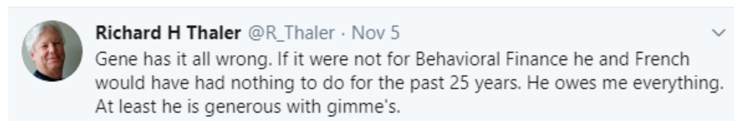
Behavioral Finance is Finance

Last week, Barry Ritholtz had a fun interview with Eugene Fama (and David Booth)[1]. In it, Gene threw out a few provocative zingers, like this one:

> *"I'm the most important person in behavioral finance…because most of behavioral finance is just a criticism of efficient markets. So, without me, what have they got?"*

Dick Thaler couldn't resist with his own witty retort on Twitter:



Gene dropped some other one-liners (actually he was very entertaining), and stated that behavioral finance had been a "failure" because they hadn't come up with a "testable theory" in Gene's mind.

> ***Gene:*** *"When I put the challenge to him (Thaler) 20 years ago, I said, okay now, you've been criticizing us for the last whatever (years); time (for you) to come up with a theory that we can actually test, and see if it works or not."*
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> ***Barry:*** *"And what was his response?"*
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> ***Gene:*** *"I'm still waiting."*

The most important person in behavioral finance?

Like-minded folks like Lu Zhang, an efficient market economist at Ohio State, followed up with a blog[2] stating:

> *"It has been almost 35 years since De Bondt and Thaler (1985), yet there is still not a single coherent behavioral theoretical framework in sight."*

Is that the standard for these EMH guys? Does behavioral finance need to figure out a model of market equilibrium that makes markets efficient? Isn't that a bit of a diversion? Hasn't behavioral finance actually provided a theoretical underpinning for many of the most successful "factors"? Hasn't behavioral finance made relevant these theory-less multi-factor models of market equilibrium? Sure, there is more to do, but hasn't behavioral finance had a great start?

Finally, back to the Ritholtz interview, Fama reiterated his earlier point:

> *"There is no behavioral finance. This is all just a criticism of efficient markets, with no evidence."*

Well, there sure is behavioral finance. It's also called finance. And it's provided plenty of evidence that markets don't always get things right. And frankly, there is very little supporting evidence of the risk story behind many of Fama and French's proposed factors. Size? Maybe (big maybe). But why is value riskier than growth? Why are firms with better gross profitability riskier than those that are less profitable? Why are firms that efficiently invest capex more risky?

And perhaps a more important, and bigger, question: why didn't Fama and French include momentum in either their three or five factor models?[3] They know it's there. They know it's a thing.

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[1] *https://www.youtube.com/watch?v=HRNczGwcTVQ*

[2] *http://theinvestmentcapm.com/blog.html*

The answer, because there is almost no possible risk explanation for momentum[4]. The behavioral guys have plenty of reasons. They have common sense, intuitive reasons; motives like loss aversion, confirmation bias, anchoring and herding. Even Fama himself has admitted that momentum "is an embarrassment to the theory".[5] Momentum isn't embarrassing for Narasimhan Jegadeesh, Sheridan Titman, Cliff Asness, or Mark Carhart. Momentum isn't embarrassing for those who know that behavioral finance hasn't been a failure. For those guys, momentum is beautiful.

Behavioral finance *is* finance. That individual human beings can sometimes do silly things, for reasons to do with either nature or nurture, is not under dispute. That they may make these same mistakes in the aggregate is no longer heretical. That is the gift of those that have been "misbehaving" by attacking hallowed, efficient market doctrine. Economists now can consider potential irrationality versus a standard model of profit-maximizing utility without being disinvited to (those wild and crazy) economist parties. Economists can now suggest that cognitive biases can affect asset prices without threatening their tenure.

Behavioral economics is no longer the domain of rogue traitors attacking efficient market theory. Behavioral economists are the patriots of finance.

So let's just (finally) drop the "behavioral" from the term. We've had almost precisely 20 years since Dick Thaler suggested the same thing himself:

> *"I predict that in the not-too-distant future, the term "behavioral finance" will be correctly viewed as a redundant phrase. What other kind of finance is there? In their enlightenment, economists will routinely incorporate as much "behavior" into their models as they observe in the real world. After all, to do otherwise would be irrational."*[6]

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[3] *https://www.aqr.com/Insights/Perspectives/Fama-on-Momentum*

[4] *Fama's story here has migrated to momentum being risky because it occasionally has discontinuous downward jumps. It isn't impossible that he is right, but this seems like a tautologous cop-out.*

[5] *https://www.top1000funds.com/2015/12/investors-from-the-moon-fama/*

[6] *Thaler, The End of Behavioral Finance, Financial Analysts Journal, Vol. 55, No. 5, Behavioral Finance (Nov.-Dec., 1999), pp. 12-17*