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Perspectives on Behavioral Finance: Does "Irrationality" Disappear with Wealth? Evidence from Expectations and Actions

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Abstract

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This paper discusses the current state of the behavioral finance literature. I argue that more direct evidence about investors' actions and expectations would make existing theories more convincing to outsiders and would help sort behavioral theories for a given asset pricing phenomenon. Evidence on the dependence of a given bias on investor wealth/sophistication would be useful for determining if the bias could be due to (fixed) information or transaction costs or is likely to require a behavioral explanation and for determining which biases are likely to be most important for asset prices. I analyze a novel dataset on investor expectations and actions obtained from UBS/PaineWebber/Gallup. The data suggest that, even for high-wealth investors, expected returns were high at the peak of the market, many investors thought the market was overvalued but would not correct quickly, and investors' beliefs depended strongly on their own investment experience. Then I review evidence on the dependence of a series of "irrational" investor behaviors on investor wealth and conclude that many such behaviors diminish substantially with wealth. As an example of the cost needed to explain a particular type of "irrational" behavior, I consider the cost needed to rationalize why many households do not invest in the stock market.

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