

MOVING FROM EFFICIENT MARKET TO BEHAVIORAL FINANCE HYPOTHESIS

Recent debates in the field of finance involve the progression of what has known as behavioral finance, which can best be referred as the irrational behavior of investors in the financial market. Fromlet (2001) states that behavioral finance is the combination of individual behavior, market phenomena and the use of knowledge taken from both psychological field and financial theory. From the financial theory perspective, behavioral finance seeks to understand and predict systematically the implication of psychological decision process towards financial market. Ritter et. al (2003) suggested that behavioral finance has two building blocks, which are cognitive (how people think) psychology and the limit to arbitrage. Some people are too overconfident and putting too much effort on recent experience which unfortunately leads to systematic errors. Limits to arbitrage refer to what extent circumstances arbitrage forces will be effective or verse versa. The conventional and modern finance are based on rational and logical theories such as the Efficient Market Hypothesis (EMH) as well as the Capital Asset Pricing Model (CAPM) where they assume that investors behave rationally. Rationality means when investors receive new information, agents update their beliefs correctly, in the manner described by Bayes' Law (Barberis and Thaler, 2003). However, as time goes by, most finance and economic experts found that there are some anomalies and behaviors unexplained by theories available. Investors nowadays are frequently behaved irrationally. For instance, The recent downturn in the US economy also shows some irrational behavior of investors which drag the market from bad to worse. The unpredictable confidence and different processes endangered by fear has become among the reasons why recession are so difficult to forecast. Some economic models like the US never have been successful in capturing a process driven in large part by irrational behavior (Johnson, Lindblom and Plantan, 2002).

research came from the article titled "Possibility of an experimental approach to investment studies by Professor O.K. Burrell, University of Oregon in 1951, followed by the W. Scott Bauman, Burrell and Bauman on "Scientific Investment analysis: Science or fiction?" in 1967 and continued by Paul Slovic who published a detailed study of the investment process from a behavioral perspective. In 1972, Bauman and Slovic continued this line of inquiry and published the first seminal paper in the area "Psychological Study and Human Judgment". From that time, many academicians attempt to explore the possibility of research area in the field of behavioral finance such as Richard Thaler (University of Chichago), Robert Shillar (Yale University), Howard Kunteuther (University of Pennsylvania), Werner De Bondt (University of Wisconsin), among other. The renewed interest in the area appears to have triggered by two developments. The first was mounting empirical evidence that existing financial theories appeared to be deficient in fundamentals way. The second was the development of prospect theory by professors Daniel Kahneman of Princeton University and Amos Tversky of Stanford University. Kahnmen and Tversky (1979) present a model of decision making that was an alternative to subjective expected utility theory with more realistic behavior assumptions. They show that judgments tend to be made using a representativeness heuristic, whereby people try to predict by seeking the closest match to past patterns, without attention to the observed probability of matching the pattern. For example, when asked to guess the occupations of people whose personality and interests are described to them, subjects tended to guess the occupation that seemed to match the description as closely as possible, without regard to the rarity of the occupation.

that the 1980s were a time of important academic discussion of the consistency of the efficient markets model for the aggregate stock market with econometric evidence about the time series properties of prices, dividends and earnings. One particular concern was whether these stocks show excess volatility relative to what would be predicted by the efficient markets model. In the 1990s, a lot of the focus of academic discussion shifted away from these econometric analyses of time series on prices, dividends and earnings toward developing models of human psychology as it relates to financial markets.

The regularly occurring anomalies were a big contributor to the formation of behavior finance whereby it assumes rationale and logical behavior. Among of the anomalies are January Effects, and The Winner's Curve. The January effect is the most important calendar anomaly. The returns on common stocks in January are much higher than in other months, and this phenomenon is due to smaller-capitalization stocks in the early days of the month. The January Effect occurs because many investors choose to sell some of their stock right before the end of the year in order to claim a capital loss for tax purposes. Once the tax calendar rolls over to a new year on January 1st these same investors quickly reinvest their money in the market, causing stock prices to rise. The Winner's Curve anomaly is the tendency of winning bid in an auction setting to exceed the intrinsic value of the item purchased. Rational-based theories assume that all participants involved in the bidding process will have access to all relevant information and will all come to the same valuation. Any differences in the pricing would suggest that some other factor not directly tied to the asset is affecting the bidding. Other main important elements and concepts that exist in behavioral finance are overreactions and the availability of bias, and overconfidence. Normally, when the company raised some good issues (such as paying a good dividend), it should also raise the business' share price accordingly to the news. And whenever there's no news coming up later on, it should not bring the share price go down. However, in reality,

THE ORIGINS OF BEHAVIORAL FINANCE - AS TIME PASSES BY

One of the earliest (if not the first) call for a scientific melding of psychological and financial

Behavioral finance, which comes from broader social science perspectives, has now become one of the most vital research programs and it stands in sharp contradiction to much of efficient markets theory. In the 1970s, the Efficient Market Theory and CAPM were very popular and reached its high dominance in the academic circles. Siegel (2002) suggested

participants in the market overreact to the new information which creates a larger effect on a security's price.

The availability bias is when people tend to heavily weight their decisions toward more recent information, making any new opinion biased toward that latest news. This happens in real life all the time. For example, suppose you see a car accident along a stretch of road that you regularly drive to work. Chances are, you'll begin driving extra cautiously for the next week or so. Although the road might be no more dangerous than it has ever been, seeing the accident causes you to overreact, but you'll be back to your old driving habits by the following week. Overconfidence is not a trait that applies only to fund managers. Consider the number of times that you've participated in a competition or contest with the attitude that you have what it takes to win - regardless of the number of competitors or the fact that there can only be one winner. There's a fine line between confidence and overconfidence. Confidence implies realistically trusting in one's abilities, while overconfidence usually implies an overly optimistic assessment of one's knowledge or control over a situation.

THE ISSUES AND ARGUMENTS

There have been some criticisms made by some expertise in the financial market pertaining to the development of behavioral finance. Eugene Fama, a Finance Professor from the University of Chicago who is widely regarded as the initiator of the efficient-markets theory, has been the field's loudest and most enduring critic. Schiller (2003) states that Fama found fault for two basic reasons. The first was that the anomalies that were discovered tended to appear to be as often under reaction by investors as overreaction. The second was that the anomalies tended to disappear, either as time passed or as methodology of the studies improved. In Fama's paper in the *Journal of Financial Economics* in 1998, he scoffed at the idea that behavioral finance, with its explanations of bubbles, panics, trends

in asset prices and insistence that the market can be beaten might replace or trump efficient-markets theory. "The field tends to attract people who are not very good statisticians. It has tended to attract people who basically just look for anomalies, without any rhyme or reason. And that's not science." In brief, Fama argues that behavioral finance hasn't shown that the tendencies of individuals, when aggregated, have an impact on world prices. He also points out that behavioral-finance models frequently contradict one another (Wharton, 2001).

Hersh Shefrin, a professor of finance at Santa Clara University however, disagrees with Fama's bottom line. He argues that it's a misconception that behavioral finance means people can beat the market. "Behavioral finance doesn't say, 'There's easy money, go after it.' It says that psychology causes market prices and fundamental values to company for a long time. Although there's a potential profit opportunity there, it comes packaged together with additional risk, and smart money can't or won't take a large-enough bet to eradicate the anomaly." This implies that smart money won't be able to arbitrage market to equilibrium - perhaps because it's not possible, it would take too long, it's too risky in the short run, or for some other reason. So the anomaly will persist. "That's the lesson about behavioral finance, and that's the lesson that most academics don't understand," he argued. He goes on to point out that retail investors who think they're clever enough to beat the markets usually don't even understand traditional ideas, and "should probably simply act as if Eugene Fama is right and follow a passive long-term strategy." He also mentioned that many weaknesses in many of the behavioral finance aspects has been written now, and have been written in the last few years. The models they are putting together are ad-hoc since there are not enough professionals who have been trained in both academic psychology and traditional finance. However, still he argues that the discipline is moving in a right decision and gaining its momentum whereby people are continuing to walk across

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