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Out of the Shadows: The Future of Behavioral Finance
by Cynthia Harrington, CFA

We are a profession in search of direction, according to the study recently published by CFA UK. Results reveal that over three quarters of British members believe markets are no longer rational and that two thirds view markets as inefficient mechanism of pricing.

From a practical standpoint, it's easy to see why the votes came in the way they did. The meaning of rational and irrational actually seems to have switched places. Individual investors may have been perfectly rational in their fleeing the equity markets, on the vague feeling that what's going on with markets and with bailouts is beyond anyone's comprehension. Alternatively, the models designed to be perfectly rational were all in same positions, and leveraged, and all had to unwind in the liquidity squeeze of August 2007, exhibiting extreme irrationality.

So what might replace the old intellectual framework? Behavioral finance, according to the article. But only a small percentage of members think that's going to happen.

I can personally attest to the inability of behavioral finance to emerge as the new framework. I've been in the field for almost a decade, after finding Gary Becker's "Human Capital". My interest accelerated when I wrote two articles for CFA Magazine. The first was an overview of the field from the viewpoints of Dick Thaler, Hersh Shefrin, Robert Shiller, and Vernon Smith; the second, how behavioral finance was being used in the field by Russ Fuller, Cliff Asness, Arnold Wood, and Richard Peterson. Since then I've had the privilege to continue to study the field and meet with researchers as a member of the CFALA-affiliated Applied Behavioral Finance Group. Yet despite the years of reading and writing about the subject, and the high level of discussion of this group, I struggle with finding useful applications of this research that I know to be valuable.

The likely reason is stated right in the British study. Behavioral finance has been primarily constructed under the old framework of rational human, and used to explain why and how humans are irrational. You can't start a new paradigm with a body of knowledge used to support a tenet of the old one. If behavioral finance is going to be the new paradigm, the body of knowledge has to find entirely new purpose.

One of the hurdles in finding the new context is that the rational/irrational construct is burned into our brains. In the $18^{th}$ century, thinkers like Adam Smith promoted the concept of the rational individual that acts out of self-interest and is inherently labor-averse as a point of view that helps us make sense of the world. In the 20th century, the

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term “Economic Man” grew somewhat to take on the specific meaning of a person who acts rationally, with complete knowledge of the implications of all choices, out of self-interest, and with the desire to have wealth.

This concept forms the basis for how we see ourselves. From leadership training courses to the offices of high school guidance counselors to parents guiding children, we seek to limit “irrational” behavior and maximize “rational” behavior. The concept is the cornerstone of investment theory, with each new tool helping us get better at this rational thing. Fundamental analysis grew in the 1930’s to counteract the rank emotions exhibited by speculators of the previous period. In the 50’s, modern portfolio theory moved rational choice upward from just finding good stock, to the entire portfolio by providing a numerical analysis of both risk and reward.

Then Tversky and Kahneman appeared on the scene with their prospect theory in 1973 which showed that people differ in their real behaviors than what we understood them to do, considering they were rational. People, they found, were risk-averse when presented with choices in which they anticipated gains, and risk-seeking when anticipating losses.

Other economists followed despite the threat of career suicide. Yet all their work that proved the concept of rational didn’t exist so far has been coopted by the old framework. All the new findings about how people really behave and really think only serve to forward the concept of rational by being lumped into the corollary -- irrational. It didn’t really challenge the premise of rationality. It didn’t really prompt us to stop and question whether the idea of rational economic human was even valid. It only served to explain that when we had bubbles, humans were irrationally exuberant, and when markets were in equilibrium, humans were behaving rationally.

When old frameworks fall it means there’s a new context, a new framework that has taken over. To determine whether we might in fact be in a true paradigm shift, it might be useful to investigate what constitutes a paradigm and what it takes to shift it.

In science, a paradigm is a framework within which research is conducted to learn more about the framework. And, as it would happen, each framework has niggling little inconsistencies that were set aside to make the framework work. Eventually those inconsistencies – outliers if you will – become too large for some to ignore. The transition takes a long time, to get from the time that first rogue scientists dare challenge the prevailing Truth, to the time that the field generally accepts the new framework. Then the research begins to prove the new framework.

A familiar example comes from physics. Since the 1600’s scientists knew that sometimes light appears as a wave and sometimes as particles. Three hundred years later, scientists copped to the seeming contradiction and began to study the phenomenon. And a hundred years after that, most agreed that, in fact, both were right. Light is sometimes particles and sometimes waves, depending on the context.

With finance, the establishment is still spouting the efficacy of the rational/irrational construct. Business schools and publishers of investment theory are all firmly entrenched in the rational framework and continue to investigate the criteria for being such. But two experiences with colleagues makes me think we may be further along the transition then is evident in the literature or classrooms. Both people are in their 30’s. One is a hedge fund manager with a non finance background and the other a Columbia Business School graduate. Neither seem to be locked into the rational/irrational intellectual ping pong match. The hedge fund manager is an MD with a long history of trading for himself. While he talks about mediating emotional responses to the market, he grew up with the deep understanding of behaviors. During graduate school he assisted in fMRI studies of behavioral choice. His investment decisions, while computer based, seek to analyze behavioral factors in the broader market as a way of determining the mood. The polemics of the old framework, of needing to be either one or the other, don't seem to affect his decisions. A recent conversation with a Columbia Business School graduate echoes this blended education experience. She told me she never got hooked into the theories. As she and her fellow students sat in the classroom hearing about rational models and efficient markets, outside the window Long Term Capital Management was blowing up. The most perfect of perfect rational models blew up and nearly took the system down with it. She said it was plain that the finance teachers were just out of touch with reality.

So there is a generation of adults, now into the roles of decision makers in the profession, who are already incorporating the new knowledge into their daily work. This is one characteristic of the transition phase of paradigm shifts. Another milepost of the transition phase is when new research isn't burdened by the outdated concept of the previous paradigm. In finance, that would mean that new research into behaviors is not used to prove rationality or define irrationality.

An independent support for the supposition that we've progressed comes from The Economist. Last December the magazine chose the ten top economists with under ten years in the field. They made the point that many economists doing traditional work now use the findings of early behavioral economists to explain outcomes that were unexpected. This fact prompted the magazine to proclaim that "in fact the disciples of field of behavioral economics no longer constitute a self contained school".

Esther Duflo's work followed that claim. Duflo, an economist at MIT, belongs to a type of economics researcher known as a "randomistas", known for testing out theories in randomized trials in the field, much like clinicians test new drugs. The explanation of results often draws from findings of behavioral economics to make sense of findings.

Similar kinds of experiments are funded by consumer product marketers, with the ultimate goal being to use the findings to get us to buy more products. The basic question research asks to discover are the triggers that guide decisions to purchase, independent of the need to label the behavior as irrational, albeit with the true intent of exploiting biases.

So using the new knowledge to explain irrationality won't get us to that paradigm shift. What is needed is a discussion from an entirely different point of view. Perhaps the seeds of that are in the writings of the early researchers. Perhaps this new point of view is something that is human-centric. Dick Thaler points us in this direction with his assertion that we should move from our identity as homo economicus to that of homo sapiens. And if we can make that leap, then perhaps the next discussion is what it means to be "normal", as posited by Meir Statman, another prolific thinker in the behavioral school.

Out of these discussion, free of the need to justify or disprove the concept of "rational human", may come the paradigm shifters. Certainly a new framework will take time to emerge. But it does seem like we've taken an important first step, in declaring the old ways unbelievable.

This is first in a 10-part series of newsletters on the topic of the shifting paradigm. The next issue skewers another tenet of the rational school and reviews research that proves how emotions are critical to making good investment and business decisions.

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