BOOKS: ECONOMICS

An Emotional High for Stocks?

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Although its message may be unwelcome to many, this important book should be read by anyone interested in economics or the stock markets. Robert Shiller, an economist at Yale, contends that the market is overvalued, and his arguments cannot be easily dismissed. This is not good news for investors. He also provides a strong case for a new branch of finance, behavioral finance. This is not good news for mainstream financial economists. Economists have traditionally argued that stock prices are determined by rational investors who act to maximize their welfare. The behavioral finance perspective, however, shows that many phenomena which cannot be understood well from the traditional perspective (for instance, the greater return of value stocks) can be explained by appealing to what we have learned about human behavior from the literature of psychology. Shiller's book joins Andrei Shleifer's *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford, Oxford University Press, 2000) as the best cases I have seen for why one has to take behavioral finance seriously when considering the valuation of the market as a whole.

Irrational Exuberance
by Robert J. Shiller
Princeton University Press, Princeton, NJ, 2000. 318 pp. $27.95, £17.50. ISBN 0-691-05062-7.

In Shiller's analysis, markets get overvalued because investors become too optimistic. Overconfidence and peer pressure cause them to ignore reality as they go along, disregarding rational valuation models because of new ideas that, promoted by the media, propagate like contagious diseases. Extant evidence is certainly consistent with investors being overconfident. Their confidence leads them to give too much importance to some ideas and to refuse to seriously take new facts into account until the grounds for believing them become overwhelming. Available data—such as the rapid departure of investors from the emerging markets in 1997—also make it difficult to reject the view that investors often appear to act more like a mob than a collection of individuals who independently figure things out.

Traditional financial economists have never argued that all investors are rational. Rather, they have argued that there are enough smart investors to ensure prices are set by those who compete to eliminate pricing mistakes. That there are both smart investors and foolish investors seems hard to refute. Where behavioral finance and traditional finance part company is in their assessments of the ability of "smart investors" to set things right. At one extreme, the most fervent believers in market efficiency (the view that stock prices incorporate available information quickly and correctly) are convinced that smart investors effortlessly dominate the markets. Thus, they hold, one can completely ignore the fact that other investors seem to base their decisions on arguments that would not survive the first few classes of a decent economics course. (An old joke provides a good description of hardcore believers in market efficiency: Two University of Chicago professors are walking toward the faculty club when a student points out a $100 bill on the ground. One professor immediately says that it cannot be there because if it had been there, it would have already been taken.) At the other extreme, some behavioral financial economists take the view that emotions so dominate the markets that smart investors never have a chance to correct pricing mistakes.

Happy traders. Celebration on Wall Street at the end of the trading day 16 March 2000, after the Dow Jones Industrial Average posted a record gain of 499.19 points.

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Shiller is reasonably cautious in his book. His most telling argument is that each previous bull market has been followed by a lengthy period of poor market performance. All his graphs and statistics indicate that we are approaching the moment when we will find out whether this bull market is different. Because some of the stock price increases are the result of hype rather than hard data, Shiller's conclusions about the psychology of markets suggest that it will not be.

The author even goes through the motions of briefly arguing why smart investors may not be all-powerful after all. One crucial difficulty facing smart investors is that they have to have capital to exploit stock market mispricings. It is, however, hard to find capital to exploit mispricings that may require a half dozen years to correct. The demise of the hedge fund Long-Term Capital is proof of this. There, a number of smart investors (more than a third of the partners had Ph.D.s from the Massachusetts Institute of Technology or had taught there, and two were Nobel laureates in economics) ran out of money even though most of their decisions would have been profitable had they possessed enough capital to keep their bets in place. But at times, Shiller sounds as if he believes that the only important determinants of market price levels are emotions. This is the book's principal shortcoming.

Markets are often astoundingly efficient—it usually takes them only minutes to incorporate news about companies in stock prices. The trick is to figure out why at some times they are so hard to understand without appeals to psychology. Shiller's book shows how important it is for finance to make progress in that direction. In summary, *Irrational Exuberance* is a must read even though it will make neither investors nor traditional financial economists happy.

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