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When market theory collides with reality



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FUNDAMENTALS

Traditional financial theory assumes investors' decisions about buying and selling stocks are always rational. In theory, the result is an efficient market – one in which prices completely and accurately reflect all available information.

In its extreme form, efficient market theory holds that because all known information is reflected in current stock prices, future performance is inherently unpredictable. That is the logic behind passive investment strategies, such as indexing.

The problem is that market theory cannot always be reconciled with market reality. The recent internet bubble, in which investors appeared to ignore critical information both in bidding up dotcom prices and slamming them back down again, is only the latest example of seemingly irrational financial behaviour.

Behavioural finance seeks to explain these anomalies by looking at how human psychology influences the choices investors make – such as how they value stocks, how often they trade, and how they make buy and sell decisions.

Richard Thaler, a finance professor at the University of Chicago, argues that investors are not necessarily irrational. Rather, he says, their thinking is often misguided by subtle biases and judgmental blind spots. Researchers call these traits “cognitive illusions” and they can lead to investment decisions that seem to make intuitive sense but produce inferior results.

Some of the most detailed data on behavioural finance has been collected by Brad Barber and Terrance Odean, professors at the University

of California at Davis. They were given access to the account records, but not the identities, of more than 66,000 customers of a leading discount broker over a six-year period, ending in 1997. In an earlier study, Prof Odean examined records from 10,000 accounts from January 1988 until December 1993.

Both studies reported similar findings: left to their own devices, many investors tend to be chronically inefficient. They are overconfident about their abilities, they overreact to abnormally high or low returns and they are inclined to buy losers and sell winners.

In the first study, reported in the December 1999 issue of the *American Economic Review*, Prof Odean compared the returns on the stocks investors bought with the returns on the stocks they sold.

Over the following year, the stocks sold outperformed the stocks purchased by a 3.3 per cent margin, net of trading costs. Prof Odean also found investors had a strong tendency to chase performance. On average, the stocks they purchased had higher past returns than the stocks they sold.

The follow-up study, published in the April 2000 issue of the *Journal of Finance*, compared the investment performance of discount brokerage customers with a composite of stocks listed on the New York Stock Exchange, the American Stock Exchange and the Nasdaq.

Over the six-year period, the typical investor earned considerably less than the composite, net of costs. By almost any measure, individuals who actively invested had the worse

results. In other words, as professors Odean and Barber concluded, “trading is hazardous to your wealth”.

Even when investors are not picking their own stocks, they can still make expensive mistakes. This was documented by Prof Thaler and Shlomo Benartzi, another noted behavioural researcher. Their findings appeared in the March issue of the *American Economic Review*.

The pair studied the decisions of participants in self-directed retirement accounts, such as 401(k) plans. The participants were asked how they would allocate their savings among a hypothetical set of mutual funds.

The study found that the choices made by participants were heavily influenced by the options offered in their plan. If the funds were more equity oriented, participants tended to put more of their money in stocks. If bond options predominated, they invested more money in bonds.

The study then examined asset allocations in 170 savings plans covering almost 1.6m workers. Again, the results showed a strong correlation between the number of equity options offered and the percentage invested in equities. As the authors noted, such behaviour “does not assure sensible or coherent decision making”. Investors may end up taking too much risk or not enough to meet their financial goals.

The first step towards avoiding such errors is recognising the biases that cause them. Investors should develop sensible long-term strategies and stick to them. While this will not guarantee success, it can at least reduce the risk of being led astray by the quirks of human psychology.

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