ogy in which the subjects make hypothetical choices. The unique feature of this study is that it analyzes actual choice data from players of two alternative Dutch lotteries; lotteries that would be expected to create different levels of regret.

Dutch citizens can play two national lotteries. The National State lottery is one in which the winning number is randomly chosen from among the numbered sold tickets. The Postcode lottery is one in which the winning number is selected at random from all national postal addresses. However to win, the householder, who's house number is selected, must have purchased a ticket. The authors point out that the Postcode lottery is likely to create greater anticipatory regret and induce more people to play since, even if they didn't purchase a ticket, residents will know whether they would have won or lost when the winning address is announced. The empirical results support this prediction. In particular, many Dutch citizens report feeling almost compelled to play the Postcode lottery in order to avoid the feeling of regret of losing that would be caused by their failure to purchase a ticket. The authors compare the Postcode findings with regret possibilities from other forms of gambling and the regret related model of investor reluctance to sell poorly performing stocks.

How People Make Decisions That Involve Risk: A Dual Process Approach

By Valerie F. Reyna

Current Directions In Psychological Science, Vol. 13, No. 2, 2004, pp. 60–66.

This short conceptual paper discusses a new way of thinking about how decision makers generate perceptions of risk. Specifically it examines the application of a dual process model of memory, called fuzzy trace theory, to risky decisions.

According to fuzzy trace theory, people form two kinds of mental representations, verbatim and gist representations. As opposed to verbatim representations, gist representations are based on traces of prior experience in the memory and are less precise and hence, fuzzy. In fuzzy trace theory people are assumed to normally remember and think on the basis of gist representations whereas previous memory models assume that people reason like a computer. That is, they follow formal rules of logic in a step-by-step fashion. In contrast, fuzzy trace theory assumes that people reason in a parallel mode, simultaneously bringing to bear alternative gists that seem relevant to the decision situation. Many of the anomalies associated with risk perceptions, such as the over estimation of small risks and the multiattribute nature of risk are seen to be more easily understood from a gist perspective than a verbatim, logic focused perspective. Fuzzy trace theory also helps to integrate emotion into the risk taking process since gist also captures the emotional experience of prior outcomes.

Institutional Herding

By Richard Sias

The Review of Financial Studies, Vol. 17, No. 1, 2004, pp. 165–206.

There is a very extensive theoretical literature providing a firm foundation for the existence of herding by institutional investors. However before this study there was not strong evidence of such actual behavior. However this extensive market based study provides rather conclusive evidence of herding among most types of financial institutions. Utilizing data on all institutional investors with more than 100 million under management and encompassing the period 1983 to 1997, the author finds that most institutional investors herd, with the tendency to herd greatest among bank trust departments and independent advisors and the least among mutual funds. Most herding appears to be based on informational cascades and is not momentum based, although most institutional investors appear to be momentum investors. In addition, institutions that herd tend to follow other like institutions. That is, banks herd on banks and mutual funds on mutual funds, etc. Finally, the author does not find strong evidence that herding appears to drive prices away from fundamental values but he does find that herding tends to decline over time and be less significant in the stocks of large firms.

Stock Prices and the Dividend Discount Model: Did Their Relation Break Down in the 1990s?

By Alireza Nassah and Jack Strauss

Quarterly Review of Economics and Finance, Vol. 44, 2004, pp. 191–207.

This empirically based paper uses market data and the well known dividend discount model to analyze the stability of the relationship between dividends and stock prices over the period 1979 to 1999. More specifically, the authors wished to determine whether the bubble in stock prices in the later 1990s was due to a fundamental change in the discounting process during this latter period. Because the dividend discount model is easier to fit to larger more stable firms, the author's sample was restricted to the firms in the S&P 100 Index. Using aggregate and firm specific data, the authors found that in general there was a stable relationship between stock prices