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Khatib

AGREE

Six thousand years of recorded history show that human nature leads to recurring, predictable, and exploitable behavioral excesses. By ignoring the causes of human excesses, traditional finance theories have failed to adequately isolate, capture, and predict in their empirical research the important effects of the behavioral dimension of market participants.

The efficient market hypothesis (EMH), the capital asset pricing models, and the dividend discount and discounted cash-flow asset valuation models have all been unable to fully predict the excess returns realized after the end of an exaggerated sell-off in the markets. In other words, when rational behavior matters most, only a few, if any, market participants behave rationally.

Enter behavioral finance: an ambitious attempt to identify and model deficiencies in the cognitive abilities of investors and analysts. Herd mentality, the contagion effect, loss aversion, extrapolation, hindsight bias, and the illusion of control are all manifestations of flawed human behavior that help explain many of the empirical anomalies in traditional finance theory.

According to psychologists Shafir and Tversky, market participants will continue to let emotions cloud their investment decision making and the processing of information, regardless of how well they have thought out their strategies. Recurring irrational behavior is thus inevitable and predictable through behavioral finance theory.

Granted, behavioral finance is an attempt to quantify the intangible, and the merging of a more abstract science with traditional finance is a tough sell. In the words of renowned economist Merton Miller, “The blending of psychology and economics will lead nowhere. The mix is becoming popular simply because conventional economics has failed to explain how asset prices are set.”

Nonetheless, recent research shows that behavioral finance theory converges with rational structural uncertainty models, at least mathematically, and should be pursued further to refine the findings of traditional finance theories. Perhaps the greatest evidence of the pertinence of behavioral finance is embodied in John Huston’s film classic, “The Treasure of the Sierra Madre,” where the pursuit of gold transforms a rational partnership into a killing bonanza. If art captured the human psyche on film 55 years ago, then finance theory should not shy away from the attempt today. **■**

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Singal

DISAGREE

*“If behavioral finance did not exist, it would be necessary to invent it.”
(with apologies to Voltaire)*

While investors may behave irrationally, irrational investors do not set prices nor do behavioral finance models explain anomalies. In fact, these models have one common flaw: The moment learning is introduced, the models fail to explain anomalous prices. Moreover, behavioral models predict initial underreaction to almost all events since investors are slow to change their beliefs. The models also imply that underreaction is followed by overreaction because investors tend to be “overconfident.” Unfortunately, most events, such as dividend initiations and omissions, stock splits, proxy contests, and spin-offs, do not follow these predicted patterns.

Anomalies may, however, be caused by rational behavior. Consider the typical investor who makes decisions based on incomplete information. Assume that there is a chance for the stock price to jump from \$100 to \$120. Given limited information, the rational investor assigns a 10 percent probability to the price increase and a 90 percent probability to no change. Thus, his/her expected price is \$102. If the price actually jumps to \$120, the pattern looks like an underreaction. If it remains at \$100, the pattern seems like an overreaction, though both outcomes are a result of rational expectations, and are not due to irrational behavior.

Anomalies may also exist due to institutional characteristics or market limitations. For example, the temporary price increase for additions to the S&P 500 index can be attributed to the index fund managers’ desire to minimize tracking error; and the January effect persists because trading costs are too high. “Apparent” anomalies may exist due to data mining, selection bias, survivorship bias, non-synchronous trading, and most importantly, inappropriate benchmarking. None of these anomalies can challenge traditional finance.

Finally, whenever a rational explanation *cannot* be found, it is easy to blame the anomaly on irrational investors. The weekend effect was attributed to irrational behavior, but recent research shows that it is probably caused by rational speculative short sellers.

It seems to me that the only purpose behavioral finance serves is to provide a catchall rationalization for any unexplained occurrence *until a rational explanation can be found.* **■**

Vijay Singal, CFA, is chair of the Finance department at the Pamplin College of Business, Virginia Tech, in Blacksburg, Va., USA. This essay draws from his book, *Beyond the Random Walk*.

AGREE OR DISAGREE
Behavioral finance is useful in explaining apparent empirical anomalies in traditional finance theories.

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