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RESEARCH ELSEWHERE

Robert A. Olsen

Temporal Construal

by Taacov Trope and Nira Liberman

Psychological Review, Vol. 110, 2003, pp. 403–421.

This extensive review article discusses the origin, nature and implications of Construal Theory for decision making. Construal Theory proposes that temporal distance changes decision makers' responses to future events by altering the way in which they mentally represent near and far future events. Specifically, according to Construal Theory, near term future events are perceived in terms of concrete and incidental details, whereas far term future events are framed in a more abstract and condensed fashion. This being the case, the direction and intensity of a response to an approaching event can change with the passage of time even though the essential features of the decision situation have not been altered. In addition, the authors demonstrate how Construal Theory can parsimoniously explain other distance dimension attitudes and behaviors, such as those associated with spatial distance, social distance, and past versus future events.

Time Discounting has been the principal theory used to explain most time related decision effects in Economics. However the theory appears to be incomplete in that patchwork modifications have been necessary to account for time related decision inconsistencies and contradictions. In particular, model modifications based on affect, conflict and outcome magnitude have been suggested. The authors discuss how these influences fit more naturally within Construal Theory, suggesting that time discounting itself may be subsumed within Construal Theory.

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The Predictive Power of Zero Intelligence in Financial Markets

By J. Doyne Farmer, Paolo Patelli, and Ilija Zovko

Santa Fe Institute Working Paper, Sept. 9, 2003, 22 pages. Available online.

This simulation based study provides stunning evidence for the importance of market structure as a determinant of aggregate stock market behavior. More specifically, it suggests that the price formation mechanism, rather than the strategic behavior of investors, may have the more profound influence on aggregate market behavior. This study thus provides additional evidence for the potential value of the "micro market structure" research, which is becoming prominent in the academic financial literature.

The authors of this paper constructed a simple model of market structure assuming zero intelligence on the part of investors. Investors were assumed to place standard market and limit orders, which were then traded in a continuous double auction. The model simulation results were tested using data from the London Stock Exchange. Overall, the model was able to explain 96% of the bid ask spreads across stocks and 76% of the price diffusion rate among stocks. While the authors do not suggest that real investors are unintelligent, they believe that studies such as this can provide benchmarks to identify strategy based investor influences on market behavior. Researchers at the Santa Fe Institute have been at the forefront of research investigating stock markets as complex adaptive systems. This study continues that research thread.

Consumer Perceptions of Financial Risk

By Stephen Diacon and Christine Ennew

The Geneva Papers on Risk and Insurance, Vol. 26, No. 3, July, 2001, 389–409.

This empirical research uses Slovic's psychometric risk paradigm to identify primary financial risk attributes perceived by a sample of British investors. Specifically, surveys were used to gather investors' perceptions about 27 risk related investment characteristics for 20 different investment products. Factor analyzed results indicated five principal risk dimensions; distrust of products/ providers, loss aversion, aversion to price volatility, lack of knowledge or information, and failure of regulation. In general these results are very similar to those obtained from studies of U. S. investors where similar research techniques were utilized. However, a unique finding of this study is the dominant role of "distrust" as a risk factor. More importantly, the authors note that lack of trust appears to play a key role in determining whether return is perceived to be an increasing or decreasing function of risk. Where trust is high, return and risk are perceived to vary inversely. Where trust is low, return and risk are perceived to vary directly. Other researchers have suggested that affect may play a role in causing risk and return to vary inversely. This appears reasonable since trust is most likely to be a strongly affect related phenomenon.

The Presidential Puzzle: Political Cycles and the Stock Market

By Pedro Santa-Clara and Rossen Valkanov

Journal of Finance, Vol. 63, No. 5, October 2003, 1841-1872.

This detailed econometric study investigates the relation between United States stock market returns and presidential administrations from 1927 to 1998. The primary finding is that real returns are higher under Democratic administrations by about 9 percent per year. Detailed statistical analysis indicates that the difference in returns is not related to differences in economic business cycle variables, is not concentrated around election dates, is not due to higher perceived market risk during Democratic administrations, and is most unlikely due to chance. If anything market volatility is greater during Republican administrations. Also, returns during Democratic administrations tend to increase as the administration's time in office progresses. Finally, the higher Democratic returns appear to be unanticipated. Anticipated returns appear to be higher under Republication administrations but are not realized. The authors conclude that this pattern of market behavior represents another economic anomaly. The authors ask, how can it be that investors are so regularly and positively surprised by Democratic administrations? Another research opportunity for Behavioral Finance!

Internet Investment Advice: Investing With a Rock of Salt

By Michael Dewally

The Financial Analysts Journal, July/August, 2003, 65-78.

Currently more than 13 million investors have online brokerage accounts. However little is known about their investment behavior except that once investors go online, they appear to trade more actively, more speculatively and less profitably. In this empirical study using market data, professor Dewally analyzes the stock investing advice offered on two major internet newsgroup investment sites and chronicles its impact on the market behavior of the recommended stocks. The study covers two one month periods during both down and up markets in 1999 and 2001 and includes approximately 33,000 investor postings. The principle conclusions from the study are:

1. The majority of the recommendations were made for higher Beta, small capitalization, growth stocks in the technology sectors.
2. The majority (60%+) of recommendations were positive, even in down markets.
3. Most of the reasons for recommendations were either due to positive past stock market performance or information about products or prospects. Information about financial results that might have been obtained from financial statements was associated with about 16% of the recommendations. In general the pattern of recommendations and comments suggested a momentum trading strategy.
4. There is no evidence that newsgroup postings and recommendations had any significant effect on stock price behavior.
5. There is weak evidence that the more frequent internet posters exhibited some minimal skill.

Lay Rationalism and Inconsistency between Predicted Experience and Decision

By Christopher Hsee, Jiao Zhang, Fang Yu, Yiheng Xi

Journal of Behavioral Decision Making, Vol. 16, July, 2003, 257-272.

This paper analyzes the results of a series of laboratory studies involving decisions (decision utility) that were inconsistent with desired outcomes (experienced utility). The primary conclusion is that when making decisions, decision makers often prefer to rely on "cold hard facts" rather than "hot" affective attributes, even when they actually prefer the choice that can be more affectively justified. Thus, many decisions may be characterized as incorrectly Lay Rationalistic. The authors present a decision behavior model that is based on Lay Economism, Lay Scientism and Lay Functionalism. Lay Economism refers to a tendency to rely on decision attributes central to economic tenants. Lay Scientism refers to a tendency to rely on decision attributes that appear to be objective or unequivocal. Lay Functionalism refers to a tendency to rely on attributes that are primary to the objective of the choice situation.