

June 13, 2006

**COMMENTARY**
*Efficient Markets*
**The Welfare of American Investors**

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*June 13, 2006; Page A16*

Behavioral finance, a developing field of academic research that emphasizes investor irrationality (and ignorance) and the inefficiency of markets, has been hailed by defenders of the SEC as offering a solid economic rationalization for our vast scheme of federal securities regulations. Even apart from the obvious implications for the regulatory system of ignorance and irrationality on the part of regulators, a closer examination of the logic of behavioral finance leaves little for the pro-regulation crowd to crow about.

Initially, behavioral finance emerged as an academic antidote to a claim of substantial market perfection in the finance field, the well-known "efficient market" theory of stock prices. Numerous "anomalies" or irrationalities were discovered in the market for securities, such as various kinds of over- or under-reactions to new information, herding behavior, endowment effects, January effects, weekend effects, small-firm or distressed-firm effects, bubbles and crashes -- to name a few.

**Faulty Data**


Most of these alleged peculiarities proved in time to be far less anomalous than was first thought. The data on which they were based were often faulty, or the econometric models were measuring the wrong thing, or various kinds of relevant transactions costs were ignored. The effects of irrational or uninformed behavior were often canceled out by opposite forces, and much of it was simply irrelevant. Furthermore, the behavioralists did not -- and do not -- have a general theory that can explain why financial markets work as well as they do. Some close approximation of the efficient market theory is still the most accurate and useful model of the stock market that we have.

Still, some of the behavioralists' criticisms stuck, especially in regard to crashes and bubbles, events that arguably should not occur in perfectly efficient markets. In this connection the efficient market theorists had no choice but to reexamine and refine their own models, which they have now done with some success. Perhaps the most important behavioralist contribution to economics has been their reminder that the market-model claim of rationality often does not comport with actual human behavior.

Economists frequently failed to qualify economic pronouncements as being limited in application to aggregate behavior. Too many assumed that if markets in the aggregate behave rationally, it must be because the "marginal" participant -- the trader who has the correct information about what a price should be -- was himself a perfectly rational maximizer. This better-informed and rational trader would always arbitrage away any discrepancies from efficiency that a market displayed.

But there is a vast difference between economics and psychology, and we can thank the behavioralists for forcing economics back into its correct posture of dealing with aggregate behavior. We can also thank the

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behavioralists for demonstrating that the marginal trader/arbitrage theory cannot explain all price formation, since we have no way, *a priori*, of knowing that this hypothetical individual will be rational. Nor can we any longer assume that the arbitrageur (apart from a purchaser of 100% of the securities of a given company) will have all the information necessary to set the correct price.

That discovery left a serious gap in economic theory. The efficient market mavens were indeed correct in their conclusions about aggregate market behavior -- but how could they explain this near perfection of functioning markets while irrational and less-than-fully informed individuals (so-called "noise" traders) were known to abound?

Traditional economics did contain the start of an answer to this question, most notably in F.A. Hayek's classic "The Use of Knowledge in Society" (1945). There, Hayek (addressing the then-pressing problem of countering socialist doctrine) made the astute observation that centralized or socialist planning can never be economically efficient because it was impossible for a central planner to accumulate all the information needed for correct economic decisions ("correct" in the sense of displaying efficient market allocations of goods). The critical information, he noted, is too scattered in bits and pieces throughout the population ever to be assembled in one person's mind (or computer). Diffused markets, on the other hand, function well because the totality of relevant information, even subjective preferences, can be aggregated through the price mechanism into a correct market valuation.

This insight of Hayek's has been a mainstay of market theory ever since it was advanced, but it remains merely an observation and a conclusion. It does not detail how new information gets so effectively impacted into the prices of goods and services. In other words, how does this "weighted averaging" get done? And why should we assume that the impact of rational participants would dominate that of irrational ones in markets?

Similarly, the efficient market theory was based almost entirely on empirical observations and did not offer a theory of how the market came to be so efficient. Subsequent literature examined the mechanisms of market efficiency (including insider trading), but these were again observational and descriptive works that did not even recognize the absence of a good theory of how new information gets properly integrated into a price. The implicit and often explicit theory of price formation was always the "arbitrage" notion, with the marginal trader calling the shots.

Enter now financial journalist James Surowiecki and his charming and insightful book, "The Wisdom of Crowds" (2004). The book opens with the story of a contest at a county fair in England in 1906 to guess the weight of an ox on display after slaughter and dressing. There were about 800 guesses entered in the contest both by knowledgeable people and by those who had no expertise in such matters. We are not told what the winning guess was, but we are told that the average of all the guesses (1,197 pounds) was virtually identical to the actual weight (1,198 pounds).

Similar results show up regularly in the relatively new use of so-called "prediction" or "virtual" markets, primarily employed today in predicting outcomes of political elections, sporting events, new product introductions or new movies. Though there are still some problems with the technique, these "markets" have proved in the main to be much more accurate than traditional interview polls. And these various illustrations of the wisdom of crowds suggest a solution to the problem of how correct prices are formed in financial markets beset by irrational and poorly informed traders.

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Weighted-average results are similar to "correct prices," since informed investors can be assumed to invest more money if their confidence in the validity of their information -- or the intensity of their desire for the product -- is higher, thus imparting a weighted average element to each price. And while the

actual weight of an ox is a more objective measure than the "correct" price of a security, the main difference may be between a static and a dynamic figure with the "correct price" of a stock being a kind of moving target.

The literature on prediction markets makes clear that the more participants in a contest and the better informed they are, the more likely is the weighted average of their guesses to be the correct one. That is true, ironically, even though the additional participants have even less knowledge than the earlier ones. The only requirements for these markets to work well are that the various traders be diverse and that their judgments be independent of one another. Clearly, there is still a lot more work of a statistical and mathematical nature to be done before the idea of the wisdom of crowds is turned into a full-fledged theory of price formation, but at least we have identified the problem and made a start towards a solution.

### **'Wisdom of Crowds'**

The implications of what we already know of this "wisdom of crowds" approach to price formation, as against the traditional marginal pricing/arbitrage approach, are apt to be startling. We should rethink any current policies based on a view of pricing in which we exclude the best-informed traders and discard the wisdom of the many. For instance, we now have a new and more powerful argument than we had in the past for legalizing most insider or informed trading.

Since such trading clearly makes the market process work more efficiently, it aids capital allocation decisions and informs business executives through market-price feedback of the best predictions about the value of new plans. Furthermore, the Supreme Court's "fraud on the market" theory of civil liability under the federal securities laws and Congress's ideas of correct civil damage claims for insider trading no longer have any intellectual merit. The same is true of any other part of our securities laws implicitly based on the notion of the marginal trader as a rational arbitrageur of price.

The new approach would suggest that it is undesirable to have laws discouraging stock trading by anyone who has any knowledge relevant to the valuation of a security. Thus, assembly-line workers, administrative assistants, office boys, accountants, lawyers, salespeople, competitors, financial analysts and, of course, corporate executives (government officials are another story) should all be encouraged to buy or sell stocks based on any new information they might have. Only those privately enjoined by contract or other legal duty from trading should be excluded. The "wisdom of crowds" can do far more for the welfare of American investors than all the mandated disclosures and insider trading laws that the SEC and Congress can think up.

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**URL for this article:**

<http://online.wsj.com/article/SB115015714883578393.html>

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