WHAT ARE INVESTMENT ADVISORS PAID FOR?
THE SHEFRIN-STATMAN AND COMPETING VIEWS

Werner F.M. De Bondt

THREE PARADOXES

Puzzling but true! The great majority of individual participants and institutional players in the stock market continue to believe that they can benefit from professional investment advice. At one end of the spectrum, eccentric stock market gurus such as Joe Granville or Robert Prechter continue to rise and fall in the public's respect and admiration. At the other, more traditional end, portfolio management firms flourish and are notorious for lucrative fees and generous salaries. For instance, in 1986, mutual funds earned $4 billion in loads. Yet, there is surprisingly little scientific evidence that either the industry or the gurus can consistently deliver upon their promises. Security analysts' earnings forecasts are known to be very imprecise and only marginally superior to naive time-series forecasts (for a literature review, see Givoly and Lakonishok 1984). Economists' expectations of macroeconomic variables as fundamental as GNP-growth or inflation appear to be very noisy and to contain predictable errors (Ahlers and Lakonishok 1980; Brown and Matal 1981). Most troubling of all, virtually no studies have shown that professionally managed portfolios systematically outperform randomly selected portfolios.
For the year 1988 (through November 30), 1,200 stock managers posted returns averaging 12.8%, compared with a return of 14.3% for the S&P 500-stock index. Only 39% of the managers beat the index.1 Maybe Burton Malkiel was right to describe financial forecasting as "a science that makes astrology look respectable" (1985, p. 152). So, the question arises: why do investors continue to pay attention? Why, for example, if investment skill is such a rare commodity, does fund growth so much depend on short-term fund performance? This is the first paradox.

There exists a second paradox, which is related to the first. Until recently, it was thought that changes in stock prices are approximately random because financial markets are efficient: prices quickly and correctly absorb all available information. But we now know that stock returns are far more predictable than it was commonly believed just a few years ago. There are distinct seasonal patterns in prices (for a review, see Lakonishok and Smidt 1989). In addition, there may be systematic disparities between value and price. "Average experience" indicated to Benjamin Graham that the time required "for a substantial undervaluation to correct itself" was approximately 1 1/2 to 2 1/2 years" (1959, p. 37). Consistent with Graham's bold claim, Richard Thaler and 1 (1985) found predictable reversals in the returns of 3- to 5-year prior winners and losers. An arbitrage strategy that buys losers by selling winners short earns average annual returns ranging between 5 and 8%.

Based on long historical series of stock market indices, Fama and French (1988) and Poterba and Summers (1988) also report mean reversion, both in the United States and overseas. Fama and French (1987) further observe that two- to four-year stock (and bond) returns are quite predictable from a market dividend-yield variable, the slope of the term structure of interest rates, and a default premium that is similar to the yield difference between investment-grade and junk bonds. Surprisingly, in some cases, the regression R-squares, which increase with the return horizon, grow as large as 60%! Expected returns on equity are high when the market-wide dividend-yield and the premium on junk bonds are high. This happens at business cycle troughs, that is, toward the end of periods with low growth in GNP and falling inflation. Expected returns are low (and sometimes negative) around business cycle peaks. Standard finance theory would argue that the predictably time-varying returns merely reflect fair compensation for rational time-varying risk. A simple, perhaps more plausible, explanation is that these returns would also occur if the typical investor is too optimistic in bull markets and too pessimistic in bear markets. Past movements in odd-lot short sales definitely indicate that small investors tend to be consistently wrong at market extremes. But, if there are market inefficiencies, why do portfolio managers not take advantage of these opportunities, eventually turning contrarian strategies useless? Clearly, the forecastability of stock returns should have allowed portfolio managers to beat the averages. Competition among managers should also have moderated any discernible patterns in prices. But neither prediction has come true. For example, the January effect has persisted during the 1980s. This is the second paradox.

There exists a third paradox, which is related to the second and the first. Many managers and their client sponsors follow investment strategies and trading practices which add to market volatility and inefficiency. Consider, for example, how almost all of the seasonal anomalies (turn-of-the-year, of-the-quarter, of-the-month, of-the-week) are associated with calendar time transitions. These are times when it would be natural to revise one's portfolio. The return patterns suggest a combination of portfolio rebalancing price pressure effects, institutional frictions, and, possibly, "herd behavior" by major groups of investors. Second, money managers are often said to be susceptible to fads. They are accused of targeting their purchases toward "story stocks." The survey evidence of Pound and Shiller (1987) confirms that institutional investors who hold high P/E "winner" stocks differ from other investors in a number of respects. Growth potential and near-term earnings prospects carry much more weight with these institutions. Consistent with fad and bubble models in economics, many investors build their holdings gradually as prices rise. Less often than other traders, they plan to sell if share prices were to increase further. But, when confronted with a short-term disappointment, they are more inclined to sell abruptly. This behavior is bound to increase the market's volatility. If prices eventually drift back to fundamentals, the institutions' "overreaction" to short-term earnings trends may explain the mean reversion in stock prices (De Bondt and Thaler 1989). Finally, consider the behavior of clients. Plan sponsors select their advisers partly on the basis of observed track records. Even though short-term market fluctuations are predominantly random, these methods lead clients to seek out the same successful advisers and "to act in blocks" (Denton 1985). Again, the potential for market instability and misvaluation increases. From all the above arguments I conclude, paradoxically, that standard business practices may well generate (or, at least, accentuate) the anomalous profit opportunities in stock returns which, as a group, portfolio managers attempt but are unable to exploit.

Clearly, to some readers, the above characterization of the security analysis and money management industry will seem extreme. The opinion of many on Wall Street is that professional advice is becoming more skillful and sophisticated all the time and that, in comparison, the individual investor scarcely has a chance. I do not completely discount this viewpoint because I admit that it remains a difficult exercise, even in theory, to distinguish between luck and skill (or superior information). Performance evaluation is beset by well-known conceptual (see, e.g., Dybvig and Ross 1985a; 1985b; and Admati et al. 1986) and measurement problems (see, e.g., Roll 1978 and Lehmann and Modest 1987). As pointed out by Verrecchia (1980), it is even wrong to assume that, on average, risk-averse "superior" investors will always achieve greater returns than uninformed or poorly skilled investors. I also admit that some
advisers deliver obvious services to their clients. Consider mutual funds: (1) they offer a well-diversified portfolio, possibly tracking a well-known index or aiming at a specific pay-off pattern; (2) they repackage less-liquid securities into a portfolio that is always marketable; and (3) they provide custodial care and perform clerical duties. However, while these and other financial services matter to small individual investors, they are not as valuable to billion-dollar pension funds, endowments, and other institutional investors who, if they so choose, could easily replicate the services in-house. Thus, the challenge of explaining the above paradoxes remains. Surely, in recent years, index funds have become much more important as investment media. Even though estimates differ, in 1987, between 200 and 400 billion dollars were held in funds modeled on the S&P 500. Nevertheless, selection and-timing “active” management strategies continue to dominate. How can we rationalize their popularity or even their survival? Below, I will argue that the inherent ambiguity of stock value and investor psychology are major, if little explored, reasons. In addition, I tie in my perspective with the economic theory of agency relationships and with the changing face of American financial markets. Some of the psychological arguments—especially on responsibility shifting and the difficulty of distinguishing between luck and skill—have also been emphasized by Shefrin and Statman (1986, 1987, 1988) and Statman (1986) in previous work. In order to give due credit to these authors, I choose to refer to their arguments as the “Shefrin-Statman view.”

THE ECONOMICS AND PSYCHOLOGY OF INVESTMENT ADVICE

It has long been recognized that investing in the stock market is a social activity and that style, fashion, and other “irrational” elements in crowd behavior may be important to understand the movements of prices. However, there is only meager systematic empirical research on investor psychology. The topic gets most attention in volatile markets or immediately after a steep market decline. Of course, crashes occur rather infrequently and it is often tempting to explain these momentous events in terms of unique historical circumstances. We have no general theory of market panics. On the other hand, if we want to learn about investor psychology, the study of crashes may well be most productive. Since the debacle typically occurs suddenly, economic and institutional factors remain (by comparison) more or less unchanged. From a practical viewpoint, crashes are about the only times that vivid descriptions of traders’ beliefs, concerns, and emotions become widely available. I therefore start my discussion with some survey evidence collected by Robert Shiller (1987) after the crash of October 1987. I use the findings to illustrate more generally how investors trade stocks.

Investment versus Speculation

Shiller contacted random samples of institutional and active high-income individual investors. He received nearly 1,000 responses. Perhaps the most interesting finding from all the surveys is that there was no single identifiable news story on investors’ minds, either on October 19 or at the time of other major stock market drops. From a list of eleven news items, occurring just before or during trading hours on the 19th, both individual and institutional investors picked what was happening in the market itself, the 200 point drop during the morning of October 19, as the most important event. The answers suggest throughout that people were more reacting to unfolding market developments than to news about fundamentals. On that fateful day, the average institutional (individual) investor discussed the events with 19.7 (7.4) other people and checked market prices 35.0 (3.2) times. Many institutional investors claimed to be checking prices “continuously,” with 43.1% reporting either sweaty palms, tightness in the chest, irritability or rapid pulse. About 28% (48% of the buyers on October 19) expected a price rebound. Most thought of the sheer magnitude of the decline as a good enough reason to predict such a reversal. Even though investors made few references to fundamentals in explaining the crash, a high (72%) of the institutional (individual) investors remembered that they “had a sense that the market was overpriced” about a week before the crash, around October 12. However, only 22% remembered being more “bullish and optimistic” than other market participants around that time. Given that 72.5% (90.1%) of the investors did not cut their stock holdings between October 12 and 19, it appears that the perceived price-value discrepancy did not dissuade them from investing into stocks.

In summary, Shiller’s survey evidence indicates that, during the crash, market participants acted more like speculators than they did like “true investors.” Their main concern was with changing market conditions in the near term, rather than with changing business conditions in the long term. Their anxiety had more to do with the drop in prices (and the need to stem losses) than with the opportunity to pick up bargains. Even in the midst of this sudden collapse, many traders continued to believe for “technical” reasons that price movements were somewhat predictable.

There are many reasons to think that investors’ behavior on October 19 was not fundamentally different from what it has been on any other day for some time. One reason is the explosion in trading volume. Even though, in nominal terms, stock prices in mid 1982 were at about the same level as in 1976, volume on the New York Stock Exchange (NYSE) more than doubled. By 1987, annual market-wide trading costs for S&P 500 companies roughly equaled the amount of all new stock issues during the year or, from a different perspective, about 17.6% of the annual earnings reported by the companies in the S&P index (Lowenstein 1988, pp. 80-87). Hyperactive trading is but one symptom of a
speculative approach towards investment. It reveals the “action-bias” of portfolio managers and their emphasis on continuous monitoring of very short-term results. Based on written surveys and some interviews, Wood (1988) concludes that “activity for activity’s sake, no matter how counterproductive (…) is clearly an outstanding feature of money management.” One respondent said, “The hardest decision is to do nothing” (p. 63).

Regret and the Ambiguity of Stock Value

I believe that the trading behavior of money managers, as well as the paradoxes described earlier, ultimately derive from the ambiguity of stock value. Investors are faced with profound uncertainty. “Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible” (Keynes 1936, p. 149). Since there is no objective way of predicting future stock prices, return perceptions, like changing fashions, oftentimes follow the prevailing social consensus. Fashion permeates our everyday life. Shiller (1984) discusses the current fashion of running for exercise. The health benefits of running were known decades ago. Yet, why wasn’t the joy of running as much appreciated at that time?

The prices of speculative assets represent average opinion but, as investors are painfully aware, average opinion may change. Therefore, in trading stocks, investors imagine not only the consequences they might experience as a result of the action chosen, but also each consequence compares with what they would have experienced had they chosen differently. This is the central idea behind the theory of psychological regret.10 Regret and its positive counterpart, pride, come with responsibility. Actions taken under duress generate little regret. Regret can be minimized by the knowledge that, under the circumstances, one acted in a prudent manner. People not only have a constant need to make sense of the world around them (“creeping determinism”), they want to understand themselves and to be able to rationalize what they do (Hogarth 1987, Chapters 1 and 2). Typically, this attitude makes it easier to act in a conventional way than to be innovative. No money manager ever got fired for adding IBM to his client’s portfolio (Arnott 1983)! Hard logical thinking, and the development of extensive rationales for a course of action (e.g., an investment “theme”), represent other methods to alleviate a sense of personal blame: “I failed but, at least, I did competent work. I tried my best.”

Finally, investors may attempt to buy peace of mind by delegating the decision to an outside advisor, a professional who offers real or imaginary insights for a hefty fee.

The observation that fund administrators prefer to shift the responsibility for uncertain investment decisions to outsiders is of central importance to the nature of the money management business. It has been suggested earlier by Shefrin and Statman (1987, 1988). Since the stock market is so volatile, portfolio management can be a nerve-wracking and deeply unsettling activity. The ex ante knowledge that one is likely to regret decisions which are still to be made induces a psychic cost which is most easily eliminated by choosing not to make these decisions at all. Thus, investors hire advisors. Notice that, if the money manager performs poorly, he can serve as a “scapegoat” (Statman 1986). The investor, on the other hand, easily maintains his self-image as a “reasonable and prudent” individual. All he needs to do is to switch his loyalty to one or more new advisers! “Choosing not the choose” is discussed by Thaler (1980). It applies in many different contexts. Individuals often voluntarily restrict their own choice set, for example, when they pay to join a smoking clinic or a “fat farm.” Among other phenomena, choosing not to choose explains the popularity of no-deductible (zero marginal cost) health insurance. Most consumers find decisions involving tradeoffs between health care and money distasteful because there is potential for regret either way. However, consumers avoid these tradeoffs if all health care is prepaid.

The Rise of Institutional Investors

Regret and responsibility shifting are important but only partial explanations for the success of the investment advisory industry. The arguments rationalize the industry’s existence but not its spectacular growth during the last few decades. There can be little doubt that money managers have greatly benefited from the rise of institutions to dominance in equity trading.11 As discussed by Friedman (1980), the growing importance of institutional investors is part of a broad postwar trend of increasing financial intermediation in the United States. The direct equity holdings of investors have steadily fallen; on the other hand, the value of indirect holdings has risen and it is spread among more American families. Daily price movements in the stock market may now matter to the economic well-being of as many as 160 million people.

Investment consultants have gained from the advance of financial intermediation in two ways. Both arguments complement the Shefrin-Statman view of investment advice. First, irrespective of whether fund administrators and trustees anticipate personal regret about difficult portfolio choices, they operate under “the prudent man” rule. Perhaps as a consequence, most institutional investors have a preference towards conservative investment strategies (Lowry 1984).12 Federal law (e.g., the 1974 Employee Retirement Income Security Act [ERISA] and state regulations reinforce conservative investment policies and fiduciary integrity. For example, ERISA requires that private pension portfolios be diversified to minimize risk. Now that the litigation crisis has also hit money management, hiring outside professional advisers helps fund trustees to rationalize portfolio performance to interested parties.
Secondly, the introduction of a third party that is legally separate moderates possible agency conflicts between the board of trustees and the ultimate fund owners. Here I follow the theory of Fama and Jensen (1983) and earlier work by Williamson (1983) in how specialized governance structures arise in response to the efficiency needs of different types of private organizations. It is also consistent with Shapiro’s (1987) sociological discussion of “the social control of impersonal trust.” Fama and Jensen specifically propose that the separation of the risk bearing and the ongoing operating management functions should lead to the further separation of decision management from decision control. This second separation is reflected in the traditional concern of auditors with the allocation of responsibilities to different agents. For example, the employee with responsibility for billing should have no role in recording customer payments. Even though for financial mutuals with redeemable claims the boards are “less important in the control process” (Fama and Jensen 1983, p. 316), it seems clear that the checks and balances of a decision system with separate outside management protects residual claimants against excessive perk consumption or outright theft and fraud. Notice that this “agency cost” argument helps to explain why even funds which follow passive index-strategies still hire professional money managers.

Luck versus Skill

Of course, in many cases, advice is sold in addition to management. This should not wholly surprise us in view of the knowledge and information gap between portfolio managers and clients. Many clients are not familiar with the latest financial innovations. They do not have instant access to new information. They do not have a trading desk that allows them, at low cost, to take immediate advantage of opportunities. The investment advisors, on the other hand, have considerable organizational capital; an image of expertise that builds upon promising investment strategies, an army of security analysts and, possibly, the association with research done at well-known universities.

To repeat my earlier discussion, however, the evidence suggests that the availability of these resources may be irrelevant and that it does not guarantee investment success. Nevertheless, since luck and skill are difficult to tell apart, it is still possible that some managers are able to achieve such success! We simply cannot be sure. Thus, it remains reasonable to hire advisors, especially if one hires several. In effect, the client holds a diversified portfolio that is tilted towards “credible” investment strategies.

There are a series of psychological reasons which also push investors toward buying advice. One reason is that there will always be some managers with exceptional performance records. This happens by chance (as long as we have a large enough number of advisors) but it is difficult to recognize. A second reason to rely on outside advice is cognitive dissonance. Over time, investors may want to believe that the product they buy is valuable. A third reason is that people often tend to see patterns where there is only randomness (see, again, Shefrin and Statman 1987, 1988). Gilovich, Varrone, and Tversky (1985) consider “streak shooting” in basketball. Apparently, an NBA superstar such as Larry Bird or Keven McHale is no more likely to sink his next basket when he is in a streak than when he is not. Yet, most fans and coaches believe that a series of successful shots without a miss is due to a “hot hand.” Cognitive errors like these probably appear in financial contexts as well. Roberts (1959) relies on them to explain the survival of technical analysis. It just seems like there are patterns in stock prices, waiting to be put to good use. Why do people not learn? There are many causes. They are the topic of the “heuristics and biases” literature in cognitive psychology (for extensive surveys, see Hogarth 1987; and Kahneman, Slovic, and Tversky 1982). One cause is hindsight bias. Once it has happened, people think about the past as inevitable (Fischhoff 1975). Another is that we often experience an “illusion of control” over pure chance events (Langer 1975). For example, most gamblers shake the dice harder when they want high numbers.

In sum, it is easy for investment fund administrators to convince themselves that outside advice is truly valuable and adds wealth. In any case, the business relationships with money managers are not built on blind faith. They are overwhelmingly governed by prudence. Most clients “consume” long professional presentations that rationalize possibly superior strategies. They hire several managers. Increasingly, they insist on incentive fees. They evaluate portfolio performance at regular short-term intervals (monthly quarterly). Whenever it is deemed necessary, they replace managers who underperform and they redirect funds to new advisers.

Money Managers, Trading Volume, and Stock Prices

The nature of the business relationship that I have described has clear consequences for the behavior of money managers. Just like clients easily imagine poor performance, so do advisers easily anticipate the regret of losing accounts. Apart from picking stocks that appreciate quickly in value, what other less hazardous means are available to these firms to “signal” competence? Some were mentioned before: the elegant presentation of well-developed investment ideas, hard work, and the reputation that comes with the firm’s name recognition and its employment of celebrated analysts. There are at least two more very important methods: one is to invest in conventional, fashionable stocks; the other, to avoid a performance ranking that is low relative to the competition. What do these policies imply for financial markets and the money management advisory industry?
CONCLUSION

In this paper, I have discussed differing, though not mutually exclusive, views of the role of professional investment advisors. The success of the investment advisory industry seems paradoxical given the limited empirical evidence that money managers can add value. Several interpretations of the reasons for this success appear in the work of Shefrin and Statman (1987, 1988). My own view partly overlaps with Shefrin and Statman but also follows quite naturally from the institutions' emergence as the dominant players in the stock market. The value of equity is fundamentally ambiguous, a somber fact of life which is unsettling for any investor. However, the law encourages fund administrators to be prudent trustees. As a result, they "choose not to choose." Also, personally, they avoid the psychic cost of possible regret by shifting responsibility to outside advisers. Hiring outside managers partly resolves possible agency conflicts between a fund's board and its ultimate owners. In addition, to delegate responsibility is reasonable in view of the enormous knowledge and information gap between clients and advisers.

The gap may be as much illusion as it is reality. It is in practice impossible to truly distinguish luck from skill. Instead, clients are forced to judge advisor competence, which is almost as difficult. Fortunately, there are proxy variables: the logic and creativity of the manager's investment ideas, his reputation for "smarts" and, most importantly, his track record and portfolio performance ranking. However, less fortunately also, advisers "game" these proxy variables, which encourages slick brochures, overpaid star analysts, fashion investing, window dressing, and hyperactive trading. It discourages contrarian and value-based strategies. As long as the interests of money managers and their clients are not perfectly aligned, some of the managers' actions are likely to hurt portfolio performance. The design of better contracts (e.g., incentive fees) is limited in what it can do to remedy the situation (see Baiman 1982).

Is there any way out of this quandary? Maybe there is no need, as long as portfolio managers "pay their own way" and are perceived by clients to be worth the fees they generate. On the other hand, from the perspective of societal welfare, the explosion in trading is difficult to justify. There are no easy solutions. Recently, many institutions have chosen for the buy-and-hold simplicity of indexing. It is estimated that between 30 and 40% of institutional funds available for stock investment are now indexed. Indexing is like shifting responsibility even one step further. If institutions abdicate their role as business owners and just buy the companies in the S&P 500 without any analysis of fundamentals, it is certain that attractive investment opportunities will open up for those who can spot them (Grossman and Stiglitz 1980).
ACKNOWLEDGMENTS

I thank John Guerard of Drexel Burnham Lambert, Inc. for encouraging me to write this paper. I also thank the reviewers, Amos Tversky of Stanford University and David Baker of Clemente Capital, Inc. Terry Amburgey, Mary Bange, William Barnett, Mark Fedenia, Anne Miner, Richard Thaler, and especially Hersh Shefrin and Meir Statman provided many helpful comments. I gratefully acknowledge financial support from the School of Business at the University of Wisconsin-Madison.

NOTES

1. This poor performance is not atypical. Each year between 1983 and 1987, roughly two-thirds of all active managers underperformed the S&P 500 (Wallace 1988). A classic article on the failure of mutual funds to earn excess returns is Jensen (1968). Ippolito and Turner (1987) study the performance of about 1,500 private pension plans over the 1977-1983 period. Trading in the stock portion of pension portfolios is inefficient in the sense that the superior performance (gross of expenses) is not high enough to offset the additional fees. Dimson and Marsh (1984) review the literature on stock recommendations by brokers and advisory services. Overall, the evidence indicates "a small but potentially useful degree of forecasting ability" (p. 1262). Dimson and Marsh's own work reaches the same conclusion. But it remains unclear whether the information is worth the extra commissions paid by investors. Differences in forecasting ability between brokers do not persist over time. Elton, Gruber, and Grossman (1986) examine the information content in buy, hold, and sell recommendations collected from 33 brokerage firms. Moderate excess returns can be earned by acting on changes in recommendations. No brokerage firm has a list of recommended stocks that is consistently better than any other firm. Copeland and Myers (1982) study the Value Line Investment Survey. They conclude that the recommendations have predictive power. However, the size of the abnormal performance "does not indicate a gross market inefficiency" (1982, p. 319). Stiglitz (1985) finds that Value Line rank changes also have information content. Again, the potential for abnormal profits is small. Dimson and Marsh (1986) study the 2-year performance of 862 press recommendations in the United Kingdom. Tipsters exhibit no evidence of stock selection skills, once the size effect is taken into account. Givoly and Lakonishok (1979) find that market reaction to the revisions in analysts' forecasts of earnings per share (EPS) collected from Standard & Poor's Earnings Forecaster is slow and gives rise to potential abnormal profits to astute investors. On the other hand, Elton and Gruber (1981) show that the market is efficient with respect to IBES forecasts of EPS.

As pointed out to me by David Baker, the above evidence, mostly based on data available to the public (and to academic research), does not exclude the possibility that money management firms know of valid investment strategies which they keep secret.

2. Extreme price movements measured over short periods (say, between one day and one month) also tend to reverse themselves. For a review of the literature on stock price reversals, see De Bondt and Thaler (1989).

3. If there are not, what is one to conclude from the fact that advisory sentiment trails the market, with the majority of advisors bullish at market tops, and bearish at market bottoms (Drexman 1982, pp. 12-16)? The bearish sentiment index—the ratio of the number of investment advisers who are bearish to the total number of advisers—clearly follows the market, say, as measured by changes in the Dow Jones Industrial Average (DJIA). However, conditional on the sentiment index, future changes in DJIA are random. See Solt and Statman (1988). A second contrarian indicator is the ratio of mutual funds cash to assets. The ratio is low at market peaks and high at market troughs (Ranson and Shipman 1981).

4. For example, Ritter (1988) finds that the ratio of stock purchases to sales by individual investors displays a seasonal pattern. The ratio is below normal in late December and above normal in early January. Between 1971 and 1985, year-to-year variation in the ratio explains almost half of the year-to-year variation in the January effect.

5. Of course, if the services cannot be replicated at competitive cost (say, because of monopoly access to information or economies of scale in the expert design of portfolios with specific payoff patterns), this creates demand for investment consultants. The argument explains the existence of investment "boutiques" which focus their research efforts on selected industries, specific investment styles, or particular geographical regions.

6. Remember, e.g., Galbraith's (1955) famous account of the 1929 crash or, much earlier, the tragicomic events, chronicled by Mackay (1841), relating to the Dutch Tulip Mania (1630-1638), the South Sea Bubble (1711), and the Mississippi Company (1716-1720).

7. Before sending out the main survey, Shiller had completed four pilot questionnaires, two of which relate to the prior week of October 14-16. My discussion refers to all the survey work.

8. In a May 1958 address to the National Federation of Financial Analysts Societies, Benjamin Graham discussed "the older ideas of common-stock investment" which persisted "until the bull market of the 1920s." Graham distinguishes between the older ("exogenous") and newer ("endogenous") speculation in common stocks. "In the past the speculative elements...resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation's individual set-up. Those elements of speculation still exist, of course... But...a new and major element of speculation has been introduced into the common stock arena from outside the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly our security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations..." This attitude obliterates a good part of the older, well-established distinctions between investment and speculation" (1959, p. 273-274).

8. It is difficult to rationalize the increased trading activity otherwise. Of course, much of it is attributable to the growth of institutional portfolios. For example, mid 1987, the stock portion of mutual fund portfolios was valued at approximately $250 billion, a fourfold increase since the end of 1982. However, turnover has risen also. The annual turnover rate on the New York Stock Exchange was 12% in 1960, 36% in 1980, and 64% in 1986 (Lowenstein 1988, p. 67). For large NYSE-listed companies, average daily turnover rates on days of earnings announcements now are close to 25%. Berkowitz and Logue (1987) consider four hypotheses: (1) over the years, the number of attractive investment opportunities has increased; (2) managers revise their portfolios more frequently because trading costs have decreased after May 1, 1975, the end of fixed stock brokerage commission rates; (3) managers often compensate their well-known dollar amount of "directed" brokerage commissions; (4) the larger turnover in stocks is related to the growth of the option and futures markets and to innovations like program trading or portfolio insurance. Berkowitz and Logue's empirical work concentrates on the first two hypotheses. The results appear to contradict (1) but they are consistent with (2).

10. See, for example, Loomes and Sugden (1982). Regret theory is part of a broader literature (surrounded by Schmeiser 1982) that has developed in response to a growing body of experimental evidence showing that most people systematically violate the axioms of expected utility theory. Regret aversion differs from risk aversion, as an example (based on Shefrin and Statman 1986) shows. Consider Mrs. X who has been choosing the same number in a state lottery for 142 weeks with absolutely no success. Now imagine that she decides to try a different number only to learn that had she played her original number she would have won $1 million. How does she feel? Note that any two numbers have the same chance at winning (i.e., the same risk). Therefore, a switch does not change the level of regret.

11. Notice that the desire to appear prudent and reasonable in one's investment decisions may explain why so many people resist the efficient markets "dart-throwing" approach.
12. For instance, between 1940 and 1980, private pension funds mushroomed from 2.4 billion to over $400 billion (Munnell 1982, p. 114). Pension funds and other institutional investors now own approximately two-fifths of the value of the stocks on the NYSE. They are responsible for about four-fifths of the trading.

13. In a discussion of portfolio insurance techniques, Bennings and Blume (1985) relate the following story. "One major corporation known to the authors has set as one of its objectives in managing its pension fund that in the next ten years there should be virtually no possibility that the total return on the fund be less than zero. The rationale... stems from the Chairman's view that it is imprudent to spend principal" (p. 151).

14. In November 1985, the SEC adopted a new rule that permits investment advisers to charge fees based on the sharing of capital appreciation in client accounts. Incentive fees tie managers’ compensation more directly to skill. Traditionally, performance fees either equal a fixed dollar sum or are a percentage of the market value of assets under management, the amount of the fee varying with this value. See Grinolds and Rudd (1987) and other papers in the January-February 1987 issue of the Financial Analysts Journal.

15. To do otherwise is impractical, since it takes data worth decades to conclusively distinguish luck from skill. Portfolio evaluation at short intervals is also sensible because many companies want immediate investment success in order to reduce their pension contributions and to push up earnings. Another familiar rationale is impatience: "...life is not long enough; human nature desires quick results, their is a peculiar zest in making money quickly, and remote gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and overexacting to anyone who is entirely exempt from the gambling instinct" (Keynes 1936, p. 157).

16. Wood’s (1988) survey evidence indicates that “managers want to have a clear path of reasoning to show clients ... For information to be useful for client decisions, it must present a very formal, convincing pattern. Everything must tie together in the scheme of things” (pp. 64-65). Interestingly, Wood reports that managers do not require such discipline with respect to their own investment decisions.

17. In a recent “Heard On the Street”—column in the Wall Street Journal (January 10, 1989), Linda Sandler discusses the changing fortunes of Martin Sonsoff, “a former highflier who at his mid-1987 peak ran $5.4 billion.” After a period of dismal performance, he now manages about $2.1 billion. Ms. Sandler observes: “Some feel that Mr. Sonsoff may have lost some of his competitive fire. “He has a villa in the south of France with a tennis court and vineyards, and he goes there all summer,” says one acquaintance. (Mr. Sonsoff says), “I go to France exactly 10 days at a time in June, July and August. I’ve never worked harder in my life. I love what I do, and my ego is involved in the business.”

18. Of course, fashion can take virtually any shape or form. For example, institutional investors now play a big role in takeover financing and the junk bond market even though, to many observers, the risks seem substantial. Initial public offerings (IPOs) of stock in what are perceived to be “growth” companies also get the institutions’ attention. Markel jokes that between 1959 and 1961 almost every IPO was successful (i.e., underpriced at issuance) so long as the company’s name “included some garbled version of the word ‘electronics”’ (1985, p. 50). However, by 1962, most of the IPOs were selling far below the offering price and many professionals had suffered heavy losses. Ritter (1988) studies 1503 firms that went public between 1975 and 1984. The average initial return is about 14% but the long-run performance differs widely by industry. Most stocks underperform. This evidence is consistent with both an investor overreaction and the relevance of fashion in the stock market. At the time that the stock market trading in the secondary market, investors seem overly optimistic that the company can achieve high profits.

19. A 1975 amendment to the Securities Act of 1934 requires institutional investors with over $100 million of assets to disclose their end-of-the-quarter holdings in public filings. However, the investors do not have to disclose when they purchased the assets in the portfolio. This allows them to time trades so that the official filings show holdings patterns that match their clients’ preferences.

20. Keynes believed that, in order to be a successful investor, one needs to be a contrarian. However, “...it is the long-term investor... who will in practice come in for most criticism, whereas investment funds are managed by committees or boards or banks. For it is the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion... Dairy wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally” (1936, pp. 157-158). To the extent that social pressure keeps investors from buying unconventional stocks, the expected return on investments in these companies rises.

REFERENCES