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For General Use

Behavioral Finance Is Fun

When I was a graduate student at the University of Illinois I audited a course in behavioral finance. The professor, Jay Ritter, was an outstanding teacher who made the material very interesting. It was fascinating to study concepts such as *subcertainty*, *mental accounting*, and *overconfidence bias*—concepts that lie at the intersection of psychology and economics. As I learned about these common mistakes that other people make, I found that I was enjoying myself a lot more than I had expected to. It's fun to study the mistakes of others.

Then, in one of those rare instances when I took an honest look at myself, I realized that I too am subject to some of these common judgmental errors. These are not just other people's mistakes—they are also mine. This took away some of the fun.

There is now ample evidence that people make errors in judgment. Sometimes they learn from their mistakes (e.g., the car I bought in 1980), but sometimes people just keep making the same mistakes year after year (e.g., what some celebrities wear to the Oscars). The great leap of logic that some behavioral economists make is as follows: People make the same mistakes over and over again. *Therefore, I can use this knowledge to make money in the financial markets.*

Does this conclusion follow from the premise? For judgmental errors to affect asset prices, there have to be enough people making the same mistake at the same time so that the mistaken traders force prices to differ from intrinsic (underlying) values. Suppose for now that this occasionally happens, and an active manager wants to exploit these situations for profit. The manager must diligently watch the markets for evidence that such a situation has occurred. When such an opportunity is discovered, the manager must check to see whether anything can be done about it. If the situation is exploitable, the manager will execute the appropriate trades as soon as possible.¹ In an active manager's perfect world, the price would then quickly revert to intrinsic value, giving the manager an immediate and handsome return.

In this scenario, timing is crucial for behaviorally motivated portfolio managers. They must trade as soon as an apparent opportunity is identified, or else it may vanish. Patient trading is usually not an option, so price impact is just a part of the game. Then, in order for the manager to realize a profit, other investors must also notice and act on the mispricing, resulting in security prices going back to their true underlying values. Since a portfolio manager's performance is frequently judged based on short time periods, a price that reverts to intrinsic value three years from now doesn't help much. And of course, there is always the chance that the manager is wrong and the asset is fairly priced. In this case, the manager pays the price impact for urgent trading and gets nothing in return.

Furthermore, unless misvalued securities appear frequently, the manager will either have a very concentrated portfolio or one that is populated with securities that the manager believes to be fairly valued. On top of everything, the manager incurs expenses by gathering the information necessary to search for incorrectly valued securities.

In spite of all these complications, are there managers who can generate abnormal returns by identifying incorrectly valued assets? I do not know, but I am convinced that there are not a lot of them. If there were, the results of the various mutual fund performance studies would have turned out much differently. Since these studies indicate that most active managers are unable to cover their costs with their security selection ability, and since there is scant evidence of persistence in mutual fund performance, how are investors supposed to pick active managers? The fees charged by these managers can be quite high, so investors need

to be able to pick a good one. Many people seem to be confident in their ability to do so. Is this confidence well founded, or is it just another manifestation of overconfidence bias? The fact that so much money has flowed into poorly performing funds supports the latter explanation.

How can we benefit from the study of behavioral finance, if not by earning abnormal returns? We can guard against the tendency to make these judgmental errors ourselves. For example, since we now know that people tend to be too confident in their own abilities, we can guard against this flaw. We can also warn those in our spheres of influence about these harmful tendencies. Realistic attitudes about the ability to earn abnormal returns might help investors to focus on more important issues, like asset allocation, diversification, and expenses. These issues are likely to have a greater impact on performance than would a search for improperly valued securities.

To all the celebrities who were offended by my remark about fashions at the Oscars, I apologize. Actually, having someone like me comment on fashion is probably the ultimate proof of overconfidence bias. But you can't profit from my overconfidence unless you sell me a suit.

I take a 40 regular.

1 There are some situations where there's nothing a manager can do about a perceived misvaluation. In the May 1991 American Economic Review, Patel, Zeckhauser and Hendricks refer to this as the poachability of the opportunity. For example, an overvalued security is not poachable if a short position in the security cannot be established.

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