
BOOK REVIEWS

Review of Stock-Market Psychology: How People Value and Trade Stocks

Patric Andersson

Stock-Market Psychology: How People Value and Trade Stocks, Karl-Erik Wärneryd, 2001, Edward Elgar Publishing, Inc., 339 pp.

About three years ago, Richard Thaler (1999) declared the end of behavioral finance and claimed that research in finance must assume some psychological mechanisms making the tag 'behavioral' redundant: After all, the trading on the financial markets ultimately originates from the behavior of various investors. In a sense, the declaration points to an on-going change in the current paradigm of financial economics where the research scope will be on empirically valid theories of investor behavior and involve new psychologically based research programs. This change in paradigm will most likely benefit from Karl-Erik Wärneryd's (2001) new book *Stock-Market Psychology: How People Value and Trade Stocks*.

Wärneryd, a retired professor at the Stockholm School of Economics, has pioneered the discipline of economic psychology. This predominantly European discipline studies psychological processes in economic behavior by employing theories and methods from the psychological science. The focus is on individual differences. Traditionally, saving is a domain that has attracted the interest of many researchers within economic-psychology. (A summary of those research efforts could be found in Wärneryd's (1999) earlier book *The Psychology of Saving*.) With the new book Wärneryd wants to expand the discipline to involve the domain of financial behavior as well as encourage researchers to apply an economic-psychological perspective when studying investors.

Stock-Market Psychology is accordingly written from an economic-psychological perspective. This is clear when one browses through the 26 pages long

reference list that spans numerous research projects in economics as well as in psychology. As usual, Wärneryd has carefully made sure that the interdisciplinary perspective rests upon a solid foundation with respect to the latest research and classical work. In that way, the reader gets a good understanding of how the ideas of modern (financial) economics relate to the ones of pioneers such as Adam Smith, Alfred Marshall, and John Maynard Keynes. Moreover, the economic-psychological perspective is not restricted to concern research projects carried out by Anglo-Americans but also European researchers. All these considerations vouch for a very stimulating reading.

The organization of the book follows also an economic-psychological perspective. Starting from a purely economic-theoretical position, the book shifts towards a psychologically oriented and empirically based view on stock-market behavior. In particular, the two introductory chapters describe the theory of efficient markets and rational models of portfolio choices as well as the evidence of deviations from those models and the attempts at modifying those models by adding variables that supposedly reflect behavioral differences between the (informed and noise) traders. The next five chapters cover psychological areas such as expectation formation, human information processing, cognition, emotions, and social influence. Wärneryd discusses those areas in depth and also how they relate to finance by reporting on research from both economists and psychologists. It is striking to note that the picture of investors is far more complex and less rational than the one assumed in traditional financial economics. Then the book proceeds to review empirical studies of investor behavior that are based on a variety of methods including surveys, experimental markets, and trading records. Consequently, the reviewed studies concern data captured on the individual as well as on the aggregate level. In the final chapter, Wärneryd summarizes his ideas on stock-market psychology and shows how they can be applied in practice and research.

When discussing human information processing Wärneryd takes a step further than what is common among researchers in behavioral finance, who often

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limit their literature review to merely concern the research program on heuristics and biases. In addition to describing this program, Wärneryd touches upon other research programs like—to name a few—dynamic decision-making, fast and frugal heuristics, and the study of expertise. For instance, he raises the question whether deliberate practice might help analysts to improve their performance. Deliberate practice refers to systematic and structured training and has been shown by his fellow countryman Anders Ericsson (1996) to be essential for the acquisition of expert performance in various domains. Considering that the reviewed empirical findings indicate unanimously that forecasts and stock-recommendations made by financial experts are often poor, it seems to be important to investigate the role of deliberate practice in finance. On the other hand, the ostensible lack of superior performance among financial experts might suggest that due to task characteristics it is not possible to perform exceptionally well in certain domains; a view that is consistent with research by James Shanteau (1992).

There are two major themes in the book: expectation formation and categories of investors. Wärneryd argues that expectancy is one of the core determinants of stock-market behavior. It is expectations about the future (with regard to profits or losses) that guide the investors when they make decisions about trading stocks. He presents his own model of expectation formation. Based on theories from economics and psychology, this model states that expectancy is a function of three differently weighted variables that represent beliefs concerning past experience, learning from experience, and new information. Unfortunately, he reports on little empirical evidence of the validity of this model.

The second theme concerns the categories of investors. Researchers in behavioral finance generally assume that there are two basic types of investors: informed and noise traders. Survey-based studies of investors show, however, that investors can broadly be categorized into at least four segments: (1) passive investors who invest some of their wealth in risky securities, (2) wealthy investors who systematically invest in securities, (3) speculation-prone investors with limited wealth who exploit every opportunity, (4) naïve investors who are enticed by stories of high profits. The seg-

ments react differently on changes in the stock-market. Evidence also shows that investors do not act in accordance with the rational models of investment. The observed variable investor behavior suggests that the present financial theory does not adequately represent all groups of investors and that there may be a need for a new theory. Or as Wärneryd puts it: "Many investors have made money on their investment despite neglecting theoretical and practical rules for financial behavior. They deserve better theory that explains their success and behavior." In his view, this could be achieved by studying the judgment and decision-making of individual investors.

In conclusion, *Stock-Market Psychology* aims at bridging the gap between researchers in behavioral finance (and economics) and economic-oriented psychologists: The former group is introduced to applicable state-of-the-art psychological theories, whereas the latter group gets an intuition for financial economics. Apart from providing important analytical tools, the book should stimulate future research and perhaps bring researchers in (behavioral) finance and psychology together in mutual projects on investor behavior. Although the book is primarily intended for an academic audience, professionals in finance (and interested private investors) may also benefit from a reading. They will not find any simple rules for making large profits, but they will get a better insight into the psychological factors of financial markets and some ideas of how to improve their own trading behavior.

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A Review of *Latticework: The New Investing*

Robert A. Olsen

Latticework: The New Investing, Robert Hagstrom, 2000, New York: Texere, 224 pp.

Latticework: The New Investing provides a concise and non-technical glimpse at the cascade of revolutionary new theories from other scientific disciplines that are beginning to be applied to Finance and Investing. Just as Physics has undergone a paradigm shift from a Newtonian to a Quantum perspective and the Biological sciences have been reoriented toward a genetically focused evolutionary and adaptive explanation of living organism structure and behavior, so is Finance beginning to feel the leading edge winds of a major paradigm shift. This incipient paradigm shift generally goes under the name of behavioral finance.

In this brief book, Robert Hagstrom takes a first pass at tracing, integrating and explaining the implications of exciting new ideas such as Complexity, Emergence, nonlinear dynamics, self organized criticality, and mental modularity, for the discipline of Finance. While the depth of coverage is somewhat uneven, this book provides the non expert with a clear and well exemplified explanation of how selected leading edge theoretical and empirical developments from physics, biology, psychology and decision science are about to cause a radical reinterpretation of investor behavior.

Hagstrom points out that current financial concepts and models such market efficiency, the Capital Asset Pricing, Arbitrage Pricing, and the various option pricing models are based on the assumptions of what is now often called the “old science.” The “old science” is constructed on a mechanistic, Newtonian, view of the universe wherein system behavior is linear (output is proportional to input), systems tend toward equilibrium (negative feedback dominates), and reductionism leads to full understanding and very accurate prediction. In addition, human actions are the consequence of learned behavior (behaviorism), humans are capable of full axiomatic rationality, and

they are focused on achieving optimum outcomes. In contrast, the “new science”, which has come to replace the “old science”, in physics and biology, views the universe as being comprised of a constantly adapting network of systems. More specifically, systems are seen as often being dominated by positive feedback, which drives them toward unstable equilibria and imperfectly predictable future states. Such systems also spontaneously generate emergent phenomena (wholes which are greater than the sum of their parts, and which have physical properties that are not contained within their constituent elements) and sudden large unpredictable system shifts that may be associated with insignificant causes (butterfly effect). For sound evolutionary reasons, human decision processes are characterized as being affectively and socially influenced, with a focus on satisfaction and survival rather than optimization. That is Humans are viewed as feeling machines that think and not thinking machines that feel, as in the “old science”. Also, the human mind is seen to be comprised of separate modules that have evolved to solve continuing problems of survival and that can only be imperfectly co-opted to address new environmental contingencies. Hagstrom provides explanations of how these attributes of the “new science” are related to market phenomena, such as herding, overconfidence, market bubbles, over and under market reaction to new information, poor forecasting etc.

While this book is not meant to be another primer on how to make money in the stock market, the author does spend a considerable amount of time explaining how very successful investors such as Bill Miller of Legg Mason Funds and Charlie Munger and Warren Buffett of Berkshire Hathaway have used many of the ideas of the “new science” to enhance their portfolio performance. More importantly, Hagstrom emphasizes that learning to look at financial opportunities from many alternative perspectives is an important element leading to investment success. In this regard, he spends time extolling the virtues of a broad liberal education and how such an education has been beneficial to a number of Wall Street executives.

In conclusion, this book is well worth a read by those who wish to know where Finance as a discipline is headed. While the discussion at many points was too cryptic for my taste, ample excellent references are provided for those who desire greater detail.

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