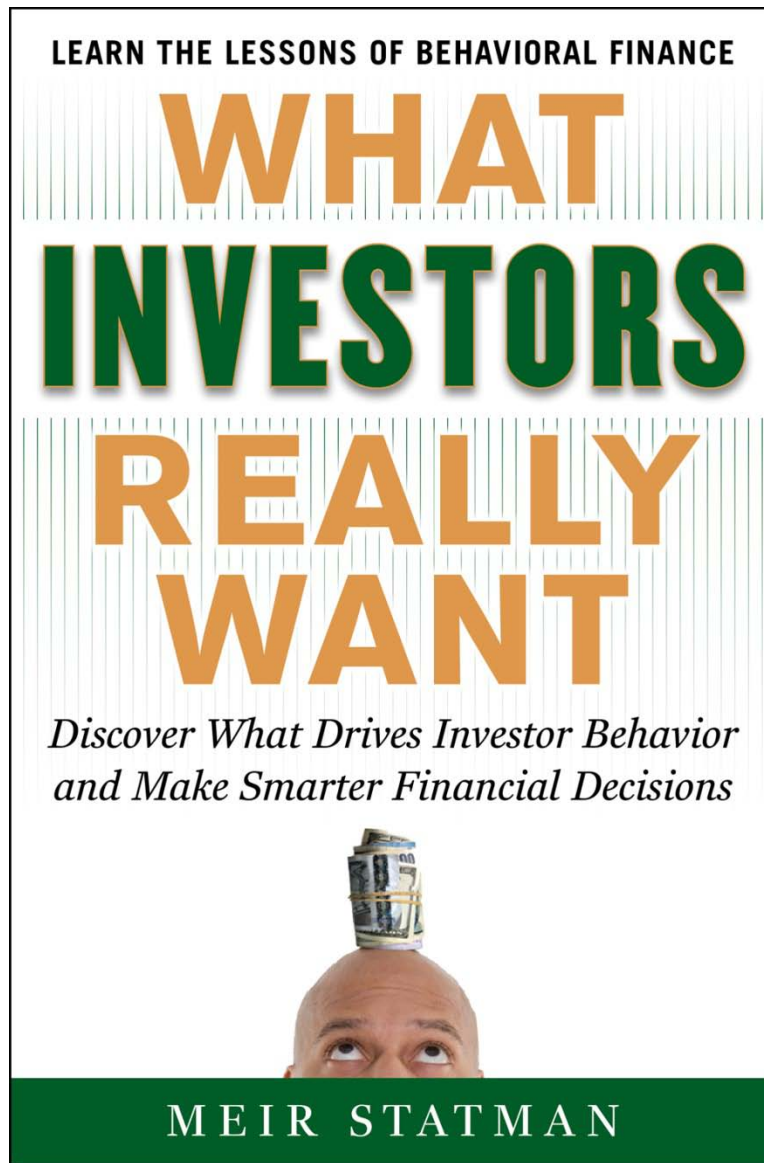


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What Investors Really Want

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Table of Contents and Introduction



Contents

INTRODUCTION: **What We Want** **ix**

We want more than high profits from our investments. We want to be number 1 and beat the market. We want to nurture hope for riches and banish fear of poverty. We want to feel the pride of profits and avoid the regret of losses. We want the sophistication of hedge funds and the virtue of socially responsible funds. And we want to leave a legacy for our children.

CHAPTER 1: **We Want Profits Higher than Risks** **1**

Investments with profits equal to their risks are as easy to find as good lunches at fair prices. But we want free lunches, not fair ones, and we are always searching for investments with profits higher than risks.

CHAPTER 2: **We Have Thoughts, Some Erroneous** **17**

Cognitive errors mislead us into thinking that investments with profits higher than risks are easy to find. Hindsight errors are one example, misleading us into thinking that we have seen investment winners in foresight when, in truth, we have seen them only in hindsight.

CHAPTER 3: **We Have Emotions, Some Misleading** **37**

Emotions, like cognitive errors, draw us into promises of profits higher than risks. Exuberance highlights profits and obscures risks; fear highlights risks and obscures profits; and unrealistic optimism exaggerates our investment skills and chances.

CHAPTER 4: **We Want to Play, and Win** **55**

The game of finding investments with profits higher than risks is tempting, even when we know that it is difficult to win. Playing the game makes us feel alive, in the groove, in control, and in the flow. And winning is exhilarating.

CHAPTER 5: We Join Herds and Inflate Bubbles 67

We stampede into investments in exuberance and stampede out in fear. We inflate bubbles and deflate them. Our herding instinct also opens the door to frauds, where early fools pull in late fools, and all turn into losers.

CHAPTER 6: We Want Self-Control and Mental Accounts 81

We do not spend dollars from “hard-earned” mental accounts as easily as we spend dollars won in lotteries. Mental accounting facilitates self-control, stopping us from buying a shiny new car today when we need the money for retirement tomorrow.

CHAPTER 7: We Want to Save for Tomorrow and Spend It Today 93

We try to strike a balance between saving too little and saving too much. Mental accounting helps us distinguish what we are permitted to spend from what we must save. Self-control helps us manage our conflicting desires to spend and save.

CHAPTER 8: We Want Hope for Riches and Freedom from the Fear of Poverty 107

Investors who hate risk buy insurance policies, while investors who love risk buy lottery tickets. Yet most of us buy both, just as we buy both safe bonds and risky stocks. We are motivated by our twin desires of hope for riches and freedom from the fear of poverty.

CHAPTER 9: We Have Similar Wants and Different Ones 119

Some investors are passionate about hope, while others care more about freedom from fear. Our personalities, life experiences, and cultures weigh on the balance we strike between hope and freedom from fear.

CHAPTER 10: We Want to Face No Losses 133

Profits bring pride while losses inflict regret. Realizing losses is especially painful because we give up hope of recouping our losses. So we realize gains quickly and procrastinate in the realization of losses.

CHAPTER 11: We Want to Pay No Taxes 151

Some investors greet taxes with acceptance or resignation. Some feel smart and savvy when they avoid taxes. Some are angry that taxes are wasted by politicians. And some are willing to forego \$5,000 in profits to avoid paying \$4,000 in taxes.

CHAPTER 12: We Want High Status and Proper Respect 161

Hedge funds open their doors only to the rich, making it easy to brag about riches without appearing to brag. Yet wealth does not always bring respect. Women investors resented disrespect a century ago, and they resent condescending attitudes today.

CHAPTER 13: We Want to Stay True to Our Values 177

Some socially responsible investors are willing to sacrifice investment profits for human rights and others are willing to sacrifice profits for a clean environment. Values extend beyond social responsibility to religion, ideology, patriotism, and philanthropy.

CHAPTER 14: We Want Fairness 195

We want to play on level playing fields in sports, investments, and every other field. We boycott stores that treat their employees unfairly, protest unfair investment practices, and forego profits to avoid money managers whose fairness we suspect.

CHAPTER 15: **We Want to Invest in Our Children
and Families** **209**

We prod our children to do well in school and we save for their college expenses. Middle-class parents worry that they might not have enough for their children's education. Rich parents worry that their children would feel entitled to spend what they do not earn.

CHAPTER 16: **We Want Education, Advice,
and Protection** **223**

We are increasingly responsible for our financial futures. We seek information, protection, and advice from financial advisors, the Internet, the government, and other investors. Some advice is good and some is bad. Some sticks with us and some washes away.

CONCLUSION: **What We Have** **237**

Some trade investments because they have a true advantage over other traders. Others trade investments because cognitive errors mislead them. Yet others trade because they want to enjoy the thrill of trading. Still, it is important to distinguish truth from cognitive errors and cognitive errors from wants. And it is important to remember that investments are about life beyond money.

NOTES **243**

INTRODUCTION

What We Want

At a dinner party some years ago, a fellow guest, an engineer who had learned that I am a professor of finance, wanted to know where he can buy Japanese yen. “Why do you want to buy Japanese yen,” I asked. “Because its value is sure to zoom past the American dollar,” he said, and proceeded to list the American budget deficit, its trade deficit, and other indicators of the advantage of the Japanese yen over the American dollar.

I wanted to tell my fellow guest quickly and gently that while his thinking is quite normal, it is not very smart. “Buying and selling Japanese yen, American stocks, French bonds, and all other investments,” I said, “is not like playing tennis against a practice wall, where you can watch the ball hit the wall and place yourself at just the right spot to hit it back when it bounces. It is like playing tennis against an opponent you’ve never met before. Are you faster than your opponent? Will your opponent fool you by pretending to hit the ball to the left side, only to hit it to the right?”

“Think for a moment,” I said to my fellow guest. “You are on one side of the net, thinking that the yen will go up. Your opponent is on the other side, thinking that it will go down. One of you must be the slow one. Have you considered the possibility that the yen seller might be Goldman Sachs, Barclays, Bank of Tokyo, Mitsubishi UFJ, or another of many traders in the yen market who have offices in both Tokyo and New York and know more about both the Japanese and American economies than you can learn from your morning’s *Wall Street Journal*?”

Yet there is more to investing and tennis than faulty thinking. My fellow guest wanted to make money on his yen trade, but he also wanted to feel the thrill of winning when the yen zooms. He wanted to express himself as a player in financial markets, not one who stands at the market’s sideline. And he wanted to be a member of the investing community, the community of people who observe financial markets, trade in them, and share their experiences with one another.

This book is about what we want from our investments. It is 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. This book is about normal investors like you, me, and my fellow guest. We are intelligent people, neither irrational nor insane. We are “normal smart” at times and “normal stupid” at other times. We do our best to increase the ratio of smart behavior to stupid behavior, but we do not have computers for brains and we want benefits computers cannot comprehend.

We want high returns from our investments, but we want much more. We want to nurture hope for riches and banish fear of poverty. We want to be number 1 and beat the market. We want to feel pride when our investments bring gains and avoid the regret that comes with losses. We want the status and esteem of hedge funds, the warm glow and virtue of socially responsible funds, and the patriotism of investing in our own country. We want good advice from financial advisors, magazines, and the Internet. We want to be free from government regulations yet be protected by regulators. We want financial markets to be fair but search for an edge that would let us win, sometimes fair and at other times not. We want to leave a legacy for our children when we are gone. And we want to leave nothing for the tax man. The sum of our wants and behaviors makes financial markets go up or down as we herd together or go our separate ways, sometimes inflating bubbles and at other times popping them.

WHAT DO WE WANT? UTILITARIAN, EXPRESSIVE, AND EMOTIONAL BENEFITS

Tennis is a job for the likes of the Williams sisters who play at Wimbledon and the United States Open. Professional players earn money from prizes and endorsements, but the benefits of their tennis jobs extend beyond money. Tennis makes up much of the expressive life of professional players, expressed in their identity as tennis players when they are cheered on the court and asked for autographs off the court. And tennis makes much of the emotional life of professional players, hoping for the thrills of victory and dreading the agony of defeat.

Most of us have jobs, even if not professional tennis jobs. We want to earn money from our jobs, but we want much more. Our jobs encompass much of our expressive and emotional life. We want to express our identity, whether that of a professor, policeman, technician, or physician. We want

pride in a job well done, satisfaction in a contribution to society, and a sense of belonging to a community of colleagues and friends. When we lose a job we lose more than money, we lose part of our identities, pride in our accomplishments, and membership in our communities.

The benefits of a job come in packages and we face trade-offs as we choose among them. A lawyer who wants to earn money but is also passionate about public advocacy can choose a public advocacy package with little money and much passion or a corporate law package with more money but less passion. Moreover, the money we earn in our jobs is only a station on the way to the benefits of spending it on food, shelter, and perhaps tennis. While professionals earn money from tennis, amateurs pay money for it, money for tennis rackets, balls, and court fees. Amateurs pay because tennis is enjoyable exercise, because it affords us time with friends, because we hope for the thrill of victory, and because we want to express our membership in the tennis community.

Investments are like jobs, and their benefits extend beyond money. Investments express parts of our identity, whether that of a trader, a gold accumulator, or a fan of hedge funds. Investments are a game to many of us, like tennis. We may not admit it, and we may not even know it, but our actions show that we are willing to pay money for the investment game. This is money we pay in trading commissions, mutual fund fees, and software that promises to tell us where the stock market is headed. And investments are about what we would do with the money we make and how it makes us feel. Investments are about a sense of security in retirement, the hope of riches, joy and pride of raising our children, and paying for the college education of our grandchildren.

Investments, jobs, products and services have benefits that enhance wealth, well-being, or both. These include utilitarian benefits, expressive benefits, and emotional benefits. Utilitarian benefits are the answer to the question, What does it do for me and my pocketbook? The utilitarian benefits of watches include time telling, the utilitarian benefits of restaurants include nutritious calories, and the utilitarian benefits of investments are mostly wealth, enhanced by high investment returns.

Expressive benefits convey to us and to others our values, tastes, and status. They answer the question, What does it say about me to others and to me? Private banking expresses status and esteem. One private bank advertised its services along with a chauffeured vintage Rolls-Royce and the tag line "Once you've earned exclusive service, there's no turning back."

A stock picker says, “I am smart, able to pick winning stocks.” An options trader says, “I’m sophisticated, willing to take risk and knowing how to control it.”

Emotional benefits are the answer to the question, How does it make me feel? The best tables at prestigious restaurants make us feel proud, insurance policies make us feel safe, lottery tickets and speculative stocks give us hope, and stock trading is exciting. Gerald Tsai, Jr. was a fund manager who pioneered the go-go performance funds in the 1960s. “He loved doing transactions,” said Christopher Tsai, recalling his father’s enthusiasm about the stock market. “He loved the excitement of it.”¹

Investment professionals are often uncomfortable with the commingling of utilitarian, expressive, and emotional benefits. Many financial advisors are puzzled by the desire of some investors to exclude from their portfolios stocks of tobacco companies. Why not invest in stocks of tobacco companies if they produce the highest returns and then use these returns for anti-smoking campaigns? As Rob Moody, a financial advisor at Compass Advisors in Atlanta said, “Those investors who are interested in social or ethical investing would be ahead if they invested in anything else, including “unethical” companies, and then donate their profits to the charities of their choice.”²

Moody’s suggestion makes as much sense to socially responsible investors as a suggestion to Orthodox Jews that they forgo kosher beef for cheaper and perhaps tastier pork and donate the savings to their synagogues. A member of the Church of the Brethren said, “I occasionally see articles by investment columnists on the sin funds that invest primarily in tobacco and alcohol, etc., advising people to take their profits from these funds and do good with them. That argument seems completely backwards to me, because the money is already out there supporting bad things.”³

Advising socially responsible investors to separate their social goals from their financial goals is symptomatic of a more general tendency among investment professionals to separate the utilitarian benefits of investments from their expressive and emotional benefits. Reathel Geary, a financial advisor with IMHO Investments understands that the benefits of socially responsible investments extend beyond utilitarian returns. He said: “We like to call it “opinionated investing”—helping our clients to invest in firms that share their views on what’s important.”

OUR WANTS, THOUGHTS, COGNITIVE ERRORS, AND EMOTIONS

Have you noticed that most movies are fiction? Of course you have. You know that the people you see on the movie screen are actors, only pretending to be who they are not. You know that the movements you see on the screen are cognitive errors, optical illusions caused by fast projection of still images. And sometimes you wear funny glasses that fool you into seeing 3-D images on a flat screen. So why are we willing to pay money for movie tickets, sacrificing wealth for fiction and truth for exploitation of cognitive errors? The answer is obvious. Movies touch our emotions and add to our well-being. They make us laugh and cry and help us enjoy the company of dates, spouses, children, and friends. Indeed, we enjoy movies more when we share expressions and emotions with our companions.⁴

The world of investments is different from the world of the movies because it offers no clear boundary between fact and fiction. Lights are rarely turned on in the world of investments, so it is hard to distinguish fact from fiction and truth from cognitive errors. But the world of investments is also similar to the world of the movies because movies offer benefits that go beyond the utilitarian benefits of facts, and investments offer benefits that go beyond the utilitarian benefits of wealth. We know that most investors who trade frequently sacrifice wealth. But frequent traders might be receiving good value for the wealth they sacrifice, enjoying hope for enormous wealth as lottery buyers enjoy hope for giant prizes. Traders also add to their well-being as they play the trading game, tracking the stocks displayed on their computer screens as video game players track heroes and villains. And traders enjoy the community of fellow traders, meeting at investment clubs, sipping coffee or beer, and swapping stories.

I tried to dissuade my fellow dinner guest from trading Japanese yen but I have probably failed. Perhaps I failed to help my fellow dinner guest overcome his cognitive error, learn that trading should be framed as playing tennis against a possibly better player, and refrain from trading. Or I might have succeeded in helping my fellow guest overcome his cognitive error and yet failed to dissuade him from trading because he wanted the expressive and emotional benefits of the trading game, the fun of playing and the thrill of winning.

Emotional benefits come with positive emotions such as exuberance, hope, or pride. Negative emotions such as fear, despair, and regret, detract from benefits in some ways and add to them in others. We are often advised to use reason, not emotions, when we make investment decisions. But this advice is neither feasible nor smart. Emotions complement reason more often than they interfere with it, and the interaction between emotions and reason is mostly beneficial, often critically so. Emotions prevent us from being lost in thought when it is time to act, and emotions reinforce lessons we must learn.

Regret is a painful emotion but it is also an effective teacher. Regret over unwise choices teaches us to make better ones. Patients with orbitofrontal cortex lesions do not feel the pain of regret, but they are also deprived of the good lessons we learn from it.⁵ Yet sometimes emotions interact with cognitive errors, reinforcing poor lessons. Cognitive errors dispose us to hold on losing investments even when selling them would add to our wealth. These cognitive errors are reinforced by regret. Reflection on losing investments brings a gnawing pain of regret, but realizing losses by selling losing investments brings a searing pain of regret. It is no wonder that we are reluctant to realize losses.

Computers want nothing. They only execute the wants of their human masters, whether programmers or users. IBM programmers wanted to win when they got Deep Blue ready for a chess match with the world's champion Gary Kasparov. Kasparov wanted to win no less than IBM's programmers and called the match unfair when he lost. He demanded a rematch and secured a draw against another version of Deep Blue.

Computers are immune to cognitive errors and emotions, and they never jump to conclusions, but we often do. The computers at the supermarket's checkout counter do not jump to the total bill. They add the prices of our groceries one at a time, methodically but very fast, before they reach their conclusion and display the total bill. We, however, might add the prices of a few groceries in our brains, perhaps those of the most expensive groceries, and jump to a conclusion, approximating our total bill. Outside the supermarket, we look at a series of stock prices, those of Google or those of Ford, detect a rising pattern or a falling one, and jump to conclusions about where stock prices will go next.

We are fortunate to have brains that jump to conclusions. Indeed, jumping to the right conclusions is the essence of intelligence. This is

what we do when we swerve our cars quickly to avoid mattresses that just fell off the truck in front of us. There is no computer today that can rival our driving ability. But sometimes we crash as we jump to conclusions. A lightning-quick combination of thoughts and emotions prompts us to slam on the brakes when the cars ahead of us stop suddenly, but we are unable to coordinate our thoughts, emotions, and foot movements fast enough to pump the brakes, as instructed in driving school. Computers are better at the braking task. The computers onboard today's cars let us jump to our own conclusions, slamming the brakes, while they pump the brakes fast enough to avoid a crash.

Rational investors know instantly, like the computers that pump our brakes, how to frame a trade. Faulty framing is one cognitive error that afflicts normal investors, but it is not the only one. Other cognitive errors include hindsight, which misleads us into thinking that we could have seen winning investments with foresight when in truth we have seen them only with hindsight; overconfidence, which leads us to overestimate our investment skills; and availability, which leads us to exaggerate the likelihood that we will pick top-performing mutual funds because mutual fund companies advertise such funds, making them available to our memory. Daniel Kahneman and Amos Tversky articulated these and other cognitive errors. The Nobel Prize committee awarded Kahneman the Nobel Prize in economics in 2002 for his contributions, in collaboration with Amos Tversky, to our understanding of human cognition. These contributions underlie much of behavioral finance and much of this book.

Human nature changes very slowly. We are more rapidly informed than our predecessors a century ago, but we are neither better informed nor better behaved. The *World's Work* magazine summed it up a century ago: "Human nature is human nature." The magazine initiated an advice column for individual investors in 1906 and its editor wrote in 1911: "In these five years of close and often intimate intercourse with investors of all sorts and descriptions the editor of this department has learned a great many things about the habits and state of mind of the individual investor. . . . One minor conclusion from all this data and experience is that the very small investor is the most inveterate bargain hunter in the world. . . . It is the small investor who always wants 100 percent cent on his money and who is willing to take the most astounding chances to get it."⁶

WHAT WE WANT AND WHAT WE SHOULD

We are not embarrassed to admit that we want our investments to support us during our years in retirement. Neither are we embarrassed to admit that we want our investments to support our children or favorite charities. But some of what we want from our investments is embarrassing, such as our wanting status. We might want to mention our investments in hedge funds, knowing that hedge funds signal high status because they are available only to the wealthy. But a loud expression of status, like a loud display of an oversized logo on a Gucci bag, can bring embarrassment rather than an acknowledgment of status.

“Wants” are also difficult to acknowledge because they often conflict with “shoulds.” The voice of wants says, “I want this new red sports car,” but the voice of shoulds says, “You should buy a used sedan and add the difference in price to your retirement account.” Investment advice is full of shoulds: save more, spend less, diversify, buy-and-hold. Wants are visceral while shoulds are reasoned. Wants emphasize the expressive and emotional benefits of investments while shoulds emphasize the utilitarian ones. Wants often drive us into stupid investment choices, while shoulds drive us mostly into smart ones.

The visceral voice of wants is especially loud and the reasoned voice of shoulds is especially muted when our reasoning is weak and our minds are overloaded. The conflict between the visceral and the reasoned is on display in a choice between a chocolate cake we want and a fruit salad we should. In one experiment, people were brought to a room, one at a time. Some were asked to memorize a two-digit number, a task unlikely to overload their minds. Others were asked to memorize a seven-digit number, a task more likely to overload their minds. Next, each person was asked to go to another room. On their way, each could choose chocolate cake or fruit salad. People overloaded with memorizing the seven-digit number were more likely to listen to their visceral voice than to their reasoned one and choose the chocolate cake over the fruit salad.⁷

Dot-com stocks were the chocolate cakes of the Internet bubble of the late 1990s, raising their visceral voice. Some companies with fruit-salad-like names turned them into chocolate-cake-like names. Computer Literacy, Inc., was turned into FatBrain.com. Prices of newly named stocks zoomed as investors rushed to grab them as they would grab a slice of chocolate cake.⁸

Indulgence, impulsive spending, and lack of self-control are the norm, testifying to the tempting voice of wants and evident in the mountains of debt we accumulate. But we can go too far in restraining indulgence and tightening self-control. Spendthrifts would do better with a little less indulgence, but tightwads would do better with a little more. The reasoned voice encourages well-off tightwads to splurge on a great dinner at a fine restaurant. They can surely afford that dinner without hampering their retirement prospects. But the visceral voice dissuades tightwads from enjoying their meal, as their thoughts drift to the pain of the restaurant tab. Years later spendthrifts regret excessive indulgence and insufficient self-control, while tightwads regret insufficient indulgence and excessive self-control. One financial advisor told me of a tightwad client who lived in a dilapidated house and deprived his family of necessities only to leave them \$3 million when he died.

HERDS AND BUBBLES

We are similar to one another in our wants, thoughts, cognitive errors, and emotions, but we are not identical. Some of us are more likely than others to be fooled by hindsight, some are more fearful, and some find special joy in trading. Our wants, thoughts, cognitive errors, and emotions affect our own behavior. But what is the sum of our behaviors?

The total number of shares of stocks changing hands as we trade is one sum of our behaviors. High returns on stocks we have chosen increase our confidence in our ability to pick winning stocks, so we trade more, overconfident in our ability to replace great winners with greater winners. A rising stock market multiplies the number of our winning stocks, and cognitive errors blind us to the distinction between winning stocks we can credit to our special stock-picking skills and those we must credit to the rising market. Conversely, a falling stock market saps our confidence in our ability to find winners. Moreover, anticipated regret deters us from selling stocks whose prices have declined. Indeed, more shares are traded after the market has risen and fewer are traded after the market has fallen.⁹

Sometimes our behaviors compound rather than merely sum. We read the same investment reports on the Internet and listen to the same investment news on television. We speak with one another and influence

one another, moving as herds. Herds inflate bubbles, pumping stock prices far above their values, and herds deflate bubbles faster than they have inflated them. Managers of mutual funds influence one another, moving as herds into some stocks and out of others.¹⁰ Investors who care about status inflate bubbles. Investors competing for status herd into similar investments, afraid that they would lose the status race if their investments trail those of the herd.¹¹ In the process, they pump the prices of the investments they herd into, inflating bubbles.

Sometimes our behaviors balance one another rather than compound or merely sum. Some investors shy away from risk, preferring safe bonds over risky stocks. Other investors seek risk, preferring risky stocks to safe bonds. The two balance each other, but the fact that stock returns over long periods exceeded bond returns indicates that the desire to avoid risk is greater than the desire to seek it. Similarly, some investors shun stocks of tobacco, alcohol, and gambling companies, branding them as “sin companies,” while others are quite ready to buy such stocks if their returns are high. The fact that the returns of stocks of sin companies exceeded the returns of stocks of virtuous companies indicates that the choices of investors who shun stocks of sin companies exert power on stock prices, a power that is not fully balanced by the choices of investors who seek nothing but high returns.

In the following chapters we will reflect on what we really want from our investments as we reflect on our thoughts, emotions, wants, and behaviors.

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