Editorial

The winner is ... behavioural finance?

The cause of behavioural finance, as a challenge to the rational investor paradigm, was given a tremendous boost with the award of the 2002 Nobel Prize in Economics to Daniel Kahneman. Together with Amos Tversky (deceased), Kahneman integrated psychology and economics and in the process provided the theoretical foundations for behavioural finance. Their work focused on decision-making under uncertainty, and demonstrated that human decisions systematically depart from those predicted by the rational decision-making assumption of traditional economics. Their alternative model, prospect theory, provides new insights to the observed behaviour of decision makers. Kahneman and Tversky also demonstrated that through the use of heuristic shortcuts, decision makers systematically depart from the principles of probability. Their work revolutionised the field of financial economics by proposing that behavioural biases in general, and prospect theory in particular, are better explanations of how decisions are made in risky situations. The significance of this shift has interesting implications for all of us with an interest in both the academic and practical fields of financial services.

In terms of a theoretical framework for the discipline of finance, we are at least approaching what Kuhn¹ refers to as a paradigm shift. It is not simply a challenge that can be accommodated within the existing paradigm, but rather a potentially dominant framework with which to view

finance. The proposition that has dominated (or should we say that once dominated) finance for over 30 years is the efficient markets hypothesis (EMH). There are three basic theoretical arguments that form the basis of the EMH. The first and most significant is that investors are rational and by implication securities are valued rationally; however, even relaxing this assumption and accepting that some investors do not trade in a rational manner, we can still support the EMH if their actions are random. In effect their trades cancel each other out without distorting the underlying values of securities. Even if we relax this assumption further and assume that investors act irrationally in a similar manner, the EMH can still be supported. The correlation of trades by irrational investors can be eliminated by the actions of rational arbitrageurs who in effect prop up the formation of rational values. The plausibility of these arguments and the emergence of the capital asset pricing model (CAPM), that simplified risk to a single conception in the form of beta, created a golden era for academic finance.

The challenges to the EMH has come on a number of fronts. In particular, mounting empirical evidence challenges the central propositions of finance that prices are efficiently determined and risk is adequately explained by beta. On the theoretical front, the contribution of Kahneman and Tversky^{2,3} have revealed the extent to which investors

systematically lack rationality. The only prospect for salvaging the remnants of the EMH lies in the potential of rational arbitrageurs to counteract the concerted actions of irrational investors. In other words this is the means by which the EMH can resist the challenge to behavioural finance. As Shleifer⁴ puts it, behavioural finance places '... the biased, the stupid, and the confused into competitive financial markets, in which at least some arbitrageurs are fully rational'. Herein lies the key to the support for behavioural finance. Only some arbitrageurs are fully rational. Arbitrage is a fundamentally risky strategy and far from perfect. Arbitrage is limited by the lack of perfect substitute strategies to take advantage of mispricing. Even when the strategies exist, prices do not converge to fundamental values instantaneously. Behavioural finance is therefore supported by two fundamental components: investor sentiment and limited arbitrage opportunities to correct for the consequences of their distortion of prices. While behavioural theory remains in its infancy as the 'new' paradigm of finance, we are presented with a stimulating environment in which to face the challenges of research. The most challenging of all is whether the study of investor sentiment will enable researchers to make precise predictions about how security prices and returns will behave.

This journal aims to explore the interface between marketing and finance and these developments are of great importance. If we take marketing as a distinct discipline, then it is clear that the influence of psychology is ever present in both theory and practice. It is no doubt interesting for marketers to observe that financial economists are finally coming to recognise that decision-making does not rest entirely on a set of assumptions about rational choice. Why has it taken so long?

The current issue of the journal, while not devoted to behavioural finance, does include papers that stimulate our thinking in this regard. The first by Drew, Stanford and Veeraraghavan examines the performance of pension funds (termed superannuation funds in Australia). The authors challenge the actions of retail investors who select funds based on past performance. They find that previous performance has little influence on future returns. The paper by Jordan and Kaas uses behavioural theories, particularly judgmental heuristics, to examine the extent to which elements of advertising influences retail investors decisions to invest in mutual funds. The remaining papers deal with a variety of stimulating topics in the area of financial services. The paper by Hovey on timeshare investing is certainly a challenge to the timeshare industry in terms of its conclusions. The paper by Rickard examines the major impact the introduction of the Euro has had on financial markets within Europe. The practitioner papers present some interesting observations in the area of marketing of financial products: Mitchel assesses the problems of measuring the performance of sales staff in various sectors of the financial services industry, followed by Evans who examines financial services marketing and develops strategies for the retention of customers.

As a guest editor I wish to thank all those who have contributed their work. This issue is also a truly international effort. The countries from which the papers originated are: Australia, Germany, the United Kingdom and the United States. Finally, apologies to those authors whose papers were accepted but due to lack of space have had to be carried over to the next issue.

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- 3 Kahneman, D. and Tversky, A. (1979) 'Prospect theory: An analysis of decision under risk' *Econometrica*, Vol. 47, pp. 263–291.
- 4 Shleifer, A. (2000) 'Inefficient Markets: An Introduction to Behavioral Finance', p. 24, Oxford University Press, Oxford, UK.