

Irrational Exuberance and Behavioral Finance

Robert J. Shiller, Ph.D.

Overview

Managing investments for taxable high-net-worth clients is more challenging than managing the portfolios of tax-exempt institutions. Though generating strong pretax returns is important for both types of clients, maximizing after-tax returns is also a key concern for taxable investors. This article offers five simple rules to help portfolio managers improve the long-term accumulation of wealth for most taxable investors: (1) maximize the use of tax-deferred investment accounts, (2) search for assets that offer capital gains rather than dividends or interest, (3) defer the realization of capital gains and harvest losses to offset capital gains realized elsewhere in a portfolio, (4) consider tax-exempt bonds for fixed-income investments, and (5) integrate estate planning and after-tax portfolio management.

In a recent conversation with members of the editorial advisory board of the *Journal of Investment Consulting*, Robert J. Shiller, a professor of economics at Yale University and leading proponent of behavioral finance, talked about the field of behavioral finance, which applies lessons from various academic disciplines—particularly psychology but also history and sociology—to economics and financial markets.

The group also discussed two of Shiller's books. In *Irrational Exuberance*, published in March 2000, Shiller analyzed the stock market boom that dominated the last two decades of the twentieth century and warned about excessive market volatility. In *The New Financial Order: Risk in the 21st Century*, published in 2003, he proposes a new risk-management infrastructure in which financial innovations would protect against risks such as loss of employment or real estate value caused by economic or technologic changes, just as insurance protects against catastrophic risks.

The Evolution of Behavioral Finance

Although the ideas underlying behavioral finance date back to the mid-1980s, people have had difficulty viewing finance as a social science. Because academia rewards people for being on the frontier, academicians tend to continue doing what they know well in order to reach the leading edge of that specialty. The problem with this approach, according to Shiller, is that the interesting ideas are usually off the main course, out in new territory. Marrying finance and psychology has been challenging because it requires practitioners to be on the frontier in both areas.

Nevertheless, behavioral finance has a stronger presence today, and Shiller predicts it will be even stronger in another ten years. He claims the field will enable us to improve markets and make them more functional as society changes and new financial institutions are created.

Volatility Calls Into Question the Theory of Market Efficiency

The concept of market efficiency is a half-truth in Shiller's view. The markets are not completely efficient or completely inefficient. If the markets are inefficient, it would be reasonable to assume that even if we can't predict which mutual funds will perform better than others, some of them ought to consistently outperform others. Although the lack of evidence for persistent returns suggests that, to some extent, markets are efficient, it also reflects the fact that the randomness in returns prevents even a smart investor from beating the market all the time.

Responding to the suggestion that mutual funds cannot consistently beat the indexes because of the difficulty in determining when the market will go up or down, Shiller says that in *Irrational Exuberance* he didn't intend to recommend that investors always try to time the market. He merely wanted to call attention to the fact that there are times when investors should pay attention to overpricing or underpricing.

Shiller believes constraints on short sales contribute to market inefficiency. Sometimes small firms become extraordinarily overpriced but are hard to sell short because short positions have unlimited loss potential. Because most investors stay away from short positions altogether, even moderately overpriced stocks may not be shorted. In other words, short selling is not enough to overcome overpricing.

Creating Innovative Vehicles to Help Manage Risk

Asked if investors biased toward long-term investments should make more use of hedge funds, Shiller replied that short positions should become a more important part of overall investment strategies. One of his companies is working with the American Stock Exchange to create securities that will make it easier for people to take short—and long—positions not only in the stock market but also in other markets such as real estate. The goal is to create hedging vehicles that are comfortable, user-friendly, and based on what is known about how investors actually operate.

Suppose, for example, an investor buys a house in a city currently experiencing a real estate bubble. Concerned that the bubble could burst, the investor might want some type of hedge. A simple way to accomplish this would be to buy a long-lived security designed to move opposite the city's real estate prices. Behavioral finance has shown that investors don't adjust their portfolios or their real estate holdings frequently, so buying this security would hedge the investor over the years.

This type of hedging essentially serves as insurance for the assets in an investor's portfolio. Insurance has proved to be more saleable if it has a cash value, if it's an investment rather than simply term insurance. Similarly, Shiller's firm wants to create a security that would sit in the investor's portfolio, pay a dividend, and look like a stock but would also hedge risk.

Implications of Behavioral Finance for Investment Consultants

A financial adviser's role, particularly with individual investors, is a bit like that of a psychologist or social worker—you give people advice about their lives. Even if you give excellent advice, your client may disagree with you or ignore you if you don't understand underlying human behavior. Most investors don't read finance journals. They are guided largely by intuition, and they need advisers who will spend time with them and help them consider their individual circumstances.

What Behavioral Finance Tells Us About Risk Aversion

Studies do not support the idea that certain personality types are consistently more risk-tolerant than others. Assuming there are timid people and bold people oversimplifies human nature. Some people will be risk-averse in one circumstance and less so in another. Some people like to plan their future; others avoid planning because they find it unpleasant. The latter group is not necessarily more risk-tolerant regarding their portfolios; they're simply not paying attention. Advisers need to recognize that these personality differences can determine success or failure.

Conclusion

Understanding the psychological foundation of human behavior in financial markets can facilitate the formulation of macroeconomic policy and the development of new financial institutions. Behavioral finance is not a niche movement. Populated by people who want to understand the broader picture, the field should be integrated into the social sciences at large.

About the Author

Robert J. Shiller, Ph.D., is the Stanley B. Resor Professor of Economics at Yale University, and is a leading proponent of behavioral finance. Dr. Shiller was cofounder of Case Shiller Weiss, Inc., and Macro Securities Research LLC in Cambridge, Mass. Dr. Shiller received the Commonfund Prize for best contribution to endowment management research in 2000 for Irrational Exuberance, which also became a New York Times nonfiction bestseller.

Although information and opinions expressed reflect responsible points of view, they do not necessarily represent the opinions of the IMCA Board of Directors, the IMCA staff, or IMCA members.