# A DISCUSSION ON DIVIDENDS, BEHAVIORAL FINANCE AND CRYPTO

Jeremy Schwartz – Global Chief Investment Officer
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Last week's podcast was a joint production with Wesley Gray of Alpha Architects. Wes invited Sam Hartzmark, assistant professor at the University of Chicago's Booth School of Business, and Patrick O'Shaughnessy, of O'Shaughnessy Asset Management (OSAM).

Wes introduced Hartzmark as the most compelling researcher in academic finance land, with a specialty in asset pricing and behavioral finance. Hartzmark has an interesting perspective; he's influenced by Eugene Fama and the classic efficient markets researchers at the University of Chicago.

## Behavioral Finance

One of the most important biases Hartzmark studies is mental accounting. One of the earliest behavioral finance studies was around the disposition effect, or the tendency for investors to be much more likely to sell a position at a gain rather than at a loss. Hartzmark described the problem with this strategy as investors loading more highly on negative momentum strategies, leading to continually bad performance.

One paper Hartzmark wrote about this phenomenon shows that when investors have a loss, they roll their mental accounts from their first investment to the next. When investors are at a loss and close out the position at a loss, they are more likely to take on even riskier stock in their next investment in a desire to get even from their loss.

## Dividends in the Behavioral Lens

Hartzmark also has looked at dividends from the behavioral finance lens, and he thinks dividends come into the mental accounting research as well. Hartzmark believes that many people exhibit what he calls a free dividend fallacy, or a view of dividends as being an independent source of return from the price of the stock, when in reality stock levels trade down by exact amounts of the dividend. In some ways, this has investors looking at dividends from stocks in the same way as interest from bonds, and by his calculations, Hartzmark sees the demand for dividends correlating highly with low interest rate regimes.

O'Shaughnessy has looked at dividends extensively in his research as well. He wonders why firms pay dividends at all instead of looking at buybacks, and some of his research focuses on capital allocation, where firms that buy back stocks at cheap prices are some of the best opportunities. O'Shaughnessy also has looked at dividend growth levels compared to dividend yield and wonders why investors look at strategies like the Aristocrats—his work showed that high levels of dividend growth was less important than just high dividend yield historically, though that dividend yield used to be more associated with value portfolios. Since the financial crisis in 2009, his work suggests the low interest rate environment has made dividend yield less correlated to typical value investing (the U.S. markets more so than international markets).

### Disposition Effect in NFL Prediction Markets

Similar to how investors want to get even in stock markets, looking at gambling prediction websites for NFL games, Hartzmark demonstrated how NFL speculators close out positions during games when they have gains and also hold on to their losing position too long when they should close out for a loss, leading to systematically biased prices in these prediction markets as well.

### Alpha vs. Assets

O'Shaughnessy was recently appointed to be the CEO of OSAM, and he brings a fresh set of eyes to build his firm for long-run success. One of the core tenets by which OSAM is building strategies that are designed for alpha, and not necessarily just for large asset gathering. OSAM sees a clear trade-off in that the more assets one gathers, the less flexibility and more trading costs and frictions one would have that can impinge upon one's ability to generate alpha. Getting specific here, O'Shaughnessy believes the capacity of some large-cap value strategies may be as much as $100 billion, while his firm could handle perhaps one-quarter of those levels.

### Price-to-Book Investing

One of the value investing factors that has received a ton of attention has been the price-to-book ratio. I wondered if price-to-book accomplishes anything beyond just being a financial sector bet today. O'Shaughnessy discussed some of the challenges of price-to-book ratios today, including: the rise of intangible assets being approximately one-third of the S&P 500's book value today, buybacks and how they impact "common equity" levels, as well as low price-to-book levels being a proxy for bankruptcy risk. Chris Meredith, O'Shaughnessy's colleague, has written about some of the challenges of price-to-book ratio investing.[1]

### Crypto Fund?

I asked O'Shaughnessy if he is planning to launch a cryptocurrency strategy, given the success of his "Hash Power" podcast series. He responded that it is something he has considered, given that it is a new asset class that is data intensive and quantitative in nature like OSAM's specialty, but he does question whether one wants to own the beta of this asset class in a similar way one wants to own equity beta. A use case that O'Shaughnessy finds particularly compelling is the "tokenization" of specific cash flow streams and having these tokens becoming a legal security in which one can invest. This will certainly be an interesting space to study, and O'Shaughnessy does his learning in a very public and educational way.

This was a great conversation with one of the leading finance academics and one of the leading asset managers. My thank-you goes to both of them and to Wes for organizing this discussion.

[1] http://osam.com/pdf/Commentary_Price-to-BooksGrowingBlind%20Spot_Nov-2016.pdf

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## DEFINITIONS

**Mental Accounting** : A tendency for people to separate money into separate mental accounts based on source of money or intent for the account.

**Disposition Effect** : the tendency for investors to be much more likely to sell a position at a gain rather than at a los.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**Dividend** : A portion of corporate profits paid out to shareholders.

**Buyback** : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

**S&P 500 Dividend Aristocrats** : measures the performance S&P 500 companies that have increased dividends every year for at least 25 consecutive years.

**Alpha** : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

**Price-to-book ratio** : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Beta** : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.