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PERSPECTIVES

The End of Behavioral Finance

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Abstract

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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 generate [...] us equity premium [...] aversion.

Surely, t [...] cial market behavior [...] should not be consi [...] and, indeed, [...] l routinely incorpor [...] al world. After [...]

Relat[...]