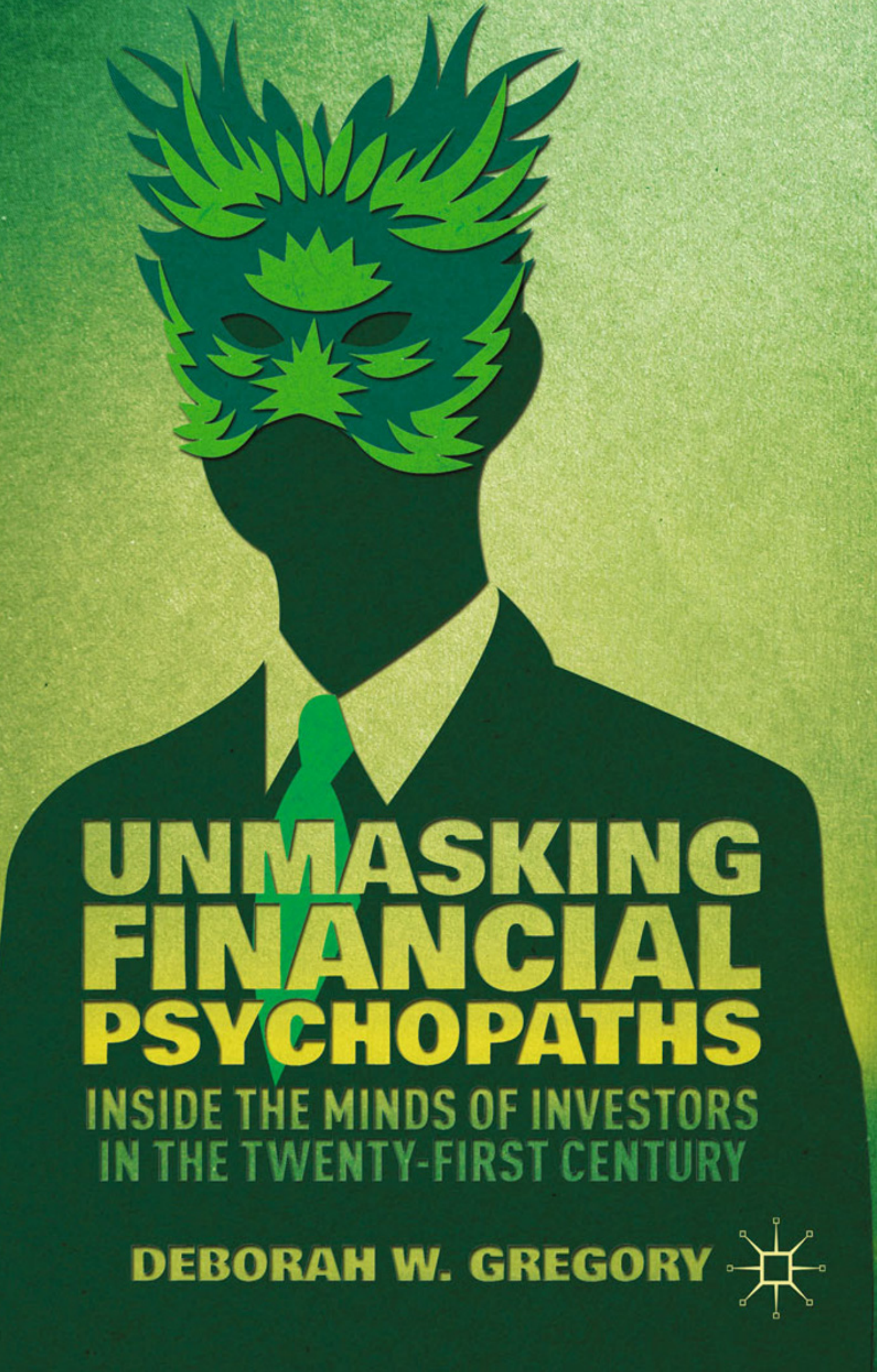

UNMASKING FINANCIAL PSYCHOPATHS

INSIDE THE MINDS OF INVESTORS IN THE TWENTY-FIRST CENTURY

DEBORAH W. GREGORY

Unmasking Financial Psychopaths

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Inside the Minds of Investors in the Twenty-First Century

Deborah W. Gregory

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This book is dedicated in memory of W. B. W.

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1

Introduction

Since the financial crisis of 2008, the veneer of the polished financier has cracked. People outside the financial world now openly question the motivations of the men and women who are at the financial helm, both in corporations and government. Apart from a few minor casualties, the public's overriding impression of how investment bankers, traders, and corporate financial executives weathered the storm is business as usual, accompanied by large bonuses that are once again increasing. Correspondingly, the average person has become acutely aware of the fragility of his or her investment portfolio, which had been fattened by the unprecedented increase in the housing and stock markets. That these same portfolios, which represent future nest eggs, college tuitions, and security during retirement, could lose so much value so quickly was not part of the plan. No wonder those involved in the financial markets bore the brunt of the anger, fueled in part by fear of not having enough in old age and, more immediately, of losing one's home and livelihood.

As after prior financial maelstroms, public discourse attributes the seemingly cavalier attitude of those in finance to unabashed greediness—that "they" were only looking out for their own interests and ignoring the dangers to the general population. Executives have been called before congressional panels to explain what went wrong and why they were unable to safeguard the system. No one has been willing to take responsibility; there have been few convictions for any misdeeds, despite clear evidence that misdeeds took place. This callousness has not gone unnoticed. Two financial journalists, Diane Henriques and Sherree DeCovny, in separate articles broached the topic and alluded to specific individuals as potentially being financial psychopaths—a much more pointed and personal indictment than the usual accusation of being greedy, which has been made since time immemorial when those involved in finance have prospered to the detriment of others.

The inherent trust that is placed in financial agents of all ilk was violated, and the outwardly unrepentant attitude of those involved left many people wondering what to do and who to trust. Something had changed between those responsible for financial transactions and custodianship and the people dependent on them for managing their money. Although the 2008 crisis has been compared to the 1929 crash, several factors are different. At a market level, regulations that had been put in place after the 1929 crash had steadily been dismantled, rendering the markets once again more vulnerable. The structure and holding of most investment banks had evolved from private partnerships to publicly held corporations, with a subsequent shift in risk from partners with money on the line to shareholders hoping to cash in on the profitable investment banking industry. Trading had become computerized, with dark pools and algorithms reducing the need for human traders and their gut instincts; using artificial intelligence, computers learned from trading how to be better and faster the next time. Quants—those with doctoral degrees in physics, mathematics, and computer science—became the most sought-after job applicants on Wall Street. The traditional economics majors with broader liberal arts backgrounds from Ivy League schools or newly minted MBAs with finance concentrations became less appealing.

And it was not just the financial industry that changed. Since 1987, individuals had become responsible for their own retirement funds (called *defined contribution plans*), rather than being assured a set pension amount from their employers during retirement (known as defined benefit plans). This meant that average Americans started to pay more attention to what was happening to the market, as they now could see the connection between what was paid into their retirement accounts and how much they would potentially have for retirement. Americans were encouraged to buy their homes rather than rent. Policies in both the government and the banking industry enabled and rewarded homeownership. Underwriting standards were relaxed, resulting in more and larger loans to less qualified individuals.

The essence of the changes enumerated above was to shift a great deal of financial risk to the individual, who on average is unschooled in finance and has little understanding of how markets function. Most people make investment decisions by relying on advice from professionals and so-called financial experts in the media, as well as from friends and family. Running the system were (and still are) the financial and political personages, who carried less risk yet became vastly wealthier. Readers familiar with the Modern Portfolio Theory (MPT) will note that this lower risk/higher return is an abnormal situation and one that unfairly favors the investment professionals; usually higher risk is compensated with higher rates of return. Thus, the structure of the system was such that it was not sustainable. Over the past 25 to 30 years, this complex interaction between individuals without financial expertise who believed that their financial well-being was being looked after, and the financial "masters of the universe" who had been schooled to make markets increasingly efficient, resulted in a toxic brew that left people wondering what had happened and why.

There is an expectation that people who steward money on behalf of others, that is, who have a fiduciary duty, are psychologically stable. To be otherwise would jeopardize the delicate structure of trust that a fiduciary duty entails. Even in 2013, five years after the start of the financial crisis, the Chartered Financial Analysts Institute, a professional organization to which many in the investment industry belong, was still struggling to shore up its reputation of integrity and trustworthiness. The target audience for this message was not those within the investment industry; rather, it was the public at large who still lacked confidence in the finance community. The idea that callous and untrustworthy individuals continue to run the investment industry today exists worldwide.

During the past two decades, the fields of behavioral finance and behavioral economics have slowly gained ground. Deemed not as glamorous as the quantitative side of finance by both academics and practitioners, behavioral finance seeks to explain how people interact with money, using cognitive psychology as the foundation and, more recently, drawing on neuropsychology. Both behavioral finance and behavioral economics account for the seemingly irrational human behavior in decision-making that was removed from economic models during the last century. Cognitive psychology focuses on mental processes—how people think about different events, situations, and so forth—and the resulting behavior. This branch of psychology fits well with the more rationally oriented economic and finance researchers, dealing as it does with more tangible factors. The inroads psychology has made into the field of finance has brought greater awareness not only to how individuals relate to their money, but also to how financial professionals approach their work. Research findings on the behavioral aspects of finance and economics are being used to craft policies to help individuals save more in their retirement accounts, as well as to inform algorithmic trading programs used by Wall Street professionals.

With advances in imaging technology, the cognitive approach has expanded to encompass neurophysiology through the use of functional magnetic resource imaging (fMRI). Researchers now watch activity in participants' brains as they engage in various financial tasks and games. The behavioral models that have emerged around financial activities thus far assume that everyone is neurotypical—that is, that the brain's neurological system is "normal." They also assume that everyone's behavior lies within the "normal" neurotic range. But what if someone lies outside the range or has a brain neurology that is not neurotypical or obviously abnormal? How does this change the models?

As fMRIs map the brain's response to financial situations, researchers seeking to push the boundary even further are investigating ways to tap the unconscious mind. Psychoanalytic theories are slowly seeping into behavioral finance and economics, seeking to explain the deeper role of the unconscious on both a collective and an individual level. Companies are employing archetypal focus groups in an attempt to unconsciously hook consumers on products—the Chrysler PT Cruiser that debuted in 2001 is one example. The Myers-Briggs Type Indicator tests based on the work of Carl Jung have been used for decades to find potential employees whose personality characteristics best match the job skills needed.

Certain psychological traits are seen as desirable when working professionally with money. For example, accountants who are more obsessive-compulsive with numbers, though not necessarily pathologically so, are highly valued as they are less likely to overlook errors when working through financial figures. On the other hand, a person who is interested only in his or her own welfare and is willing to financially hurt a client for personal gain is not, by most people's standards, a good fit for managing retirement portfolios. But a trading operation may value that same trait of self-interest in an employee, believing it drives the person to work harder to make more money, benefitting both the employee and the firm. Under the economic models that focus on rational self-interest, it makes sense that a person would put his or her own interests above others. No judgment is passed on how the trades are made; rather the bottom line is the overriding factor—how much profit has been made by the end of the day. In such a world, theoretically everyone wins. Thus, in the world of finance, the same psychological profile can be perceived as either an asset or a liability, depending on which segment of the financial industry is considering employing the individual.

Finance can be divided into distinct areas, each with a distinctive culture. Those individuals who display the desirable traits for a given area will become integrated into that particular segment of the industry. Potential employees who want to work within a given area of finance will either inherently possess the preferred traits or will learn to mimic them in order to be accepted.

In the following chapters, we will look at the traits of psychopaths to see which ones are seen as desirable within the investment world. Researchers have found that a greater proportion of psychopaths are found in both the financial and public service sectors than would be expected statistically. This leads us to consider two related questions. First, are psychopaths behind the helm guiding the global financial ship onto another set of rocks? Second, is the culture of finance inherently psychopathic? Or are there other factors in play that have led financial professionals to act in the manner of psychopaths to the detriment of society worldwide? This book explores the world of finance, psychopathology, and other factors that might influence the presence of certain psychopathologies within the finance profession. Its aim is to discover whether the labeling of individuals as financial psychopaths is justified in the fallout of the 2008 financial crisis or whether men and women in the financial industry are simply a product of their culture.

2

Entry into the Universe of Finance

Very few people outside of the financial professions have a clear picture of what is encompassed within the universe of finance, other than the handling of enormous amounts of money. When *finance* is mentioned in conversation, the vast majority of people have an emotional reaction to the word. They mentally and emotionally link it to some abstract idea they hold about what the word *finance* means to them. Adults not professionally involved in finance may immediately think of their own personal finances. Regardless of how much wealth a person has, a common concern is whether there is "enough" money. An administrative assistant earning $40,000 a year may be less fearful of not having enough than the CEO whose annual salary is more than a million dollars. Both bring their own fears and hopes about money, which shapes how they interpret the meaning of *finance*.

Others may take a different, less immediately personal perspective, instead making an associative leap to the wealthy people portrayed in the media. The recent Wall Street protests in Zuccotti Park in New York City demonstrated a concern about wealth equality that touched public consciousness. The movement sparked similar protests across the globe in reaction to the increased accumulation of wealth by the top 1 percent of the population. Some critics opined that such wealth redistribution has come at the expense of the "little" man, negatively impacting society and requiring changes in compensation and business practices. Those who identify with the "little" man may feel inadequate and that they will never get ahead financially. In contrast, others hear the same news and it fuels their desire to be among those who have accumulated and control vast quantities of money with seeming ease. They do not want to be counted among the majority of "little" men. Wealthy individuals, whose lifestyles are frequently idolatrized by the media, become visible role models for aspiring millionaires.

Young people who settle on a career in finance frequently do so with the sole intention of becoming rich. They are unlike their peers who are more entrepreneurially inclined—those college students who are passionate about something tangible and want to build a better mousetrap. Their primary purpose is not to become rich; wealth is a side benefit of their hard work. For the finance student, money is the passion and making more of it is the goal. How that is accomplished is less relevant.

To better understand the intentions, actions, and consequences put in motion by the financially ambitious young adult, the first step is to understand how such people are trained and what comprises the universe of finance that they will enter upon completion of their studies. With this grounding, it becomes possible to identify the types of individuals who would be attracted to the riches a profession in finance is rumored to offer. In this chapter, a brief overview of the field is given, focusing solely on corporate-oriented investment finance due to its special position as the home of media-sighted "financial psychopaths." Although other areas, such as public finance or personal finance, are also key to the workings of the financial universe by their very nature, they have not been singled out through media coverage as hotbeds for financial psychopaths and so will not be covered.

Finance, as a subject in its own right within university curricula, is relatively new. In 1958, Franco Modigliani and Merton Miller published an article entitled, "The Cost of Capital, Corporation Finance and the Theory of Investment," concerned with the separation of financing and investment decisions by firms. This article was published in the prestigious economics journal *American Economic Review*, providing the necessary widespread recognition the academy needed to acknowledge Modigliani and Miller's work as the seminal article establishing finance as a separate discipline from economics. Students pursuing degrees in finance are still required to take courses in both macro- and microeconomics, as traditional economic theory still forms the foundation for understanding how resources should be allocated to meet the needs of individuals and corporations alike. In addition to economic theory, finance curricula also require foundational coursework in statistics, mathematics, accounting, and, of course, finance-specific classes, such as corporate finance and investments. Undergraduate students at AACSB (the Association to Advance Collegiate Schools of Business)-accredited colleges and universities are also required to fulfill coursework requirements providing them with a broader educational background outside the business focus, as it is believed that such knowledge will create better-rounded individuals.

The traditional three pillars of academic finance—corporate, investments, and intermediation[1]—offer students the opportunity to focus on one specific area within this broad and highly complex field. College students who decide to concentrate in finance rarely understand the breadth and depth of the discipline when they first select their major. Knowing that finance is related to money and being driven by the desire to "make (a lot of) money," they sign up for a course of study that frequently does not match their inherent talents and interests. It is not until later, when students have been exposed to the fundamental theories of finance, that they realize the degree of mathematical complexity involved in the discipline. The pillar of investments (where many students believe they can make the most money) is especially reliant on higher order mathematics. Once the realities of the academic demands begin to sink in, some students either switch to a less mathematically rigorous path or opt out of finance and into a different field of study.

Classroom Finance: Corporate, Investments, and Intermediation

All students majoring in finance are first required to take the basic corporate finance class. Until recently, enrollment was only permitted to juniors. Waiting until the start of the third year was considered necessary, allowing students the time to obtain a firm foundation in both micro- and macro-economics, statistics, and basic financial and managerial accounting. In the basic finance course, students are introduced to the basics of financial mathematics and given a broad overview of the fundamentals of corporate finance, covering a general overview of how to manage the finances of large corporations, including how to raise capital (both equity and debt) and how to calculate the corporation's cost of capital. Financial theories, such as the Capital Asset Pricing Model (CAPM), are also included in the basic curriculum, touching on the concepts of risk and return. Working capital management, with its focus on short-term money management, is given more or less attention depending on the focus of the finance department. General financial strategy is usually taught in greater depth at more advanced levels. As topics gain or lose popularity, emphasis is shifted to different areas within the curriculum, but the overall gist remains relatively consistent over time and