Emotions Series:

Affect

BY MEIR STATMAN, Ph.D.

Editor’s note: This is the second in a series of articles about emotions and the lessons they hold for investment advisors and their clients.

I had a beautiful neighbor when I was a teenager, but it was her car, a beautiful red MGB roadster, that I coveted. An MGB was way beyond my teenage budget but the feeling stayed with me. I got one many years later, as a cure for the midlife crisis.

Psychologists describe my feeling toward the MGB as “positive affect.” Zajonc (1980), a psychologist, wrote, “We sometimes delude ourselves that we proceed in a rational manner and weight all the pros and cons of the various alternatives. But this probably is seldom the actual case. Quite often ‘I decided in favor of X’ is no more than ‘I liked X’... we buy the cars we ‘like,’ choose the jobs and houses we find ‘attractive,’ and then justify these choices by various reasons.”

Look at the two ice cream cups below. How much would you be willing to pay for each? When the two cups are shown side by side, as they are in this picture, everyone is willing to pay more for the one on the right, containing only 7 ounces. However, Hsee (1998), a psychologist, found that when the cups were shown one at a time people were willing to pay more for the one on the right containing 7 ounces than for the one on the left containing 8 ounces. Why? Because the affect of the 7-ounce cup that is overflowing with ice cream is positive while the affect of the 8-ounce cup that is stingily unfilled is negative.

We rely on the affect heuristic when we choose cars, houses, and ice cream cups. We also rely on it when we choose stocks, hedge funds, and financial advisors.

Asset gathering is one key to the success of financial advisors and affect is one key to turning prospects into clients. Prospects, whether they know it or not, are influenced by the “chemistry” of affect when they choose advisors. Some tools for enhancing affect are obvious and universally true. Advisors enhance affect when they listen to prospects, empathize, and respect. But what enhances affect for some prospects detracts from affect for others. Consider, for example, the difference between the G.I. generation of people born between 1910 and 1932 and the baby boomer generation born between 1946 and 1964. Ruth Mitman (2006) noted that, in general, members of the G.I. generation, who matured in a time when manners were formal, feel respected when they are addressed as Mr. or Mrs. Jones, while members of the boomer generation prefer to be called by their first names, Henry or Helen. Boomers want to stay forever young and being addressed as Mr. or Mrs. makes them feel old. Similarly, G.I.s regard professionals, whether physicians, professors, or financial advisors, as authority figures. They expect professionals to lead and are ready to follow their recommendations. In contrast, boomers are suspicious of authority. Boomers want professionals to present options and discuss their relative merits. But boomers want to make the choices.

Individuals vary by temperament, even when they belong to one generation or the other. In “Investment Temperament,” Wood and I (2004) describe the four main categories: Guardians whose motto is “Discipline is the key to security,” Artisans whose motto is “Good investments will prevail,” Idealists whose motto is “Money just isn’t top priority,” and Rationals whose motto is “Cool reason conquers all.” Financial advisors who know the temperament of prospects can use that knowledge to foster affect and improve guidance. For example, Idealists prefer to learn about investments in plain English, while Rationals are comfortable with mathematics. Guardians find it easy to save while Artisans find saving difficult. Artisans, and especially Rationals, are quite willing to take risk, while Guardians and Idealists greet it with less enthusiasm.

Attention to affect helps financial advisors attract prospects and retain...
clients. It also helps advisors select investments for clients. Compare two companies, Google and General Motors. Google exudes positive affect. It is an admired company with great future prospects. In contrast, General Motors exudes negative affect. It is a company that always is a short step away from bankruptcy.

Fooled by affect, investors regularly conclude that good stocks are stocks of good companies and choose the stocks of the Google of the world over those of the General Motors. But investors who are seduced by affect when they choose investments often turn out to be the losers.

Every year *Fortune* magazine asks prominent investors such as executives, members of boards of directors, and analysts to grade companies and their stocks. Enron topped the list in the 2000 survey, published in March 2000. Enron’s management was most admired and its stock was most highly recommended. In contrast, Caremark Rx was near the bottom of the list, its management despised and its stock shunned. It turned out that the prominent investors of *Fortune*, like most investors, were blinded by affect. Admired Enron went on to bankruptcy. Its stock declined from $68.76 on March 3, 2000, to nothing. In contrast, the shunned Caremark Rx went from $4.56 on March 3, 2000, to many times that price.

Not all ugly ducklings turn into beautiful swans and few General Motors turn into Googles, but enough beautiful swans turn into ugly ducklings and enough ugly ducklings turn into less-ugly ducklings to make investment in despised companies superior to investments in admired companies. Deniz Anginer, Kenneth Fisher, and I (2007) found that stocks of despised companies did better than stocks of admired companies during the 23 years of the *Fortune* survey, 1983 to 2006.

Sometimes what is beautiful outside is ugly inside. This is the story of the stocks of admired companies and this is the story of my MGB. It was exhilarating for a while, then trouble came again and again. The car with the most beautiful skin had a sick body, and I finally sold it to a man as enamored of its skin as I was. However, at other times what is beautiful outside also is beautiful inside. Good financial advisors convey affect to prospects and clients and go on to help them achieve their financial and life goals.