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The End of Behavioral Finance

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Abstract

The controversy surrounding behavioral finance is dying out as scholars accept it as simply a new way of doing financial economic research.

Behavioral finance has, during its short history, been considered a controversial field. Some consider it heresy. Why? Few have ever believed that all investors really make decisions according to the rational axioms of choice under uncertainty. Rather, defenders of the rational efficient market hypothesis have argued that markets can be efficient even when many investors make systematic errors; as long as there are a few smart arbitrageurs, according to this logic, market prices will still be rational. We now know that this argument is flawed. Limits to arbitrage allow for the possibility that prices can diverge from intrinsic value, even in the presence of rational arbitrageurs.

A useful example of this principle is the case of Royal Dutch/Shell Group. The two components of this company (Royal Dutch and Shell Transport) should trade at a price ratio of 1.5 because, by charter, Royal Dutch is entitled to 60 percent of the revenues, with the rest going to Shell. Although prices in this case would seem simple enough to get right, the actual price ratio has deviated from the expected one by as much as 35 percent. Hedge funds have tried to profit from this discrepancy, but such trades run the risk that the prices will diverge even more (as happened in August and September 1998).

If markets can get prices wrong in this relatively simple case—and wrong by so much—then in other, more complex situations, prices can be much farther out of line. For example, consider the current prices of Internet stocks. If they exceed intrinsic values (as many believe), arbitrageurs can do little to correct the situation. “Smart” investors who have been short the Internet sector over the past two years have had a painful ride.

Plenty of other evidence indicates markets do not seem to be behaving in a textbook fashion. Compared with a rational model, markets seem to have too much volume and too much volatility. Companies pay dividends, although share repurchases seem to be a dominant strategy. Stock prices move in predictable patterns. And the return difference between stocks and bonds, the equity premium, has historically been much higher than any rational model can explain.

Some of these puzzles are beginning to be understood by incorporating psychological phenomena into our models of financial markets. For example, too much trading is explained by overconfidence. Stock price predictability can be explained by the biases generated from the use of simple rules of thumb, or heuristics. The enormous equity premium can be explained by a combination of mental accounting and loss aversion.

Surely, the idea that we might be able to understand some aspects of financial market behavior by incorporating ideas from psychology and other social sciences should not be considered controversial. I am thus predicting an end to the controversy and, indeed, an end to behavioral finance. In the future, financial economists will routinely incorporate as much “behavior” into their models as they observe in the real world. After all, to do otherwise would be irrational.

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