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BOOK REVIEWS

Mark Kritzman, Senior Editor

MEIR STATMAN'S BOOK "WHAT INVESTORS WANT"

(*Reviewed by Manny Hunjan, PIMCO*)

When I used to manage quantitative equity portfolios for an institutional asset management shop a few years ago, one of our investment themes was to exploit pricing anomalies that became apparent when stocks' excess returns are sorted cross-sectionally based on their volatility. The underpinning of the theme was behavioral, namely investors make systematic and cognitive errors when they overpay for the glamor in volatile stocks while neglecting the value in stable stocks. Over the years, there has been a steady flow of articles in behavioral finance, documenting how "normal" as opposed to "rational" investors behave and resultant effect on capital markets. What has been missing is a volume on investor psychology for the masses. That wait is now over with the book, "What Investors Really Want: Discover What Drives Investor Behavior and Make Smarter Financial Decisions", by Meir Statman. What makes this a compelling book, besides the fact that it is a pretty comprehensive treatise on investor behavior, is that is a very easy and quick read.

The main theme of the book is that investments offer three kinds of benefits: utilitarian, expressive, and emotional. When framed in this context, a lot of investor behavior that appears anomalous at first glance, begins to at least look understandable. As the author points out, this book is a about "how we think about our investments, how we feel about them, and how investment markets drive us crazy as we try to cajole them into giving us what we want". The book starts with an aptly named chapter "What We Want" that appropriately frames the context for further discussion in the book. The opening section is followed by a number of chapters that start with either "We Want…" or "We Have…" whereby commonly observed investor behavior paradigms are tackled one by one. The book ends with a chapter titled "What We Have", where the author reiterates the multifaceted role that investments play in investors' lives, urging us to accept the sum total of these investment experiences. Dr. Statman sprinkles the book with a number of anecdotes that most of us can relate to. Recent events such as Madoff fraud and 2008–2009 financial crisis feature prominently in the book. One of the enjoyable features that I found in the

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book was how well it flows from chapter to chapter.

This book is really intended for the lay investor; if you are looking for mathematical models to explain why investors behave the way they do and what are the effects on financial markets, you will be disappointed. On the other hand, if you are looking for intuition behind why investors do what they do, you will most likely find it here. The material is extensively cross referenced with a bibliography that probably covers most of the substantive material published in the field of behavioral finance.

I did not find much to criticize in the book. One caveat worth mentioning is that though the subtitle suggests that the book will help you make better financial decisions, there is little "actual" advice. The author helps illuminate why one does what one does when it comes to investing rather than offering concrete ideas and suggestions. I personally found this to be strength rather than a weakness of the book.

In closing, "What Investors Want" is a terrific book that will resonate very well with most of us, help to provide a deeper understanding of normal investor behavior, make each one of us better aware of our biases, and ultimately lead us to make better investment decisions.

PENSION FINANCE: Putting the Risks and Costs of Defined Benefit Plans under your Control

by M. Barton Waring, A CFA Institute Research Foundation Book, John Wiley & Sons, Inc., 2012

(*Reviewed by Bruce Grantier*)[a]

M. Barton Waring is the well-known financial economist and lawyer, retired CIO for investment strategy and policy at Barclays Global Investors, and an active advisor in pension finance and institutional investing. His 35 published articles, five of which were prizewinning, have been very thoughtful contributions to the industry. One especially insightful contribution was his support of policy allocation following the bursting of the dot com bubble in 2003—in the face of some advocates of switching to timing strategies. He serves on the editorial advisory boards of the Financial Analysts Journal, the Journal of Portfolio Management, and the Journal of Investing. He holds a J.D. in law from Lewis & Clark College and an MPPM in finance from Yale University. I have met Barton several times over the years at his speaking engagements—the latest being the CFA 65th Annual Conference in Chicago in May 2012. He has always been most gracious, including his kind assistance in reading this review and offering comments. Special thanks also goes to my friend, Malcolm Hamilton, Principle in Mercer Canada's Pension Practice for knowledgeable comments and perspective.

On the cover, Robert Merton writes: *"Pension Finance* is a comprehensive, integrated, and self contained offering on the structure, management, and oversight of defined benefit pension plans, carefully composed by a prime observer and practitioner in the defined benefit world… an important and much needed contribution to defined benefit pension knowledge." Wiley's "Praise For" section contains some 18 accolades of other well-known academics in financial economists and pension practitioners. Needless to say, this book should be required reading for anyone remotely connected to pension funds: government and corporate sponsors, investment managers,

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and service providers generally, especially actuaries and pension accountants.

In this review, I propose to start with his main conclusion: a Financial Economic approach to valuing liabilities is a more realistic and ultimately would be better for the industry than Actuarial or Accounting discounting assumptions. We then comment on the three main sections of the book: Core Principles of Pension Accounting, Investment Strategy, and Implications for Policy.

Economic vs. Actuarial Discounting Assumptions

In discussing his main theme, Waring begins with an outline of the deficits of defined benefit plans in the US, which he considers in a state of crisis—a crisis, like the US federal deficit, measured in *trillions* of dollars. The 50 state plans at the end of 2008 reported a roughly $700 billion deficit, updated to $1 trillion by The Pew Center on the States. One academic study, using market-determined discount rates, estimated this deficit to be in the order of $3 trillion. For corporate plans at the end of 2009, Mercer estimates plan deficits of $291 billion using a 5.8% weighted average discount rate. Adjusting this to the market-determined discount rate increases this figure to more like $600 billion. Waring concludes that *all US plans* are probably in a deficit to a total of about $4 trillion.

Waring notes the three perspectives on actuarial reporting of pension plans: First, the pension actuarial perspective, originally intended to securely fund the plan, and partially governed by legislation and regulation. Second, that of pension accounting, focused on reporting income according to GAAP. Third, that of the financial economist, the view Waring advocates, also called economic or market value accounting. This perspective is the most conservative and realistic, and is based on discounting liabilities, not on what assets might earn, but on actual discount rates in the market today. The correct rate to use is the expected return on the "liability-matching asset portfolio" (LMAP). He makes the point throughout that if one uses the economics to control risk, the actuarial and accounting versions will follow with reduced risk also.

Core Principles of Pension Accounting

Several chapters are devoted to the important core principles of pension accounting using the economic approach. Included are discussions of calculation of meaningful present values, accrual accounting and normal costs, credit risk and the discount rate, and finally pension expense and contributions. The liability-matching asset portfolio (LMAP) is introduced. The discussion of normal costs covers various alternative methods, including the economic normal cost. Waring discusses the three main economic measures of liability—the present value of future benefit payments, the benefit security liability, and the full economic liability—"the most inclusive and ultimately the most important of the three."

Investment Strategy

Waring briefly reviews the extensive literature on asset/liability matching strategies, dating back to the late '50s, to which he has contributed significantly over the years. He outlines the uses of the two-fund LMAP and RAP (risky asset portfolio) for forming investment policies. In discussing the implementation of the LMAP and RAP portfolios, he realistically points out the inadequacy or incompleteness of certain areas of the market and the need to use derivatives—swaps, futures, etc.—to replicate liabilities. He goes into a good discussion of the need to hold both real and nominal duration assets—in my opinion, an important concept

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sometimes overlooked. He describes an example of holding a two-fund portfolio with a portion of the assets devoted to leveraged duration liability-matching bond assets and the remaining portion of the portfolio devoted to risky assets through physical derivative-based leveraged equity assets. He goes on to discuss varying risk RAP strategies and sponsor risk tolerance. Finally, he discusses the conventional approach of asset liability studies—a technology based on the actuarial approach and completely inadequate to control pension risk, as shown in the light of the financial economic approach.

Implications for Policy

In these final chapters, Waring turns to the implications of economic account for policy makers and sponsors. The first chapter of this section proposes "retiring" the required rate of return, i.e., the expected return on assets method, of setting the discount rate. Waring notes that he might not have written this chapter, relying on the logic and evidence of his earlier chapters, but felt the faulty logic of the required rate of return was too deeply embedded in current practice to ignore. The chapter is quite dramatic, and indeed makes one want to attend the retirement party! In his own opinion Waring's next chapter (saving the underfunded pension plan) may be the most important chapter in the book. Corporate plans are slowly terminating—even though DC plans have proven to be unsuccessful at accumulating significant retirement assets. Waring provides an action plan grouped under headings; accounting policy, contribution policy, benefit policy, and investment policy—a very difficult task but realistically the right approach. His next chapter addresses needed policy improvements in GAAP and regulatory accounting for public and private pension plans. Waring concludes on an optimistic note about the benefits of the economic accounting approach and the potential for dramatically reducing future pension funding risk.

Our overall conclusion is this book provides a timely and very realistic insight into the problems and solutions facing the pension industry. It does so in a well-researched and well-explained manner, with a persistent measure of optimism throughout, in spite of the size of deficits and widespread concern in the industry. As mentioned, it is a must read for anyone even remotely connected to pension funds.

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