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COMMENTARY

Moving from an Efficient to a Behavioral Market Hypothesis

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Behavioral finance typically is introduced in investments courses in the context of the efficient markets hypothesis (see, e.g., the widely used textbooks by Bodie, Kane, and Marcus [2002] and Reilly and Brown [2003]). This note offers a diagrammatic approach to "position" visually behavioral finance between the information available to market participants and their investment decisions.

The traditional exposition of the efficient markets hypothesis is displayed in Figure 1. The key idea is that in an efficient market all available information is reflected in the market price for a security. (Note: Economists' novel usage of the verb "reflect" usually needs to be explained to students.) Following the seminal work on market efficiency by Eugene Fama [1970], the central question is the type of information that is available to market participants: For "weak form" efficiency it is historical prices; for "semi-strong form" it is publicly available information like financial statements and analysts' reports; and for "strong form" it is all information, both public and private, thereby including that available only to insiders.

The critical assumption in the traditional exposition is that this information, for whatever form being assessed, leads directly and seamlessly to the ensuing investment decisions. These decisions are to buy, sell, issue, or continue to hold the security. Then the market price is determined in the usual way as represented by the intersection of the demand and supply curves. Decisions to buy shift the demand curve out, raising the market price. Decisions to sell or to issue more of the security shift the supply curve out, lowering the price. As long as there are no impediments to the market-clearing outcome, such as price controls, the resultant price fully reflects the available information. The only behavior in the model is profit maximization. Implicitly, buyers and sellers can and do make correct decisions to optimize their expected rate of return (or cost of funds for the issuers) given the assessed level of risk.

Figure 2 demonstrates the price determination sequence from the perspective of behavioral finance. An additional box is placed between available information and the investment decisions. The relevant information, be it historical price charts, accounting ratios, or corporate takeover plans, inevitably is processed by human beings who are subject to the various psychological biases that are studied in the behavioral finance literature. Flaws in the processing impact the buy, hold, and sell/issue decisions, thereby affecting the market price. That price could be higher or lower. In sum, the observed market price determined by demand and supply

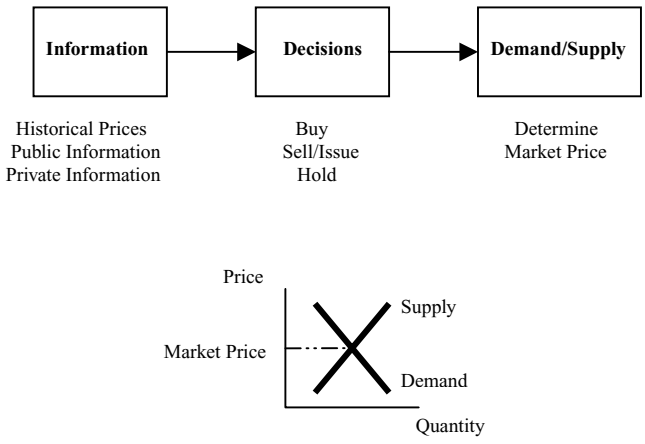

FIGURE 1 Tradition Exposition of the Efficient Markets Hypothesis

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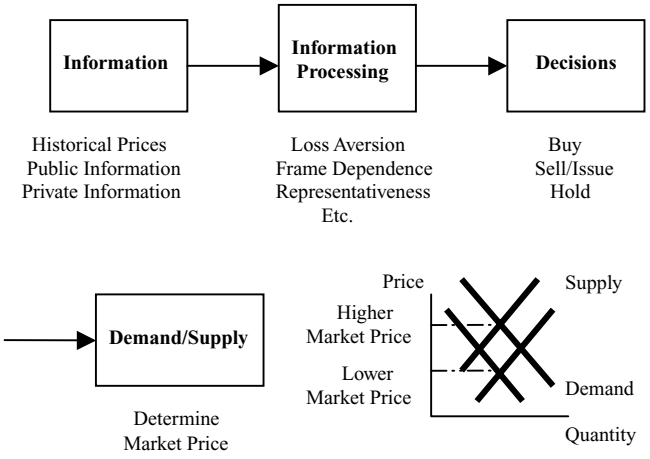

FIGURE 2 The Behavioral Finance Perspective

can fully reflect available information, as well as fully reflect the flawed processing of that same information.

Obviously, these diagrams do not provide any new results about market efficiency or behavioral finance.Nevertheless, the author has found this presentation to be very effective in the classroom and offers it to readers of this journal. As the old saying says, "A picture is worth a thousand words."

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