The Myth of the Rational Market

Current Harvard Business Review editorial director and former Fortune writer Justin Fox wrote an article in 2003 titled, "Is the Market Rational?" Much of the article focused on the intellectual rivalry between two Chicago professors—Eugene Fama and Richard Thaler—and Fox made no secret which of the two he found more persuasive. The next generation of finance professors, he said, were "ripping Fama's teachings to shreds," and market efficiency – that markets do a good job of quickly assimilating information via fairly valued prices – as an organizing principle was being shouldered aside by something called "behavioral finance."

In the behavioral finance view, irrational investors make systematic judgment errors that produce predictable patterns in stock prices. Fox noted approvingly that the Nobel Prize in economics had been awarded the previous month to a Princeton psychology professor in recognition of his work on behavioral biases and suggested it was possible for investors with sufficient "contrarian gumption" to outperform the market by exploiting such biases. But he doubted most of his readers would be successful in this effort, due to their own propensity to make mistakes. His conclusion for investors? "That's easy," he wrote. "Buy and hold. Diversify. Put your money in index funds. Pay attention to the one thing you can control—costs—and keep them as low as possible."

Fox’s article later mushroomed into a 328-page book released in 2009, which I read recently while on vacation. The title is no longer a question but an assertion: The Myth of the Rational Market. The book has much to recommend it—a wide-ranging survey of the battle of ideas among financial economists over the last century, with an enormous cast of characters. Of particular interest are the stories of how many of the leading academics and thought leaders brought their ideas to bear, how they were (or were not) accepted, and how they were permeated throughout academia and into the mainstream. The story also shows how these thought leaders may have evolved their beliefs and theories over time. This back story is not contained in Finance or Economic textbooks, yet is important to understand.

Financial economics as a distinct field of inquiry has grown from humble beginnings in the 1950s to a major field of study, and Fox takes the reader on a long journey in his effort to find a comprehensive explanation for the mystery of markets and rational behavior. Perhaps too long for the dispassioned investor but one I consumed with fever. Only those with considerable intellectual curiosity are likely to make it all the way through the discussions of random walks, asset pricing puzzles, expected utility theory, fractals, futures contracts, game theory, organizational behavior, corporate governance, central bank policy, derivatives, behavioral biases, and on and on.

For those hoping to find some concrete suggestions for improving their investment results, the book is apt to be disappointing. Fox finds little evidence of success among professional money managers in exploiting the inefficiencies he believes are so clearly evident. He has some kind words for academics
that have set up money management firms to apply research on behavioral biases to generate superior returns, but he cites no evidence of their success, perhaps because their results are generally well explained by the standard asset pricing models he is so quick to condemn.

Fox appears frustrated that the evidence of market irrationality appears so clear but the evidence of investor success in exploiting these mistakes is so thin. His brief message to investors toward the end of the book carries an air of resignation—all the effort devoted to identifying flaws in the rational market model doesn't appear to offer hope of a superior approach. Almost as an afterthought, his practical advice to investors includes the following suggestions, "If you have money to invest, the only sensible place to start is with the assumption that the market is smarter than you are. You don't have to stop there. But if you do come up with an idea for beating the market, you need a model that explains why everybody else isn't already doing the same thing you are."

Minus concrete investment suggestions, the book is very powerful in helping to understand wide-spread ideas that have shaped modern finance and investing, including the underlying assumptions and limitations to financial models. While most consumers may not find this interesting, I consider this required reading and knowledge for any serious investor. John Maynard Keynes wrote, "The ideas of economists and political philosophers, both when they are right and when they are wrong are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist." This statement is more true today in our globally-integrated world of money, markets, and information than when Keynes concluded with it in his renowned General Theory with the passage in 1936.

Kevin Kroskey, CFP®, MBA is President of True Wealth Design, an independent investment advisory and financial planning firm that assists individuals and businesses with their overall wealth management, including retirement planning, tax planning and investment management needs. Prior columns can be obtained by visiting www.TrueWealthDesign.com/bathjournal.