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Investor psychology in capital markets: evidence and policy implications[☆]

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Abstract

We review extensive evidence about how psychological biases affect investor behavior and prices. Systematic mispricing probably causes substantial resource misallocation. We argue that limited attention and overconfidence cause investor credulity about the strategic incentives of informed market participants. However, individuals as political participants remain subject to the biases and self-interest they exhibit in private settings. Indeed, correcting contemporaneous market pricing errors is probably not government's relative advantage. Government and private planners should establish rules *ex ante* to improve choices and efficiency, including disclosure, reporting, advertising, and default-option-setting regulations. Especially, government should avoid actions that exacerbate investor biases. © 2002 Published by Elsevier Science B.V.

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1. Introduction

In 1913, John D. Watson introduced behaviorism, a radical new approach to psychology. He held that the only interesting scientific issues in psychology involved the study of direct observables such as stimuli and responses. He further argued that the environment rather than internal proclivities determine behavior. Behaviorism was later developed by B.F. Skinner in what aimed to be a more rigorous approach to psychology. Skinner and his followers had a highly focused research agenda which excluded notions such as ‘thought’, ‘feeling’, ‘temperament’, and ‘motivation’. Skinner denied the meaningful existence of such internal cognitive processes or states. Based primarily on experiments on rats and pigeons, he argued that all human behavior could be explained in terms of conditioning by means of reinforcement or association (operant instrumental conditioning or classical conditioning).

In retrospect it is astonishing, but for decades (1940–60s) behaviorism was pervasive and dominant in academic psychology in the U.S. Contrary evidence was downplayed or reinterpreted within the paradigm. Eventually, however, a combination of evidence and common sense led to the ‘cognitive revolution’ in experimental psychology, which reinstated internal mental states as objects of scientific inquiry.

This episode exemplifies a common pattern of innovation, overreaching, and long-horizon correction in the soft sciences. Freudian psychology and Keynesian macroeconomics provide other examples. A genuine innovation is interpreted either too dogmatically or too elastically (or both!) by enthusiasts, is extended beyond its realm of validity, yet dominates discourse for decades. Indeed, such patterns seem common in intellectual movements of many sorts.

In financial economics, the most salient example is the efficient markets hypothesis. The efficient markets hypothesis reflects the important insight that securities prices are influenced by a powerful corrective force. If prices reflect public information poorly, then there is an opportunity for smart investors to trade profitably to exploit the mispricing. But, as vividly described by Lee (2001), just because water likes to find its own level does not mean that the ocean is flat. And just because there are predators in the African veldt does not mean there are no prey.

While there are important forces that act to improve market efficiency, the notion of a corrective tendency was carried to extremes by enthusiasts. For example, it is often argued that markets must be presumed efficient on a priori grounds unless conclusively proven otherwise. The classical economists had a broader view. For example, Adam Smith’s analysis of ‘overweening conceit’ and compensating wage differentials across professions described how individual psychology causes mispricing and inefficient resource allocation. In recent years, some finance researchers have returned to such a broader conception of economics, and have denied market efficiency its presumption of innocence. This denial is based upon theoretical arguments that the arbitrage forces acting to improve informational efficiency are not omnipotent.¹ Furthermore, evidence of at least some degree of guilt has accumulated. Even some of the fans of efficient market agree that investors

¹ See, e.g., DeLong et al. (1990a), Shleifer and Vishny (1997), and Daniel et al. (2001).

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