Irrational exuberance

The tendency to invest with your heart instead of your mind has always been a factor in market behaviour and a leading researcher in the discipline of behavioural finance has recently updated his research. PETER PONTIKIS reports.

Advances in behavioural finance. Volume II
By Richard H. Thaler
Russell Sage Foundation, New York, 2005

This second volume by Thaler et al is an abridged collection of the up-to-date salient research in the new discipline of behavioural finance. It has, as Thaler says, been more than a decade since his first edition first sought to bring into one book the cutting edge advances in this new and sometimes maligned area of financial economics.

The book is neatly divided into six sections that encompass the areas of the limits to arbitrage, stock returns and premiums, empirical studies of under and over reaction, theories of under and over reaction, investor behaviour and corporate finance. It is a book with a wide scope and it has something to offer even the most knowledgeable and specialised of finance practitioners.

The book predictably begins with an analysis of the impact and interplay between non-rational (or politely labelled quasi-rational) market agents and the institutional limits to arbitrage. It is a situation long recognised in behavioural economics that leads markets to produce sub-optimal outcomes, or in a word ‘mis-pricings’, and at the very least biases prices in favour of the ‘optimists’.

Part two revisits in greater detail familiar aspects of observed stock pricing anomalies, most notably in the area of myopic loss aversion and its impact on the equity premium. Its articles on persistent mis-pricings of tech floats and long term stock valuations highlight the challenge to the efficient markets hypothesis where irrational investors contest market values against a complement of risk averse, but otherwise rational, arbitrageurs and investors.

The third section takes a hard look at the institutional biases of sell-side analysts and considers (in the aftermath of the Enron and tech bubble/saga) the impact of their recommendations, investor choices and the abuses of the IPO process (at least in the US), and predictably concludes that non-IPO affiliated analysts tend to perform better as a group in analysing stocks compared to analysts who are affiliated to floats. The section also takes a look at the co-variance of stocks based on characteristics as an alternative to ratio analysis with implications for correlation and stock strategies.

The subsequent section takes on the theories of under and overreaction that make for asymmetric responses of markets to new information, and notes once again the phenomenon that underreaction to information in the short run will eventually lead to informational overreaction in the long run. All this is exacerbated by the interplay of the returns – dependant confidence of investors and well-documented heuristic strategies such as technical or earnings-based momentum models, otherwise called positive loop-back strategies.

Part five looks at the range of investor behaviours from naïve diversification to overconfidence as direct outcomes of what is called bounded rationality (or decision making under conditions of incomplete knowledge). Something that of itself is combined with constraints on arbitrageurs feeds again into the above-mentioned momentum strategies (and phenomena).

Add to this the peccadillos of cyclical confidence and risk aversion and analysts are given a more realistic map of the financial market place but one ever more nuanced and at the same time exotic.

The final section delves into the quirks of managerial capitalism in its review of the effect of optimistic managers and the earning managements on financial reporting, presenting the business case for sober non-insiders on boards to complement the enthusiasm of organisational incumbents. It concludes with a cautionary paper on the value of Beta in capital budgeting, stating while it is by no means dead, the traditional CAPM approach is in need of serious modification.

The plus 700 pages is designed with the post graduate audience in mind and one should be warned this is not an easy read, as many of the papers are clearly of a highly technical and academic nature. While overwhelmingly US-centric in terms of research (and arguably unavoidable given its origins and infancy as a branch of finance), it is probably the best book available at this point in time exotic.

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