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Editorial: Theoretical perspectives

Behavioral finance has come of age

Did the recent financial crisis vindicate behavioral finance and vitiate rational finance? Perhaps the history of general relativity could guide the answer.

Albert Einstein developed his theory of general relativity from 1907 to 1915. At the end of that period, Einstein showed how general relativity could explain anomalous movements of the planet Mercury without any arbitrary parameters or "fudge factors". He also predicted that starlight passing near our Sun would appear slightly shifted because of its gravitational attraction. Traditional Newtonian physics would predict half as much of a shift. Four years later, British astrophysicist Sir Arthur Stanley Eddington tested that prediction during a solar eclipse and found that traditional, Newtownian physics was wrong, and the new, Einsteinian physics was right. Ever since then, general relativity has continued to develop, as has traditional physics, but there is no longer any animosity or friction: general relativity was correct, and any future physics would require accepting its predictions.

Is that what was happened in the past few years? Is it the case that behavioral finance predicted a crash, traditional finance did not, and we can now all acquiesce to the new behavioral world order?

Unfortunately in the fields of finance and risk, theories are often more difficult to differentiate than they are in physics. Clean natural experiments are difficult to find, and implications from experiments in laboratories are not easy to translate into broader markets.

Rational finance can easily claim to have predicted a crash too: without specifying *when* the crisis would occur, and, more importantly, precisely *why*, then one has done nothing more than specify a negative skewness to returns, possibly compensated for with extra return.

Behavioral finance has certainly expanded beyond the narrow work of a few pioneering individuals. In that sense, it is well beyond the stage where general relativity was in 1915. On the other hand, there has not been a single, obvious, irrefutable observation that conforms only with the predictions of behavioral finance and not with rational finance. In that sense, it is well short of widespread acceptance. It thus exhibits a ghostly and uneasy co-existence with traditional finance.

Both academic journals and mainstream media routinely report on the results and implications of both rational and behavioral models, often in the same issue, without compunction, clarification or cohesion. The momentum strategy discovered by Jegadeesh and Titman in 1993 has spawned thousands of studies and explanations, about half rational, half behavioral.

It would be nice if we were able to say that the two fields co-exist in the same way that different interpretations of quantum mechanics co-exist: an uneasy truce on what it means but an exact agreement on models, predictions, and experiments. Unfortunately, we are not in that camp either.

Certainly the crisis has helped behavioral finance receive more attention in recent years than it otherwise would have, even accounting for its rapid growth over the past few decades. But it would be wrong to presume that rational finance has inhaled its last breath. The two fields continue to operate side-by-side.

Indeed, what we may be witnessing is the birth of something new. Behavioral finance has not come of age in the way of a prince, ready to attack the king and claim his rightful throne. Instead, it has come of age in the way of a princess, ready to be wooed by the various princes of rationality, and it is their offspring that we hope will bring light and peace to the turmoil.

In that spirit, this special edition of *Risk and Decision Analysis* brings together five papers that aim to combine the best of both worlds to reach novel and important conclusions about our world today. These papers were either presented or inspired by the International Research Forum held at the Hong Kong Polytechnic University in December 2010.

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