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The Noise Trader Approach to Finance

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Abstract

This paper reviews an alternative to the efficient markets approach that we and others have recently pursued. Our approach rests on two assumptions. First, some investors are not fully rational and their demand for risky assets is affected by their beliefs or sentiments that are not fully justified by fundamental news. Second, arbitrage—defined as trading by fully rational investors not subject to such sentiment—is risky and therefore limited. The two assumptions together imply that changes in investor sentiment are not fully countered by arbitrageurs and so affect security returns. We argue that this approach to financial markets is in many ways superior to the efficient markets paradigm.

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