The Journal of Behavioral Finance
2003, Vol. 4, No. 4, 238–240



# RESEARCH ELSEWHERE

**Robert A. Olsen**

### Bounding Rationality to the Real World

by Peter Todd and Gerd Gigerenzer

*Journal of Economic Psychology*, Vol. 24, 2003, pp. 143–165.

In this conceptual article the authors present and defend their thesis that humans are generally Ecologically Rational but not necessarily rational according to the dictates of formal logic or probability theory. Ecological Rationality arises from the need to adapt to one's external environment and involves making appropriate decisions with mental mechanisms whose internal structure can exploit the external information structures available within the external environment. The authors discuss how the mental mechanisms decision makers use have both evolutionary and social roots that sometimes lead to what appear to be cognitive errors, such as base rate neglect, overconfidence, etc.. However, they argue that these evolved mental decision mechanisms generally lead to more efficient and adaptive decisions than the complex decision processes, which require extensive data, time and computational resources, often suggested as replacements. The authors discuss how current economic and behavioral models of decision making stem from misinterpretations of Simon's concept of Bounded Rationality and they proceed to lay out a program of ecologically focused research following from Simon's original ideas. The article also contains extensive discussion of the empirical evidence supporting the concept of ecologically rational decision making.

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### Analyst Forecast Revisions and Market Price Discovery

by Cristi Gleason and Charles Lee

*The Accounting Review*, Vo. 78, No. 1, 2003, pp. 193–225.

This empirical study, using data on analyst earnings forecast revisions and stock price reactions for the period 1993 to 1998, investigates potential influences on the rate of post revision price drift. The analysis is based on approximately 372,000 analyst earnings forecast revisions for 6,505 firms. Gleason and Lee find that price drift is greater following large earnings forecast revisions, but that stocks which are followed by "celebrity" analysts, and large groups of analysts, experience less stock price drift. "Celebrity" analysts are those identified from The Institutional Investor "All Stars" and the Wall Street Journal's survey of sell side analysts. In addition, the authors note that most price drift occurs in distributed lag form, clustered around subsequent earnings forecast revisions, suggesting that earlier revisions by a few analysts act as a catalyst for later revision by other analysts. Finally, it is suggested that the market tends to undervalue the opinions of a number of analysts who exhibit considerable forecasting prowess.

### Returns Chasing Behavior, Mutual Funds and Beta's Death

by Jason Karceski

Journal Financial and Quantitative Analysis, Vol. 37, No. 4, 2002, pp. 559–593.

In this paper the author develops and empirically tests a model of mutual fund investor behavior and managerial response. Utilizing extensive mutual fund and market data for the period 1984 to 1996, the author identifies the following behaviors.

1. Mutual fund investors chase returns across time causing aggregate equity fund inflows to lag market returns. These inflows are statistically large an economically significant.
2. Mutual fund investors chase returns across funds. Again, these flows are significant.
3. Because superior fund performance is necessary to retain investor funds, especially during up markets when new cash flows are greatest, fund managers tilt their funds toward the high Beta stocks that are expected to yield the higher returns. This tilt toward high Beta stocks tends to depress returns and reduce the statistical significance of Beta as a return determinant

In general, the author finds that mutual fund managers often adopt investment behaviors that might appear illogical from a rational economic perspective. However, in hindsight, these behaviors make sense when the primary goal of managers is seen to be the retention of the funds of financially unsophisticated clients.

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### When Success Breeds Failure: History, Hysteresis, and Delayed Exit Decisions

by Jennifer Bragger, Donald Bragger, Donald Hantula, Jean Kirnan

Journal of Applied Psychology, Vol. 88, No. 1, 2003, pp. 6–14.

The sunk cost effect, economic hysteresis, and escalation of commitment all deal with situations where there is an initial investment, some indication of nonprofit making and continued investment in the face of negative feedback. In this laboratory study, the authors investigate the influence of the equivocality of feedback on the commitment process. The authors note that according to the Equivocality Theory of escalation, decision makers are not necessarily in error when they stay the course in the face of uncertain information. Delays in exiting from unprofitable circumstances may be adaptive, especially where the costs of exit, and decision reversibility are large and where staying on course may allow for further information gathering and the possibility of a reversal in fortunes. In a series of experiments the authors found that subjects (1), maintained a losing commitment longer the more equivocal or uncertain the feedback, (2),maintained a losing commitment longer the more experience they had with prior successful, but unrelated, commitments, (3), sought out greater additional information when faced with equivocal feedback. In general, decision makers realized that a significant loss may be incurred from moving too quickly away from what may be a bad short term situation. Part of this behavior may be learned, but part appears to be natural in origin.

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### Global/Industrial Diversification and Analyst Herding

by Chansog Kim and Christos Pantzalis

Financial Analysts Journal, March/April, 2003, pp. 69–78.

This empirical study, using analysts' earnings forecasts and firm financial data, for the period 1980 to 1998, investigates whether earnings forecast herding varies directly with firm complexity. Theory suggests that analysts may have an increased incentive to herd when earnings forecasting is more difficult. Following this premise, the authors suggest that greater herding might be expected where greater firm geographical diversification or operational complexity exist. Measuring the degree of herding using alternative measures of earnings forecast accuracy and dispersion, the authors find that herding is positively associated with the degree of unrelated industrial diversification and the degree of geographical dispersion of foreign assets.

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### Why Humans Value Sensational News: An Evolutionary Perspective

by Hank Davis and S. Lyndsay McLeod

Evolution and Human Behavior, Vol. 24, 2003, pp. 208–216.

While this conceptual and empirical paper is not focused on financial issues per se, it is thought provoking and relevant in that it discusses the nature of sensational news and how such news items come to dominate public thought and action. From the analysis, it is clear that the financial markets are not likely to be immune from the influence of sensational financial events. Take Enron as an example. The authors make the case that most sensational news is not socially constructed and that the dominant sensational themes are the same across cultures and across time. More importantly, these themes, such as people's status, cheating, resource allocation, sex etc. are the very same themes that have significant adaptive importance from an evolutionary perspective. It is also pointed out that most sensational news has a dominant emotional content, as would be expected where timely reaction to the sensational event is important. This paper is pregnant with financial implications and research topics.

### Daily Momentum and Contrarian Behavior of Index Fund Investors

by William Goetzmann and Massimo Massa

Journal Financial and Quantitative Analysis, Vol. 37, No. 3, 2002, pp. 375–389.

This paper investigates the investment behavior of approximately 91,000 investors in the Spartan Index fund for 1997 and 1998. Specifically, the purpose of the study was to discover how Index Fund investors responded to short term (daily) changes in the stock market, as a whole. The authors find that from the pattern of account inflows and outflows that contrarian trading is more common than momentum investing. Almost 25% of the accounts displayed negative feedback trading while 12% displayed positive feedback trading. However, the more active traders tended to be positive feedback traders. In addition they found that investors tended to be consistent in their feedback trading behavior, seldom switching from positive to negative feedback trading or vice versa. Also, any herding present appeared to be primarily related to selling, as opposed to purchasing.

### Deep Thoughts and Shallow Frames: On the Susceptibility to Framing Effects

by Robyn Le Boeuf and Eldar Shafir

Journal of Behavioral Decision Making, Vol. 16, 2003, pp. 77–92.

This laboratory study investigates whether framing effects may be primarily due to superficial cues and if framing effects occur less frequently if decision makers are required to think more carefully about their choices. Using a well known set of decision situations, such as the "Asian Disease problem," the authors found that requiring more thinking on the part of subjects, i.e. requiring justification for decisions, etc. did not alter the occurrence of framing effects. However, they did find that subjects who expressed a greater need for cognition, as measured by standard tests, were more consistent. That is, these subjects were still "framed," but they were more consistent in how they responded to the frame in repeated trials.

### Market Focusing: The Science of Gut Feel

by Flavia Cymbalista

Papers on this topic may be downloaded from the internet at www.marketfocusing.com.

This paper provides an introduction, via a proposed clinical technique, to a very new area of study dealing with the role of emotion and more importantly, bodily sensation, in decision making. For some time the well known investor George Soros has written about the informational importance of bodily sensation, especially when making very complex decisions under great uncertainty. More recently, in his book titled" Looking for Spinosa: Joy, Sorrow, and the Feeling Brain," the well respected neuroscientist Antonio Damasio presents a theory and empirical evidence for the role of bodily sensation in decision making. In particular, he notes that bodily sensations may precede emotion and cognition and serve as clues to guide the decision maker. In this paper the author discusses a clinical technique called Marketfocusing. This technique is designed to use sensation to separate an individual's habitual tendencies and biases from the exogenous uncertainty in a situation, thus freeing the decision maker to more objectively evaluate decision alternatives.