Swiss Finance Insight

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Behavioral finance for wealth management

Interview with Dr. Matthias Uhl, Analyst, Global Investment Office, UBS Wealth Management

In which areas does UBS apply behavioral finance?
Within UBS Wealth Management (WM), there are two main areas where behavioral finance principles are applied. The first is in the investment process for the WM business. The investment process that leads to the UBS House View is created by the Global Investment Office, headed by the Global Chief Investment Officer (CIO) Alexander Friedman. The UBS House View gives our investors guidance on both the strategic asset allocation (SAA) - the long-term view on how to allocate between asset classes - and the tactical asset allocation (TAA), which attempts to anticipate short-term (6-month) market moves. For the TAA, we have two pillars of input: quantitative and qualitative. The quantitative part looks at data and is interpreted by models. In the qualitative part, we analyze market events that are not captured by our models, such as extraordinary central bank action or political issues. In the quantitative part, we have three distinct models that make use of behavioral finance principles. First, we use sentiment survey data to capture developments in the real business cycle. Second, we measure price momentum. And third, we consider sentiment in newspaper articles.

The second area where UBS WM deals with behavioral finance is in its employee training. Our internal educational institution, the UBS Business University, has two programs: the WM Diploma and the WM Master. We teach in both programs the basic principles of behavioral finance in private banking, such as Prospect Theory and several investor biases. This is meant to enable client advisors to understand and advise our clients even better, while trying to go beyond the asset and income statement of a client by considering also the client's emotions. We work closely together with Thorsten Hens, SFI Professor at the University of Zurich who regularly gives lectures at the UBS Business University.

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> MATTHIAS UHL

What have been, in your opinion, the biggest achievements in behavioral finance research so far and how did these help to improve wealth management at UBS?
One of the biggest achievements that established behavioral finance is the Prospect Theory by Daniel Kahneman and Amos Tversky, published in 1979. The theory simply states that losses hurt more than gains give joy, which at that time was a revolutionary theory, since it went against the many theories stating that investors were rational. These findings are still a very important cornerstone of our classes at the UBS Business University. For the quantitative models we use, more recent work is important. A great piece that was helpful for our news sentiment model is the one by Prof. Paul Tetlock from Columbia University entitled "Giving Content to Investor Sentiment: The Role of Media in the Stock Market." It was published in 2007 in the Journal of Finance.

Are there any open research questions in behavioral finance you would like to see addressed?
At UBS's WM division, the areas of behavioral finance research we work on are well covered. However, one can and should constantly look for ways to improve the models and make them more efficient. The most exploited and researched data is probably the sentiment survey data for our business cycle model, as well as the price momentum model, because the data are widely accessible. In terms of news sentiment, since this is the newest stream of research, there is probably much larger room for improvement by looking at various types of data and models.

MP

SFI NEWS

Lunch & Learn @ SFI
Starting in February, the Swiss Finance Institute will be holding several information sessions where participants can gather information about its education offerings. The first session will take place at SFI's Zurich offices on February 24 from noon to 2 p.m. A small lunch will also be provided.
http://www.sfi.ch/events

New Faculty Appointment at HEC Lausanne
Artem Neklyudov has been appointed Professor of Finance at HEC Lausanne. He joined the SFI faculty at University of Lausanne in August 2013, after obtaining his PhD in finance from Tepper Business School at Carnegie Mellon University. His main research interests lie in securitization trading and market microstructure. Prof. Neklyudov's PhD thesis was awarded the Alexander Henderson Award for Excellence in Economic Theory.
http://www.sfi.ch/Neklyudov

SFI on Facebook
On December 20, the Swiss Finance Institute launched its Facebook page as part of its goal to encourage an enriching dialog between Swiss finance academics and practitioners. Check out Facebook.com/SwissFinanceInstituteSFI for regular updates about upcoming events and the latest findings by SFI researchers at leading Swiss universities.
https://www.facebook.com/SwissFinanceInstituteSFI

Upcoming Events

February 24, 2014 – Zurich
Lunch & Learn @ SFI.
Participants will be given an overview of SFI's executive education programs.

March 25, 2014 – Zurich
Evening seminar with Boris Collardi, CEO of Julius Baer. The talk is part of SFI's Swiss Banking Transformation Testimonials series.

June 3, 2014 – Zurich
Breakfast seminar with Martin Scholl, CEO of Zürcher Kantonalbank. The talk is part of SFI's Swiss Banking Transformation Testimonials series.

Value Around the World

Deciphering the value premium

"Our study shows that culture not only influences how people speak, what they eat, how they dress… but also matters for stock market returns."

THORSTEN HENS

Excess returns of value over growth stocks have been puzzling researchers since the early nineties. New SFI research shows that differences in these returns can be explained by differences in individual time and risk preferences across countries.

Since the early nineties, finance researchers have been looking into a recurring asset pricing anomaly known as the value premium. The value premium is defined as the excess return that portfolios of stocks with high book-to-market values (value portfolios) have over portfolios with low book-to-market values (growth portfolios). This excess return appears to be consistently larger than what can be explained by traditional asset pricing models.

Finance academics and practitioners alike have been investigating the value anomaly in different stock markets. Possible explanations of the excess return of value strategies focus on two different aspects.

On the one side, there is the "hidden risk explanation" given by traditional finance. This literature tries to find increasingly sophisticated risk factors that can justify the excess returns of value stocks over growth.

On the other side, there is a new and growing literature in behavioral finance that highlights suboptimal investor behavior caused by cognitive and emotional factors leading to pricing errors, which are responsible for asset pricing anomalies in general and for value premia in particular.

Recently, new insight has been added to the second stream of literature by SFI Professor Thorsten Hens and SFI PhD student Nilufer Caliskan (both at the University of Zurich), who conducted the largest international study on portfolio returns based on book-to-market ratios. Theirs is also the largest international study on cultural differences in financial behavior. This allowed them for the first time in history to examine how cultural differences affect the magnitude of value returns.

Key Concepts

Value premium:
Excess return that stocks with high book-to-market values (value stocks) have over stocks with low book-to-market values (growth stocks).

Patience:
Percentage of survey participants willing to wait for a higher return.

Risk aversion:
Average compensation that survey participants require for a given loss.

"When we started this endeavor, many colleagues predicted that the effort wouldn't be worth undertaking," says Prof. Hens. "They contended that most investors are rational and that cultural differences should not matter for stock returns."

To measure cultural differences in connection with stock returns, Hens and Caliskan look at two dimensions: patience and risk aversion. Patience is measured as the percentage of participants willing to wait for a higher return. Risk aversion is measured as the average compensation participants require for a given loss. For the latter, behavioral finance also uses the term "loss aversion."

The findings of the study reveal that risk aversion is positively related to the magnitude of value profits: the higher the compensation investors want for a given loss, the higher the value profits. Patience, on the other hand, has a negative link to value profits: profits increase with a country's impatience.

This result gives scientific evidence to the frequently held claim by practitioners that value stocks provide 'short-term pain but long-term gain'.

Consequently, impatient and risk averse investors prefer not to hold value stocks. In countries with these types of investors, there needs to be higher compensation for holding value stocks.

One could ask whether the relationship between the cultural factors and value returns does not rather stem from a country's economic development or other economic variables. The study addresses these questions extensively. However, the link between patience and value returns is confirmed even after taking into account economic differences across the countries considered by Hens and Caliskan.

As Prof. Hens points out, "this study shows that culture not only influences how people speak, what they eat, how they dress… but also matters for stock market returns. Actually, culture matters more than economic differences!"

MP

Links

- **"Value Around the World",** by N. Caliskan and T. Hens: http://ssrn.com/abstract=2274823
- **Prof. Thorsten Hens:** www.sfi.ch/Hens

Impressum

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