Behavioral Finance Insights for
Wealth Managers and Their Clients

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OCTOBER 2008

Hedonic Arbitrage™: More Hedonics For Your Money

I bet many readers are intrigued by the term "Hedonic Arbitrage." What I mean by the term is that you can get more hedonics (or pleasure) for your money. In other words, I believe you can enhance your hedonic experience as a consumer and an investor without necessarily having more money. How is that possible? Let us begin with a simple example.

Suppose you are debating between buying a new BMW X3 versus a new BMW X5. The X3 is smaller than the X5, so it costs less. For the purpose of the exercise, let's assume that a basic version of the X3 costs $38,000, whereas the X5 costs $46,200. Would you rather own the X3 or the X5?

To answer the question above, let's consider what $8,200 can buy. Assuming that: (a) you drive 1,000 miles per month, (b) your vehicle gets 20 miles per gallon, and (c) gas costs $4 per gallon, then $8,200 pays for your gas consumption for three years and five months! (The calculation could vary slightly depending on your geographic location, as gas is more expensive outside the U.S.)

X3 FOR $38,000

?

X5 for $46,200

If you are like the majority of people, then you chose the X5. BMW reports that in 2007 more X5 vehicles were sold than X3s. Do you think most auto buyers made the right decision paying the extra $8,200 for the larger vehicle?

Let's return to your dilemma of whether to choose the X3 or the X5. Would you rather have the X3 and gas for three years and five months at the cost of $46,200, or would you rather have the X5 for $46,200, but have to pay out of pocket for your gas? I suspect many people would much rather have the X3 and years of free gas.

Why do the little number games above make people switch from the expensive vehicle to the inexpensive one (relatively speaking)? Frederick et al (2008) find that the reason is the failure of most people to recognize opportunity costs. In other words, people ignore what the price difference between the expensive choice and the inexpensive choice (in the above example, $8,200) can buy them.

The main insight of the auto example is that your decision making can be improved and your hedonic experience can be enhanced by factoring in opportunity costs. Put differently, I believe many people would have greater pleasure driving the X3 and not paying for gas for many years than driving the X5 and paying for gas.

The broader implication of the auto example is that there are in fact ways for you to arbitrage your hedonic experience. That is, there are ways for you to get more enjoyment out of your money. Helping you maximize your hedonic experience is the main goal of this article and many more to follow. As a starting point, let us propose a concrete mechanism to enhance your hedonic experience of investing.

Hedonic Arbitrage is a new way to think about money and happiness.

Suppose you have $250,000 in your brokerage account. Your advisor tells you to invest in a few well-diversified funds with low fees. This, he explains, would help you achieve long-term growth without taking too much risk or paying too much in fees.

If you find this investment advice soothing, I say accept it and stop reading this article. It is indeed very good advice to select well-diversified funds with low fees. Honestly, skip the rest of this article and wait for the next one.

If you can suppress the urge to meddle with your portfolio, stop reading this article. You are in good shape.

However, if you are like most people, you're thinking: Good advice, but kind of boring! You still have the urge to meddle with your portfolio. Perhaps you just took a new BMW out for a test drive and found it to be so much fun that you now want to invest in BMW stock. You ask your advisor: Why not invest a bit in BMW?

Your advisor insists it is a very bad idea for you to buy individual stocks, let alone mixing a fun test drive with a good investment. He even gives you a copy of a research paper by Barber and Odean, published in the esteemed Journal of Finance in 2002. He tells you that the researchers documented that the more individual investors trade, the more money they lose.

You start yawning – you think the research applies to other people; you're smarter than they are. Your advisor immediately hands you another paper by Barber and Odean (2001) illustrating that men trade more than women, and as a result, their investment performance is worse. Now you are about to fall asleep.

While you have a lot of respect for academics, you really have no interest in reading academic papers. Most importantly, your urge to meddle with the portfolio is overpowering. What can you and your advisor do about it?

Realizing many people feel like you, George Loewenstein of Carnegie Mellon University, Alessandro Previtero of UCLA and I decided to apply lessons from behavioral finance to help. Our proposal is straightforward: create multiple subaccounts, one for you to meddle with and another for your advisor to professionally manage. Here are the key ingredients of our proposed solution:

The Multiple Accounts Solution

1. Your advisor manages the bulk of the money. He/she is likely to pick well-diversified funds with low fees on your behalf, which makes good sense.

2. You will manage a small fraction of your portfolio. You should **never** self-manage more than you can comfortably lose.

3. Work with your advisor to set account labels that reflect the goals of the accounts. You can, for example, create the Nest Egg account for your advisor to professionally manage and the Have Fun account for you to self-manage.

The idea behind the multiple accounts solution is to let investors have fun without risking too much of their money. At the risk of repeating ourselves, you should never self-manage more money than you are willing to lose.

If the urge to meddle with your portfolio is overpowering, consider setting up multiple accounts – with one being a small subaccount that you self-manage.

Multiple accounts can also help people identify their financial objectives and ensure they stick to their goals. For example, retirees can set a "pay the bills" account and a "spoil the grandkids" account. The earmarked accounts are more than labeling and semantics, they help you and your advisor establish investment strategies that fit your specific goals. In this case, the portfolio choices for the "pay the bills" subaccount might be more conservative than those for the "spoil the grandkids" subaccount.

To summarize, you can get more hedonics for your money, at potentially no extra cost. All you have to do is change the way you think about your finances and the way you handle your wealth. This article proposed using multiple accounts as one specific technique to enhance your experience as an investor. Try starting with one subaccount for a specific purpose and see if you find it a useful way to achieve your goals and increase your satisfaction with your investments.

References

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