

End of Behavioral Finance

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Abstract

I really don't know why Richard Thaler chose this headline for a research paper. Many other behavioral finance academic papers also capture attention. "Can the markets add and subtract?"; "The winner's curse"; "The gambler's fallacy", "Does the stock market overreact?" While the popularity of the subject has increased and behavioral biases have got so pervasive that everybody seems to be biased, the question is whether the behavioral finance experts are bias-free?

Deviation

Behavioral finance is a subject built around price anomalies. The anomaly is a deviation or departure from the normal. Prices tend to deviate from normal most of the time. Markets tend to overvalue or undervalue asset prices more often than staying at a fair value. So, whether it is stock markets diverging from the real economy or a performing sector diverging from an underperforming one, it all boils down to divergence. This idea of deviation, departure or divergence can be extended from the markets to nature. A low paying job versus a high paying job, a lot of rain compared to drought, magnetic anomalies, divergences are all over the place.

Are these deviations different?

Well, statistically speaking; no. But, psychologically speaking, yes. It's not the task of behavioral finance experts to look for transcending rules across areas of study, be it psychology or nature. Many time thinkers are so focused on "pattern-seeking" that the big picture eludes them. And whose job is it anyway, to look for common rules across nature? Even Mandelbrot, who could have pushed himself for connecting diverse areas, concluded that it was all geometry, there was no law. I disagree with Mandelbrot and the behavioral school of thought. I am with the statisticians. They are the ones who look at deviations, departures as errors and they are the ones who identified that fat tails were more normal than irregular. So, if diversions are a reality in nature, then is behavioral finance not getting ahead of itself by basing every stock market departure as owing to psychology and ignoring the rest of the natural divergences?

The academic paper in question

Let's get more specific. The five aspects Thaler points out in his paper 'End of behavioral finance' (a term he confidently used to suggest that behavioral finance will be the only form of finance left) are 1) The equity premium puzzle, 2) Predictability, 3) Dividends, 4) Volatility and 5) Volume myth. All of these five aspects can be explained as mean reversion failures.

First; the equity premium puzzle is that the undue premium equities get over treasuries are more than justified by the inherent risk in equities. So, the question behavioral finance is asking here is why equity premium (above the risk premium) does not revert to the mean (vanish), or why don't equities erase the respective premium vs. treasuries over a certain period.

Second; behavioral finance suggests that predictability in markets is a factor of mispricing. When value gets mispriced versus glamor, it invariably corrects and delivers abnormal returns. Here behavioral finance suggests that because a mispriced asset reverts to mean it delivers returns. This again is a case of a mean reversion failure followed by a regular mean reversion.

Third; dividends, i.e. why do most large companies pay cash dividends? And why do stock prices rise when dividends are initiated or increased when companies can make their taxpaying shareholders better off by repurchasing shares rather than paying dividends? Here behavioral finance seems to be questioning why dividend stocks earn a premium when they shouldn't. Or, in other words why dividend premium should not revert to a mean value (vanish)? Fourth and fifth; volatility and volume are other cases of mean reversion failure. Both volatility and volume are unexplained, exhibit extreme behavior and don't adhere to any standard models.

In conclusion, I am making two points here. First; if mean reversion failure is the ubiquitous phenomenon witnessed across markets and nature, then is psychology or mood not just a tail explanation of an elephant phenomenon. And second, if mean reversion failure is the big picture, why don't statisticians jump on behavioral finance experts with bolder academic headlines illustrating the authors the limitation in "psychological pattern seeking" and why using END along with a loving creation could be risky.