



Feedback and the success of irrational investors[☆]

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Abstract

We provide a model in which irrational investors trade based upon considerations that have no inherent connection to fundamentals. However, trading activity affects market prices, and because of feedback from security prices to cash flows, the irrational trades influence underlying cash flows. As a result, irrational investors can, in some situations, earn abnormal (i.e., risk-adjusted) profits that can exceed the abnormal profits of rational informed investors. Although the trading of irrational investors cause prices to deviate from fundamental values, stock prices follow a random walk.

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1. Introduction

Investors often share common misconceptions and errors of analysis. For example, a substantial number of investors employ technical rules that are supported by neither

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conceptual considerations nor empirical evidence. Fads of investment in industry sectors, methods of security analysis, and simplistic theories of the stock market tend to proliferate through the mass media and word of mouth. (Shiller, 2000, discusses such phenomena.) Groups of investors who have fallen prey to common elementary errors, such as confusing the company Telecommunications Incorporated with the firm with ticker symbol TCI, have caused large price movements in one stock based upon news arrival in another unrelated stock (see Rashes, 2001). As another indication of the commonality of trading errors, investors and prices sometimes react to the republication of information that is already public (see Ho and Michaely, 1988 and Huberman and Regev, 2001).

Anecdotally, during the late 1990s it became increasingly popular to value stocks based upon ad hoc heuristics. For example, many analysts (and presumably the investors who listened to them) began to value tech firms based upon revenue instead of earnings; and to value e-commerce firms based upon eyeballs instead of revenue. These valuation methods allegedly were inappropriate, a criticism that, at least with the benefit of hindsight, seems to carry some weight.¹ With the rise of the Internet, there has been increased opportunity for investors to gain improved information about stocks. However, questionable stock market theories can also be spread more rapidly and widely.

A growing literature explores the effects of irrational trading on market prices and the profitability of such trading (Hirshleifer, 2001, and Barberis and Thaler, 2003, review this literature.). While our paper contributes to this literature, our focus is different. In contrast to the existing literature, irrational trading in our model does not provide profit opportunities to uninformed rational investors, even if they are aware that traders with psychological biases are in the market. From the perspective of the rational, but uninformed, investors, the market is informationally efficient. Nevertheless, irrational trading affects prices and, thereby, affects firms' fundamental values. Moreover, the irrational investors in our model can, under some conditions, earn positive expected profits that can even exceed the profits of rational informed traders.

We are not the first to consider conditions under which irrational traders can earn higher expected profits than fully rational ones. However, in previous work, the irrational traders either earn high average profits by accepting greater exposure to systematic risk or achieve higher average risk-adjusted profits by more aggressively exploiting private information.^{2,3}

¹See, for example, "Eyeballs, Bah! Figuring Dot-Coms' Real Worth," *Business Week Online*, October 30, 2000, or www.fvginternational.com/industries/industries_internet.html, that respectively discuss the invalidity and validity of these approaches. Ofek and Richardson (2003) provide evidence suggesting that the internet bubble was driven by the naïvely optimistic trading of some investors.

²In DeLong et al. (1991), investors with fundamental information underestimate risk, and therefore take larger long positions in the risky asset. Therefore these investors take fuller advantage of the asset's risk premium than their rational counterparts. Thus, in DeLong et al., high irrational returns reflect a premium for market risk. Several other papers have examined how in an imperfectly competitive securities market overconfident informed traders can benefit by trading more aggressively on private information (In an imperfectly competitive securities market, such aggressiveness can intimidate other informed traders; see Kyle and Wang (1997), Wang (1998) and Fischer and Verrecchia (1999). In a competitive securities market, Hirshleifer and Luo (2001) show that overconfident investors who trade aggressively in response to their private information signals can exploit liquidity traders more profitably than rational investors.). All of these papers, however, require that irrational investors have direct information about fundamentals.

³Another strand of literature goes beyond the analysis of trading profitability to consider long-run consumption and wealth accumulation when individuals make intertemporal consumption/investment decisions. In Blume and Easley (1990) and Kogan et al. (2003), irrational investors who have utility functions that are closer to logarithmic than those of rational investors can accumulate more wealth in the long-run than their rational counterparts.

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