

Countries and Culture in Behavioral Finance

A cumulative overview

June 21st, 2011

Dear Friends,

Recently, the subject of Behavioral Finance has been of intense research for finance professionals. Contrary to the traditional principles of finance (risk and return), investors combine their psychological characteristics with finance principles in evaluating an investment.

Every individual has his or her own opinions, interests, dislikes... But when researched deeply, it has been understood that **the surroundings and culture of the investor also play a decisive role in his or her behavior.**

Behavioral finance focuses on the cognitive and emotional aspects of the investment decision-making process. Although we can say that people are built mentally and physically the same everywhere, the collective set of common experiences that people of the same culture share have will influence their investment decisions. Thus, **different cultures and countries show different behavior towards investment decisions.**

We first discuss briefly different cultures with some real life incidents and surveys, and then we describe the difference in propensity for risk tolerance among countries and cultures and how individualistic-collectivistic line affects the risk tolerance. In the end we give a brief summary about Islamic Finance which shows us how a culture affects investment decisions.

Difference in Cultures

Incident 1:

Meir Statman, Professor at Santa Clara University experienced this incident when he came to the US from Israel to pursue a PhD at Columbia University. While sitting in a train Meir overheard a conversation: "I told my daughter that I would support her through college but she is on her own afterward." Meir was astonished. The culture in Israel was one in which parents continue to support their children even after college and sometimes also after marriage. *(Source: Countries and Cultures in Behavioral Finance, Meir Statman)*

Incident 2:

A British National went to Saudi Arabia to work not aware of the cultural differences between the countries. On his arrival the British Embassy handed him a guide which said “Sentences for alcohol offences range from a few weeks or months imprisonment for consumption to several years for smuggling, manufacturing or distributing alcohol. Lashes can also be part of the sentence”. Saudis understand that the ways of non-Muslims are different from their own and they will not generally interfere with what foreigners do. But foreigners who take advantage of this to break the law are running serious risks. This surprised the British National but he had to follow the law to continue working in Saudi Arabia.

Survey 1:

In their work, “Cultures of Corruption: Evidence from Diplomatic Parking Tickets,” Fisman and Miguel (2006) examined whether diplomats took advantage of immunity from prosecution to park wherever they wanted in New York City without paying parking fines.

The following results were observed:

- Diplomats from Kuwait, for example, accumulated 246 tickets per diplomat during 1997–2002.
- Diplomats from the UK, Holland, Australia, and Norway accumulated no parking tickets.
- Even more interesting is that the number of parking tickets per diplomat was generally higher in countries where corruption levels are higher.
- **Conclusion: People import norms from the culture they know into their new surroundings**

Survey 2:

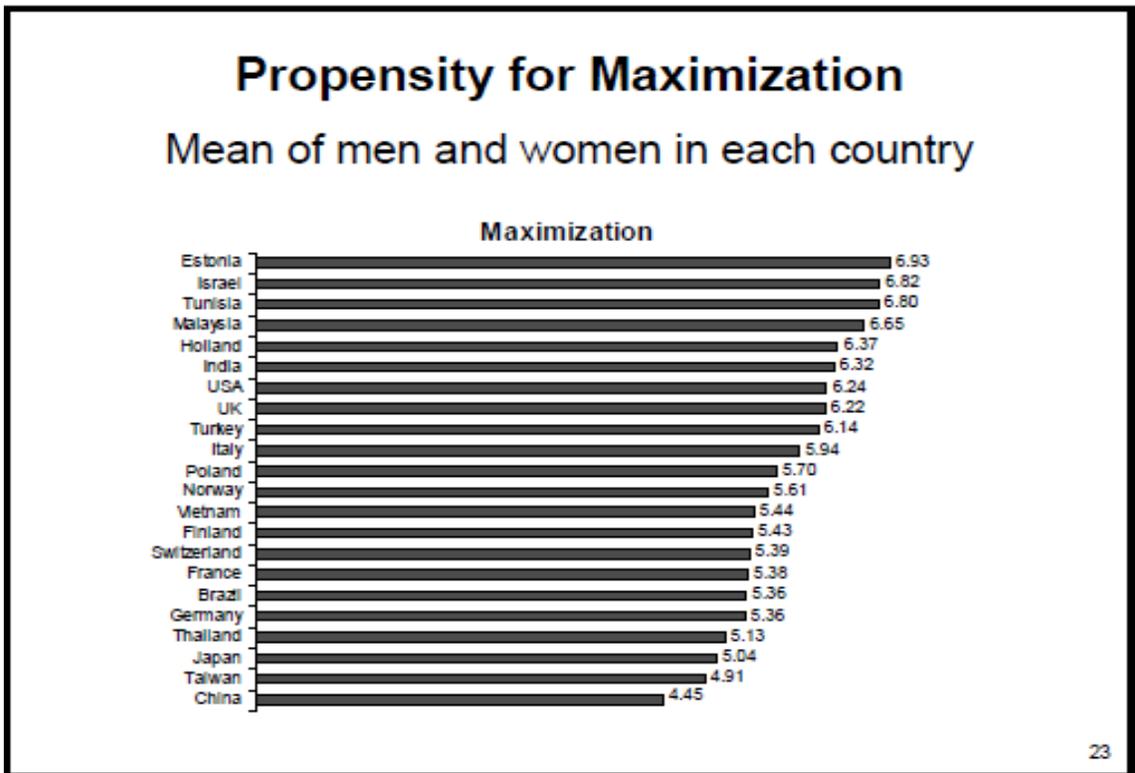
Propensity for Maximization:

Question: “I always want to have the best. Second best is not good enough for me.”

Propensity for Regret:

Question: “Whenever I make a choice, I try to get information about how the other alternatives turned out and feel bad if another alternative has done better than the alternative I have chosen.”

Score: (Strongly Disagree) 1 2 3 4 5 6 7 8 9 10 (Strongly Agree)

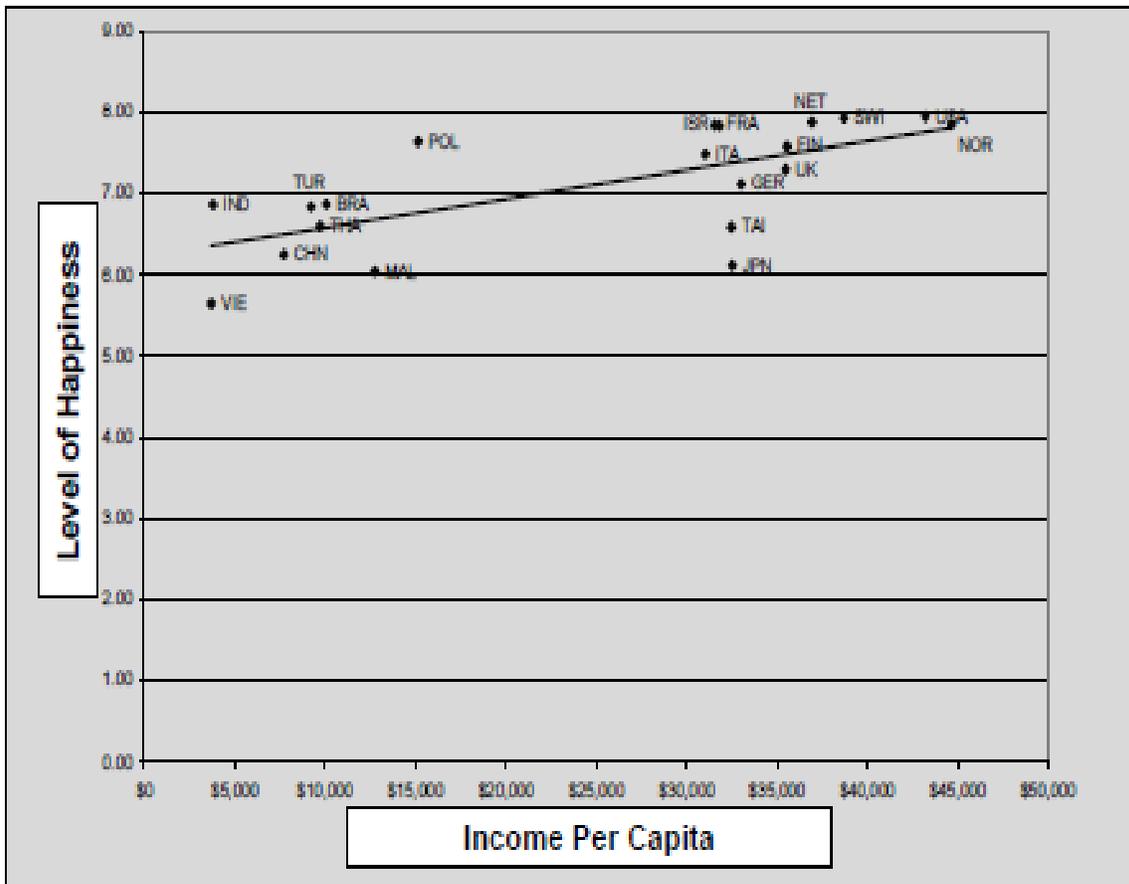


(Source: Countries and Cultures in Behavioral Finance, Meir Statman)

Different countries show different score for both tables. This shows cultures are not the same everywhere since people react to the same situations in a distinct manner in each country.

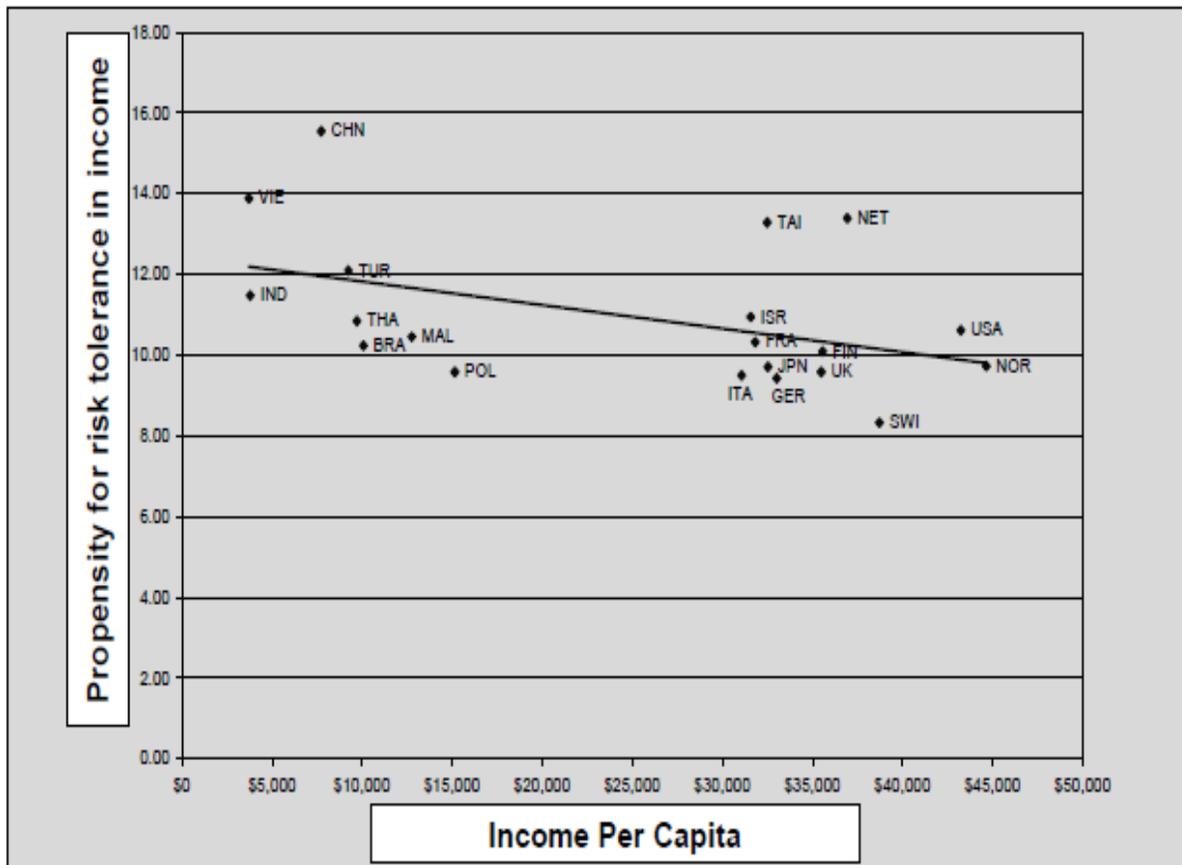
Why do we have differences in risk tolerance in income among countries?

Levels of happiness are higher in rich countries.



37

The propensity for risk tolerance in income is lower in rich countries



39

(Source: *Countries and Cultures in Behavioral Finance*, Meir Statman)

- People in low-income countries have not “arrived” yet. They have high aspirations relative to their current incomes and not as happy relative to higher-income countries.
- **People in low-income countries have a higher propensity for risk tolerance** than people in high income countries for the same reason that poor people spend more of their income on lottery tickets than rich people.

Differences in risk tolerance in income among countries can be explained by the Individualism-collectivism line. (Source: *Countries and Cultures in Behavioral Finance*, Meir Statman):

Individualism: Everyone is expected to look after himself and his/her immediate family.

Collectivism: People are integrated into strong, cohesive in-groups, often extended families (with uncles, aunts, and grandparents).

- When people are in groups, i.e. collectivism, they are provided downside protection.
- Propensity for risk tolerance increases automatically when downside protection is provided.
- **Conclusion: Propensity for Risk tolerance is higher in collectivistic countries.**
- One other interesting fact resulted from this survey is **“People are more happy in individualistic countries than collectivistic countries” as seen in the figure above.**
- Out of 88 countries ranked by individualism: USA ranked as #1 while China ranked at #65.

Islamic Finance:

The main principles of Islamic finance include:

- Prohibition of taking or receiving interest.
- Capital must have a social and ethical purpose beyond pure, unfettered return.
- Investments in businesses dealing with alcohol, gambling, drugs or anything else that Islamic law considers unlawful are deemed undesirable and prohibited.
- Prohibition on transactions involving speculation.
- Prohibition on uncertainty about the subject-matter and terms of contracts – this includes a prohibition on selling something that one does not own. (Source: ©Freshfields Bruckhaus Deringer 2006)

Our Advice

We can summarize some of the practices that should be followed:

- Financial advisers need to probe their clients more about their culture. Also important is to know the client's obligations towards others. As we saw above, individualistic and collectivistic groups have different styles of thinking. This reflected in their investment decisions.
- Continuously strive to learn more about investing.
- Understand the complexities in investing. The adviser will have to do more research and be sure that he does not fail his fiduciary duty. For example, an Islamic Finance Client can sue his adviser if his/her portfolio deviates from Islamic Principles.
- Saving Rates depend a lot on culture. It is important to understand your culture before you make investment decisions. Higher saving rates cultures are more risk tolerant than low saving rate cultures.
- Many times investors exhibit different abilities and willingness towards risk. Always honor the willingness to risk because the investor feels comfortable if his risk level is under his/her control.

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