighbors or siblings—all of which cause stress. The man I just described was miserable even while holding $30 million. Success in investing is about status; it is about security; it is about life.

Financial advisors must be financial physicians. To the knowledge of markets, securities, and portfolios—all the lessons learned from the science of finance—financial advisors must add the qualities of good physicians: listening, hand-holding, and reassuring. Physicians promote health and well-being, and financial advisors promote wealth and well-being.

Listening. What are investors' aspirations, emotions, and thoughts? What do investors really want? Like a good physician, an advisor must *really listen* to what investors need and want. Suppose a client took to heart a comment made by his brother-in-law at the last family gathering that implied his brother-in-law was wealthier, and the comment still bores into him, even two weeks after it was made. This client does not want to discuss his angst about that comment with anyone—whether an old friend or a new investment advisor. So, how can an advisor uncover this client's true feelings? The answer is through listening, empathizing, and diagnosing, just as a physician does. Investors trust good advisors as they trust good physicians. And trusting investors are honest investors. What do investors really fear? Is it risk? Is risk standard deviation? Much too often advisors jump into questionnaires about risk tolerance and miss the real fears and aspirations of investors. Consider international diversification. Risk is not what is driving investors away from international diversification; nor is an increase in correlations between domestic and foreign stock returns. Investors are being driven away from foreign stocks by the miserable performance of such stocks in the past decade and the fear that more miserable performance is in store.

Stress and Status. Good investment advisors listen to clients to uncover their sources of stress. A recent book contains interesting articles about well-being, including a particularly intriguing article by Robert Sapolsky that compares the physiology of animals under stress with that of humans under stress.[1] Consider two humans sitting at a chessboard and moving pawns from square to square. Their heart rates and hormone secretions respond as though they are gazelles being chased by lions. What is going on? Gazelles experience hormone secretions that increase their heart rates only when under stress—the fight-or-flight phenomenon, but we humans tend to be under stress all the time. We worry about mortgages, relationships, and the thinning ozone layer, all of which are mysteries to the gazelle. This constant stress can cause actual physical ailments, such as heart disease.

We experience stress most often in environments of little predictability, little control, and little social support. The man I described earlier who was given more than $30 million had only one reasonable option—to invest the money. He was thus facing the unpredictability of securities markets for many years to come. Securities markets are an environment in which we have little control and a place where we find little social support. Indeed, in the world of investing, friends and relatives are more likely to be competing against than supporting one another. (Interestingly, studies on behavior show that brothers-in-law are a source of particularly great competition and stress.)

What reduces stress? Status reduces stress. We always compare ourselves with others. Are we richer than our brother-in-law? We also compare our current positions with our own past positions and our aspirations for the future. Are we richer today than a year ago? Are we as rich as we aspire to be? We are happy when our status is high relative to that of other people and to our own past, or aspired, positions.

Wealth is absolute. Status is relative. Although most people cannot imagine what it would be like to be worth $100 million, most can easily imagine what it would be like to earn an extra $100,000 a year. This fantasy might become an aspiration, and that aspiration brings with it the stress of knowing that "I am not there yet."

[1]Robert M. Sapolsky, "The Physiology and Pathophysiology of Unhappiness," *Well-Being: The Foundations of Hedonic Behavior*, edited by Daniel Kahneman, Edward Diener, and Norbert Schwarz (New York: Russell Sage Foundation, 1999):453–469.

Status seeking is good for us as a society because it spurs economic growth and innovation. But status seeking is also bad for us individually because it spurs stress as it separates winners from losers. Moreover, status is not fixed. Declines in relative wealth can be rapid, and status can drop even if wealth does not. An entrepreneur who brought her company public and netted $50 million is happy until she discovers that her rival netted $100 million. I remember an old story my mother told me about a man who complains to his rabbi that his house is much too small for him, his wife, and their many children. "Bring the goat inside the house," instructs the rabbi. The instruction makes no sense, but the rabbi is the rabbi. A week later, the man returns to the rabbi to complain that now the situation is intolerable. "Take the goat out of the house," instructs the rabbi. Suddenly, the house feels big.

Reasonable Benchmarks. The story of the man, the rabbi, and the goat is valuable to advisors because it addresses the concept of benchmarks. Advisors have to adjust the benchmarks, or aspirations, of their clients (and themselves). Whenever a client says, "Gee, I am not doing as well as Joe; Joe told me he invested in XYZ stock, and he has done so well," the advisor needs to change the benchmark of that client so that she can see how far she has come in her own investing. Remember that status and well-being can depend on one's position relative to other people as well as to one's own past and aspirations.

Benchmarks and aspirations need to be reasonable or stress will inevitably rise. My wife and I just finished renovating our home, a giant project. The other day, I realized that our new kitchen is bigger than the entire apartment we had as students. That apartment serves as a perfect benchmark. I say, "Relax some, Meir, you are doing okay."

Lessons of Behavioral Finance. Why do we humans behave the way we do? The answer is that the forces of evolution have designed us to behave this way. Our brains have evolved as our other organs have. The brain evolved to have modules that perform special tasks, just as the heart evolved to pump blood. For example, an important task of the brain is rapid recognition of facial expressions, knowing whether someone is happy, sad, angry, or threatening. This capability is hardwired because of its importance for human survival and reproduction. The same is true for status seeking. But not everything that is hardwired or "natural" is useful. Our brains do not develop as fast as our environment, and modules that helped us in past environments can hurt us in today's environment. Status seeking is crucial to survival in environments where food is scarce. High status in such environments brings sufficient food and other life necessities. But status seeking often backfires in environments where food and other necessities are plentiful. Now, people with $30 million are stressed because they aspire to $100 million, as if $100 million is as necessary for survival as a daily meal. Similarly, the learning tools embedded in the brain are imperfect, and we are subject to cognitive biases when such tools fail.

Hindsight bias nicely illustrates cognitive biases. Hindsight bias fools us into thinking that we have known the future all along when, in fact, we knew it only with hindsight. Consider Warren Buffett. "Oh yeah? What about Warren Buffett?" is a common response to anyone who suggests that beating the market is difficult. Buffett is indeed a genius. But did we know Buffett's genius with foresight, when it would have mattered, or did we know it only recently, with hindsight?

Warren Buffett's Berkshire Hathaway returns first appeared in the CRSP database in October 1976, so Jonathan Scheid and I used that date to begin a comparison of the returns of Berkshire Hathaway stock with the returns of other stocks.[2] If investors had put $1 into Berkshire Hathaway on October 31, 1976, they would have had $1,044 by December 31, 2000; if investors put that same $1 in the S&P 500 Index in October 1976, they would have had only $30 by December 2000. Indeed, Buffett did much better.

What would have happened to the price of Berkshire Hathaway's stock in 1976 if people had known then, with foresight, that Buffett was a genius? Undoubtedly, it would have zoomed higher in 1976, lowering returns for investors who bought Berkshire Hathaway stock later, in 1980 or 1985. In fact, what is amazing about Berkshire Hathaway stock is how gradually its price rose. This slow rise is an indication that people have come to know that Buffett is a genius only in hindsight, not in foresight.

What about foresight in other investments? Mylan Laboratories, a producer of generic drugs, performed better than Berkshire Hathaway in the 1976–2000 period; investors who had put $1 in Mylan Laboratories' stock would have earned $1,545 over that period. Did investors really know with foresight that Mylan Laboratories would do even better than Berkshire Hathaway? Home Depot also did better than Berkshire Hathaway, and in less time. Did investors really know it all along?

[2]Meir Statman and Jonathan Scheid, "Buffett in Foresight and Hindsight," *Financial Analysts Journal* (July/August 2002):11–18.

Hindsight misleads us about the past, and it makes us overconfident about the future. When we, as investors, look back and see how well we "predicted" the past, we are fooled into thinking that we can predict the future just as well. We become overconfident.

So, investors who were overconfident in their bullishness two years ago may be equally overconfident in their bearishness today. The mind-set of investors simply switches from "now we are going to have high returns forever" to "now we are going to have low returns forever." But hindsight is not foresight, and perfect knowledge of the past does not imply perfect knowledge of the future. Financial advisors must know the range of cognitive errors and use lessons, such as that illustrated by Berkshire Hathaway, to help investors overcome them.

■ *Rational versus normal.* Behavioral finance attempts to describe the investment decisions we humans make. We are neither irrational nor rational. We are normal—intelligent but fallible. We have brains, not computers, in our heads. We commit cognitive errors such as hindsight bias and overconfidence.

Consider normal behavior in the context of portfolio management and the mean–variance framework. Given the range of securities—from domestic stocks to derivatives to exchange traded funds—how do advisors think about the place of each security in a client's portfolio? The mean–variance framework assumes that investors are rational in the sense that they care only about the risk and expected return of their overall portfolios. So, investors should not look at stocks, bonds, and cash as individual components to help them achieve their personal and financial goals; rather, they should look at the overall relationships among the assets in their portfolios, and correlations between assets are paramount. But are we mean–variance investors?

Analyses of the brain, intelligence, and human behavior have taught those working in behavioral finance that investors are driven not so much by their attitudes toward return and risk but by their aspirations and fears. This predilection was noted long ago by Milton Friedman and Leonard Savage, who observed that people who buy insurance contracts often buy lottery tickets as well.[3] From a mean–variance perspective, lottery tickets are not only stupid; they violate all norms of rationality.[4] They have a negative expected return with high risk. But a

[3]Milton Friedman and Leonard J. Savage, "The Utility Analysis of Choices Involving Risk," *Journal of Political Economy* (August 1948):279–304.

[4]See also M. Statman, "Lottery Players/Stock Traders," *Financial Analysts Journal* (January/February 2002):14–21.

lottery ticket that costs a dollar gives us hope for an entire week. All week long, we can think about how to spend the $150 million jackpot we might win ("Oh boy, what I will do with that fortune!"). And by the way, the fun of playing the lottery is not always selfish. We often think of how we might spend our winnings on others. The desire to play the lottery might be irrational, but it is perfectly normal. Playing lotteries (within limits) contributes to our well-being.

■ *Mental accounting.* Humans—investors—care about upside potential, and lottery tickets provide it. Call options and aggressive growth mutual funds provide it as well. But while we are looking for upside potential, we are also looking for downside protection. When clients talk about risk, they are usually talking about the search for downside protection. And when they talk about returns, they are usually talking about the search for upside potential.

We tend to compartmentalize the assets we use for downside protection from the assets we use for upside potential. In the old days, many people kept their money for rent, furniture, groceries, and so on, in separate jars. Today, we have the same mental accounting approach to our various pools of assets. For example, T-bonds are viewed as assets suitable for downside protection (to avoid poverty), and high-flying assets—not long ago, Internet initial public offerings (IPOs) and hedge funds—are thought of, or mentally set aside, for upside potential. In behavioral portfolio theory, the old notion of the pyramid applies. People divide their money into layers; the bottom layer is designed for downside protection (e.g., U.S. T-bills), the middle is for steady wealth growth (e.g., U.S. T-bonds and Blue Chip stocks), and the uppermost layer (the next hot investment, whatever it is), is designed to provide upside potential.

Investment advisors tend to see themselves accordingly. For example, some advisors consider themselves conservative: "We are here to provide downside protection. We want to make sure that your retirement income is secure. If you want wild upside potential, take 5 percent of your wealth and go play with it yourself. You risk it; you lose it."

My mother understood the principles of mean–variance portfolios long before Harry Markowitz thought of them. When it came to food, she cared about two things: nutrition and cost. She had little patience for the presentation of the ingredients on the plate. She used to say, "It all mixes in the stomach." This description is a perfect representation of mean–variance theory. From the perspective of the stomach (portfolio), food (investments) is just bundles of nutrition (risk and expected returns). Who cares whether the bundle is called IBM, Amazon.com, or Philip Morris? But most people do care about how food looks, smells, and tastes, just as investors care about the identities of the securities in their portfolios. Most people do not want to be served a wonderful dessert that is ground up to look like it will in the stomach. And most investors do not want to have their securities ground up into a bland "index" portfolio.

Sometimes financial advisors become so enamored of means, variances, covariances, and the other paraphernalia of the mean–variance framework that they forget that portfolios must be palatable. But even my mother, who focused on cost and nutrition, paid some attention to the presentation of her meals. She knew the meals had to be appealing or else a child would not eat them. As investment advisors, we should follow her example. We have to focus on clients' fears and aspirations. We must give them downside protection and upside potential. We can use a mean–variance framework to assure that the portfolio makes sense as a whole, from the perspective of the stomach, but the portfolio must also appeal to the eyes, nose, and tongue. It must have distinct components—money for Johnny's education, retirement, and to keep alive the dream of riches.

■ *Regret.* Risk has so many definitions that without further clarification, the word is almost meaningless. One definition of risk is the possibility of not having enough for essential outlays. If that is risk, then people with $30 million face no risk. So, why are they afraid? The rich are not afraid of risk; they are afraid of loss of status, and they are afraid of regret.

Regret is what we feel when we realize that we could have sold all of our Nasdaq stocks at 5,000. Although risk is about looking forward, regret is about looking backward. Regret comes when we contemplate, with hindsight, what we could have done but did not.

Why do we feel regret? Evolutionary psychologists say it is a useful learning tool. When we observe our past actions and their outcomes, we learn what works and what does not. The painful kick of regret says, "You should not have done that. Don't do it again." The problem is that a learning tool that works so well in a highly predictable world does not work well in a world where randomness rules. For example, when we treat friends badly, we can anticipate the predictable consequences and know that we will regret our behavior. The anticipated regret usually serves as a deterrent. But regret often teaches us the wrong lesson in the stock market, where randomness and luck rule. We feel regret because we chose a stock that proceeded to crash when, in fact, we were simply unlucky.

Regret is associated with responsibility. Investors in the throes of regret often try to soothe the pain of regret by shifting responsibility to the nearest person. Often, this person is the advisor. "I didn't choose foreign stocks," say investors after foreign stocks post miserable returns, "My advisor chose them for me."

■ *Self-control.* The ability to learn self-control, like the ability to learn a language, is hardwired. But unlike language, self-control must be taught. Children may not be as eager to embrace self-control as they are to learn a language, but self-control has to be taught by parents because the ability to postpone pleasure is crucial for life. Advisors must extend the self-control lessons of parents.

Self-control is especially challenging for young or new investors, such as actors or athletes, who receive huge amounts of money at young ages. Investment advisors sometimes resort to drastic solutions, such as doling out an allowance to the client while keeping the bulk of the money under their control.

And lest one think self-control problems affect only young wealthy people, think about the rest of us. Social security, 401(k) plans, and IRAs—any pool of money that cannot be touched without penalty until some advanced age—are mechanisms to help us control the urge to spend.

But there is such a thing as too much self-control. Some clients need to be persuaded to spend more. Some people in their 70s and 80s insist on saving and feel financially insecure despite their $30 million portfolios. Advisors can help such clients relax the purse strings a little; a cruise around the world, for example, would not break the bank.

Wealth and Well-Being among the Very Wealthy. Some events in life bring a person both greater wealth and greater well-being. For example, Panel A of **Figure 1** shows the efficient frontier for an entrepreneur who just brought her company to market in an IPO. She has moved up the wealth axis and the well-being axis. She now has a greater amount of money and a greater sense of pride and achievement.

Once the wealthy (and the rest of us) are on the efficient frontier between wealth and well-being, however, they face trade-offs. They can have more well-being, but only if they deplete their wealth. Admiration enhances the well-being of the wealthy, but the wealthy we admire are the ones who contribute wealth to worthy causes. People admire Rockefeller and Carnegie for establishing the Rockefeller and Carnegie Foundations, not for making lots of money from oil or steel. As shown in Panel B of Figure 1, the wealthy can trade off wealth for well-being. When they donate their money to promote health in Africa or to support their alma mater, they lose wealth but gain well-being.

Not all wealthy people understand the trade-off between wealth and well-being, and not all accept that society does not owe them admiration, or even respect, just because they are wealthy. One potential outcome is the "angry affluents" phenomenon, where people conclude that "as rich as I am, I am not rich enough." Some angry affluents have been stung by insurance schemes or phony trusts set up to avoid taxes. The outcome of such schemes is rarely positive—either from a wealth or a well-being standpoint. Financial advisors can point out to angry affluents that they can reduce both their anger and their taxes by donating money to a cause they really want to support. They will lose some wealth but will gain well-being.

Some wealthy worry that they are not wealthy enough, but others worry that wealth takes a toll on themselves and their children. Parents who used to worry about not being able to pay for their children's college education instead worry about their children turning into spoiled brats. Again, financial advisors can help investors and their children see the benefits of balancing wealth with well-being and can create structures, such as family charitable foundations, that facilitate that balance.

Conclusion

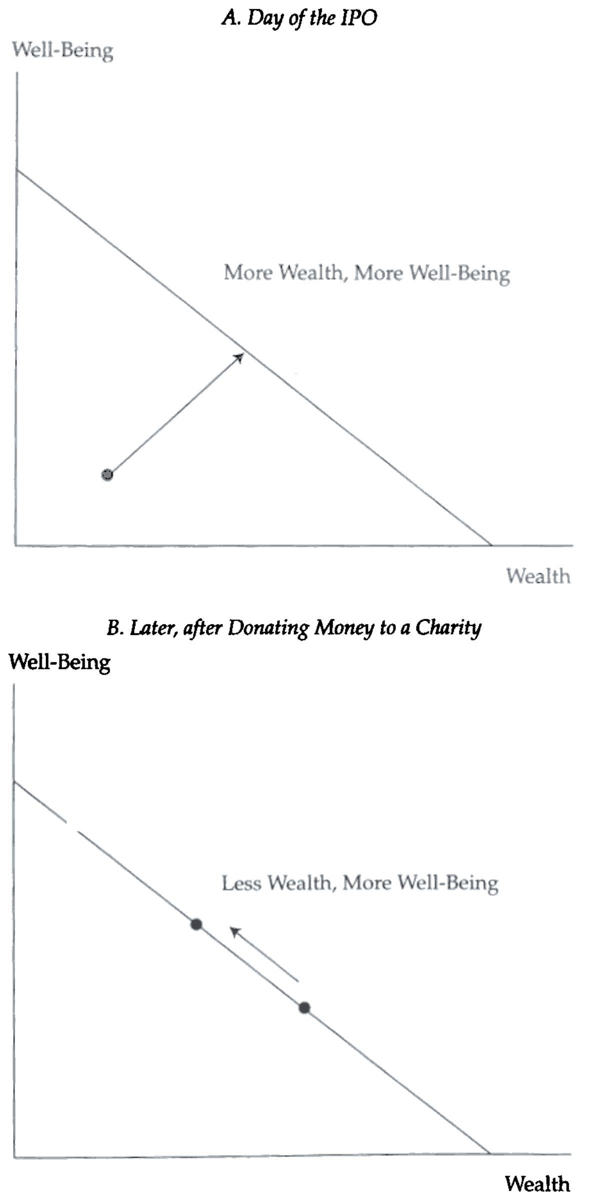
Conversations with clients often resemble the Gary Larson cartoon in which the man says to his dog, "Ginger, I have had it! Stay out of the garbage, Ginger. Understand, Ginger? Stay out of the garbage, or else!" And Ginger hears: "Blah blah blah, Ginger. Blah blah blah, Ginger. Blah blah blah, Ginger." Financial advisors say, "High returns cannot be guaranteed. No one can guarantee that high risk will bring high returns. No guarantee, you understand?" And clients hear: "Blah blah blah high returns. Blah blah blah no risk. Blah blah blah guaranteed!" Conversations with clients can be frustrating.

Remember that investing is about more than money. It is about reducing stress in an environment—the securities markets—that creates large amounts of stress. Advisors need to remember the story of the man, the rabbi, and the goat to maintain their perspective.

Follow the pattern of the physician: Ask, listen, diagnose, educate, and treat. Financial advisors who act as financial physicians combine the science of finance and securities with the ability to empathize with and guide clients—thinking not about risk and return but about investors' fears, aspirations, and the errors they are likely to make. Financial advisors promote wealth and well-being just as physicians promote health and well-being.

Life does not resemble the Olympic games, and there are better goals than being first at the finish line. Remind clients, "Who cares if your brother or sister has $31 million and you have only $30 million? You have more than you could possibly need for anything you might reasonably desire. If your desire to outrun your siblings is so strong that it causes you to collapse midway through the marathon called life, what good is $31 million? The real goal is to get to the finish line in one piece."

Figure 1. Wealth and Well-Being Efficient Frontier



Question and Answer Session

Meir Statman

Question: How are young investors different from old ones?

Statman: When we are young, competition drives our consumption habits. We want sports cars and other toys. Advisors must help investors regain self-control and reduce consumption. Advisors know that young people cannot live without toys altogether, but they must set savings structures so they can afford necessities, including cars, when they are older.

Older people have the opposite problem. Some become so good at self-control that they turn into misers. In *The Millionaire Next Door*, for example, the interviewer asks an older person about donating to charity, and the person responds, "I am my favorite charity."[1] Advisors must remind investors gently that life does not go on forever and help them give up some control—whether giving control of the family business to the next generation, giving money to charity, or learning to spend money on themselves.

Some people are too hot and need to be cooled off; other people are too cold and need to be warmed up. Such are the challenges that advisors face every day.

Question: Do you have any advice on how to overcome individuals' desire not to pay advisors their fees?

Statman: I think financial advisors have conditioned their clients to believe that financial advice is free. As financial advisors, you have encouraged the impression that you earn your fees by beating the market and the rest is a side benefit. I think the result is horrible because it puts undue pressure on you to beat the market when your real work is your work as financial physicians.

I do see some improvements. First, the move from transaction-based fees to asset-based fees is a step in the right direction, and second, there is nothing like a bear market to show people that they need financial physicians. The next step is for investment advisors to re-engineer the perception in the market that advisors are primarily market beaters; advisors need to teach plainly that they are promoters of both wealth and well-being, not just promoters of wealth.

In the heyday of the bull market I spoke to a group of financial advisors who asked, "How can we compete with the free advice being given on the radio, television, and Internet?" My answer drew on the analogy with physicians: You can get a lot of medical advice from the media also, but when you have a pain in your back, you see your own physician. If your physician says, "That pain is nothing, you just pulled a muscle, and it will go away in a day or two," you don't feel resentful about paying the physician's fee. You have gained the well-being that comes from knowing that the pain is not an indication of cancer and that you are not going to die soon. That information is a great service that is worth the fee.

Question: Money managers subject themselves to additional stress by ranking and comparing themselves with other money managers. Do you have any advice for helping to promote well-being within ourselves so that our personal well-being might flow through to our clients?

Statman: Money managers live with stress; teachers live with stress. Living without stress altogether is not only unrealistic but also probably not useful. The real question is whether we can bring it under control so that we can manage it.

The way to bring it under control is to put things in perspective and readjust our benchmarks. There are many benchmarks. One is relative to other money managers, another is relative to your prior year's performance, and another is relative to your aspirations. Think: "I cannot be number one all the time, first quartile is not that bad; yes, I lagged the market, but I did better than my peers; well, I didn't do as well as my peers, but my wife loves me."

Controlling stress and encouraging well-being depend on identifying the kind of race you are running. If you see yourself as racing against the market, then you are in a tough race. But if you see yourself as a financial physician to clients, then your race is easier to win and a happier one to run.

[1]Thomas J. Stanley and William D. Danko, *The Millionaire Next Door: The Surprising Secrets of America's Wealthy* (Thorndike, ME: G.K. Hall, 1999).