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# JOIM CONFERENCE SERIES MARCH 11–13, 2018/UCLA CAMPUS BEHAVIORAL FINANCE CO-SPONSORED WITH MASTER OF FINANCIAL ENGINEERING PROGRAM (MFE) UCLA ANDERSON SCHOOL OF MANAGEMENT

## CONFERENCE SUMMARIES

**Andrew Lo**
Massachusetts Institute of Technology
*Keynote Speaker*

**Meir Statman**
Santa Clara University
*A Second Generation Behavioral Finance*

Discussant: Donald Bennyhoff, Vanguard

The first generation of behavioral finance, starting in the early 1980s, largely accepted standard finance's notion of people's wants as "rational" wants—mainly high expected returns and low risk. That first generation commonly described people as "irrational" – misled by cognitive and emotional errors on their way to their rational wants.

The second generation, presented in Statman's Finance for Normal People (Oxford University Press, 2017), describes people as "normal", neither "rational" nor "irrational". Normal people are people like you and me. Each of us has wants – hope for riches, freedom from poverty, nurturing children and families, being true to values, gaining high social status, playing games and winning, and more. We apply knowledge and cognitive and emotional shortcuts as we pursue our wants. Sometimes, however, we are diverted from our wants by ignorance and cognitive and emotional errors. Our wants, even more than our knowledge, ignorance, and cognitive and emotional shortcuts and errors, underlie answers to important questions of finance, including portfolio construction, saving and spending, asset pricing, and market efficiency.

**Hersh Shefrin**
Santa Clara University
*Analysts' Fundamental Error in the Computation of Fundamental Value*

Discussant: Sharon Hill, Macquarie Investment Management

Discounted free cash flow analysis is the primary methodology for computing the fundamental value of a stock. Sell side analysts who employ discounted free cash flow analysis to establish target prices are vulnerable to making biased valuation judgments. The bias in question is call "growth opportunities bias", (GOB) which occurs when a firm is expected to earn a rate of return that is different from, and usually exceeds, its cost of capital during the terminal horizon. This paper illustrates the magnitude and importance of GOB using events that took place during the first three quarters of 2017. The evidence suggests that GOB is substantial and economically significant. The paper describes possible explanations for GOB and concludes with a discussion about GOB-nudges, as well as limits to GOB-nudges.

**Juhani Linnainmaa**
University of Southern California
*Financial Advisors and Risk-Taking*

Discussant: Ehud Peleg, UCLA Anderson School of Management

We show that financial advisors increase stock market participation and risk-taking. We first exploit a regulatory change in Canada that restricted the supply of financial advisors in all provinces except Quebec. Our estimates suggest that having a financial advisor increases marginal household' risky asset shares by 30 percentage points and stock market participation by 10 percentage points. We also use micro-level data on financial advisory accounts to examine how the length of the advisor-client relationship affects clients' willingness to take financial risk. We use exogenous shocks to advisor-client pairings as an instrument for the relationship length. We find that clients who started with a new advisor before the 2008–2009 financial crisis were 8 percentage points less likely to remain invested in the stock market throughout the crisis. These effects are consistent with the trust model of Gennaioli, Shleifer, and Vishy (2015).

**Vineer Bhansali**
LongTail Alpha
*Everybody's Doing It: Short Volatility Strategies and Shadow Financial Insurers*

Discussant: Jeffrey Bohn, Swiss Re Institute

The extraordinary growth of short volatility strategies creates risks that may trigger the next serous market crash. A low yield, low volatility environment has drawn various market participants into essentially similar short volatility-contingent strategies with a common non-linear risk factor. We discuss these strategies, their commonalities, and the generally unrecognized risks that they would pose if everyone unwinds simultaneously. Volatility selling investors essentially provide "shadow financial insurance. Market participants and regulators would benefit from preparing for large, self-reinforcing technical unwinds that may occur when central banks change policy or when macro or political events affect investor confidence.

**Avanidhar Subrahmanyam (Subra)**
UCLA Anderson School of Management
*Keynote Speaker*
*A Protocol for Factor Identification*

We propose a protocol for identifying genuine risk factors. The underlying premise is that a risk factor must be related to the covariance matrix of returns, must be priced in the cross-section of returns, and should yield a reward-to-risk ratio that is reasonable enough to be consistent with

risk pricing. A market factor, a profitability factor, and traded versions of macroeconomic factors pass our protocol, but many characteristic-based factors do not. Several of the underlying characteristics, however, do command material premiums in the cross-section, suggesting behavioral forces in the stock market.

**Colin Camerer, Caltech**
*The Psychology and Neuroscience of Financial Decision Making*

Discussant: Joshua Livnat, Quantitative Management Associates (QMA)

Financial decisions are among the most important life-shaping decisions that people make. We review facts about financial decisions and what cognitive and neural processes influence them. Because of cognitive constraints and a low average level of financial literacy, many household decisions violate sound financial principles. Households typically have under diversified stock holdings and low retirement savings rates. Investors over extrapolate from past returns and trade too often. Even top corporate managers, who are typically highly educated, make decisions that are affected by overconfidence and personal history. Many of these behaviors can be explained by we-known principles from cognitive science. A boom in high-quality accumulated evidence-especially how practical, lo-cost 'nudges' can improve financial decisions is already giving clear guidance for balanced government regulation.

**Brett Trueman**
UCLA Anderson School of Management
*Overnight Returns and Firm-Specific Investor Sentiment*

Discussant: Mark Clements, Research Affiliates

We examine the suitability of using overnight returns to measure firm-specific investor sentiment by analyzing whether they possess characteristics expected of a sentiment measure. We document short-term overnight return persistence, consistent with existing evidence of short-term persistence in share demand of sentiment-influenced investors. We find that short-term persistence is stronger for harder-to-value firms, consistent with existing evidence that sentiment plays a larger role for such firms. We show that stocks with high (low) overnight returns underperform (outperform) over the longer-term, consistent with prior evidence of temporary sentiment-driven mispricing. Overall, our evidence supports using overnight returns to measure firm-specific sentiment.

**Jason Hsu**
Rayliant Global Advisors
*Anomalies in Chinese A-Shares*

Discussant: Michael A. Rosen, Angeles Investment Advisors

We apply well-studied factor strategies from the U.S. equity anomalies literature to Chinese A-shares, demonstrating which factors have worked and which have not over the last two decades since the opening of China's stock markets. We find while a number of traditional factors like value and size appear to work well in China; other factors are less effective, including A-shares momentum which works in the opposite direction. Our analysis reconciles conflicting results from the prior A-shares anomalies literature and explains differences in U.S. and Chinese factor investing experiences on the basis of unique features of China's evolving investing landscape, including issues related to regulation, financial reporting standards, difference in market microstructure, and investor behavior. After

reviewing evidence on the performance of specific factor strategies applied to A-shares, we demonstrate ways in which a deep institutional knowledge in China's financial markets leads to more effective investment strategies through factor design and portfolio construction tailored to novel features of A-shares. Our findings will be of interest to researchers of equity anomalies and to those developing quantitative strategies for Chinese Equities.