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BEHAVIORAL FINANCE

Behaviorial Finance: Past Battles and Future Engagements

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Abstract

Market efficiency is at the center of the battle of standard finance versus behavioral finance versus investment professionals. But the battle is not joined because the term "market efficiency" has two meanings. One meaning is that investors cannot systematically beat the market. The other is that security prices are rational. Rational prices reflect only utilitarian characteristics, such as risk, not value-expressive characteristics, such as sentiment. Behavioral finance has shown, however, that valueexpressive characteristics matter in both investor choices and asset prices. Therefore,

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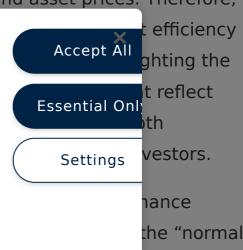
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investor" of behavioral finance has needs and preferences that go beyond the utilitarian needs of the "rational investor" of standard finance.

Marketing scholars divide the characteristics of products into two groups, utilitarian and value expressive. This breakdown applies to the investment business just as it does to, for example, the watch business. Consider a Microsoft Corporation share and a Kmart Corporation share. The two may be different in terms of utilitarian characteristics; they are surely different in terms of value-expressive ones. Microsoft, like a Rolex, is a high-status (growth) stock; Kmart, like a Timex, is a low-status (value) stock. Timex buyers, like Kmart buyers, do not beat the watch market when they buy a \$50 Timex in place of a \$10,000 Rolex. Rolex buyers, like Microsoft buyers, get \$50 worth of utilitarian time-telling and \$9,950 worth of value-expressive status.

The fact that arbitrage between Rolex and Timex or Microsoft and Kmart is limited does not imply the market is inefficient in the beat-the-market sense. It only means that equilibrium prices reflect value-expressive characteristics.

Investment academics and professionals usually consider investments to be utilitarian products: A dividend dollar is identical to a capital dollar and a tobacco dollar is as green as a socially responsible dollar. Many investors, however, care about the value-expressive characteristics of investment products; they know that their investments, like their watches, say a lot about them. Some investors want the righteousness of socially responsible funds; other investors want the high status of hedge funds.

Utilitarian and value-expressive characteristics play roles in the battle among standard finance, investment professionals, and behavioral finance over market efficiency. Investment professionals embrace the finding of return anomalies by behavioral finance as an ally in the battle. But the market efficiency battle is futile because the term has two meanings. One meaning is that investors cannot systematically beat the market.

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Question

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rs hold the

key to understanding how the products and services of the investment profession affect

the bottom line of the investment business. Acceptance of market efficiency in the beat-the-market sense and its rejection in the rational sense allow us to explore the many roles of investment professionals, roles that go much beyond market beating. For example, investment advisors help investors stay the investment course when markets are volatile, and Internet brokerage firms provide 24-hour trading to those who seek excitement.

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