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RESEARCH ELSEWHERE

Robert A. Olsen

The Mechanisms of Market Efficiency: An Introduction To The New Finance

By Lynn Stout

The Journal of Corporation Law, Vol. 28, No. 4, 2003, pp. 635–669.

This one of those extremely rare exquisitely reasoned and written critiques that one encounters all too infrequently in academic research. It also demonstrates the great value of cross-disciplinary research where, in this case, a legal scholar comments on the theoretical and practical significance of the Efficient Market hypothesis. Professor Stout begins by arguing that the weaknesses of the efficient market hypothesis (EMH) were apparent from a careful inspection of its initial premises and that the market anomalies noted in recent years can be substantially explained by modifying the EMH's three main assumptions. Specifically, the author suggests that the assumptions of homogeneous expectations, effective arbitrage, and investor rationality (of the homo economicus variety) render the theory impotent as either a descriptive or prescriptive model of market behavior. In short, the utility of the model does not match its mathematical elegance and tractability. Professor Stout carefully dissects each of the three major assumptions and demonstrates how the limitations of each can be seen as the root cause of specific stock market anomalies. For example she points out that by assuming expectations heterogeneity, as opposed to homogeneity, one can readily explain why stock prices tend to be higher, rather than lower, for more risky and uncertain firms. She also discusses how loss aversion as opposed to risk aversion readily explains why the risk premium on equities appears to be so high over time. Finally, and most damaging of all, she points out that the combination of the EMH with the Capital Asset Pricing model (CAPM) results in a prediction of fundamental security value that is tautologically, rather than behaviorally, determined.

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The Behavioral Relevance of Mental Accounting for the Pricing of Option Contracts

By Bettina Rockenbach

Journal of Economic Behavior and Organization, Vol. 53, 2004, pp. 513–527.

This controlled laboratory study investigates the degree to which investors tend to allocate funds among different portfolio assets as if the individual assets are independent parts of the investment portfolio. In particular, the issue in this experimental study was whether investors split their funds between safe and risky assets as if each of the two asset types represented separate portfolio layers or mental accounts. Student subjects (later replicated with investment professionals) repeatedly allocated funds among stocks, call options and a risk free bond. The principal finding was that the pricing of the option suggested that subjects saw stocks and options as substitutes and in a separate class from risk free bonds. More specifically, the results demonstrated the continuous existence of unexploited portfolio arbitrage opportunities. The author discusses how the empirical results are consistent with other research indicating that investors do not see investment funds as fungible, but instead treat their portfolio as a collection of independent accounts with assets to match each investment sub goal.

Consequences of Regret Aversion in Real Life: The Case of the Dutch Postcode Lottery

By Marcel Zeelenberg and Rik Pieters

Organizational Behavior and Human Decision Processes, Vol. 93, 2004, pp. 155–168.

Previous research has shown that decisions may cause regret and that the anticipation of regret may cause decision makers to become risk seeking or risk averse, depending upon the particular situation. Most research on regret has adopted a scenario methodol-