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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 value-expressive characteristics matter in both investor choices and asset prices. Therefore, the discipline of finance would do well to accept the first meaning of market efficiency and reject the notion that security prices are rational. We could then stop fighting the market efficiency battle and focus on exploring (1) asset-pricing models that reflect

both value-expressive and utilitarian characteristics and (2) the benefits, both utilitarian and value expressive, that investment professionals provide to investors.

Investment professionals can benefit from understanding how behavioral finance augments standard finance. And they can benefit from understanding that the “normal 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. The second is that security prices are rational. That is, prices reflect only utilitarian characteristics, such as risk, but not value-expressive characteristics, such as sentiment. I argue that we would do well to accept market efficiency in the beat-the-market sense but reject it in the rational sense. This approach would allow us to explore capital asset pricing models that include both utilitarian and value-expressive characteristics.

Questions about the utilitarian and value-expressive preferences of investors 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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