Book review


Why does the stock price of Philips Electronics fall after the company has announced a 15% profit increase? Because investors had already foreseen this increase and are now taking the profit on their shares. Why does the stock price of Amazon.com rise after the announcement of last quarter’s US$36.4 million loss? Because analysts had expected an even bigger loss.

If one watches CNN or any other program discussing the stock market, there seems to be an explanation for everything. In his book, Karl-Erik Warneryd (KEW) provides the reader with tools for analyzing stock-investor behavior. Stock-market Psychology gives an excellent overview of the state-of-the-art literature on this subject in the fields of economics, psychology and finance. KEW synthesizes the different concepts in the different fields and guides the reader through them. This book may be seen as a next step towards an integrated theory on stock-investor behavior. KEW focuses exclusively on one segment of investors in the stock market: private investors like you and me, the so-called ‘noise traders’. They are individual investors who are not rational in the economic sense, yet less emotional than the mass media make us believe. By making this distinction, his approach recognizes the heterogeneity of investors, a laudable position that was long neglected in finance theory. The heart of Stock-market Psychology is the individual investor’s perception of the world.

KEW postulates that most private investors are relatively inactive, opt for long-term investments and add to their investments rather than sell. He uses economics, finance and psychological reasoning to build his case that ‘those who make short-term investments to save up for not too distant purchases tend to lose or make lower gains, due to short-term variation in stock rates and bond interest rates. Those who speculate and buy and sell continuously end up with lower wealth than the less active first category. Those who really gamble on the stock market and freely buy and sell stocks and/or derivatives in a few cases end up very rich but, in many cases, lose everything’ (p. 5). It is particularly interesting that KEW does not take sides in terms of method to explain stock-investor behavior: he uses ‘traditional’ finance theory to structure his study of investor behavior, alongside with findings from psychology to complement the picture.

Chapter 1 provides an overview of the efficient-market theory and some alternative hypotheses that can explain the observed deviations from the finance theory,
such as financial bubbles and crashes. Surprisingly, KEW does not discuss the related concept of market depth here, despite the considerable research attention it has received in financial theory and its ability to provide new angles on phenomena like ‘fads’, ‘noise’ and ‘bubbles’. Chapter 2 elaborates on the anomalies found in finance and discerns two segments of investors: rational traders and noise traders. With the help of Shefrin and Statman’s Behavioral Capital Asset Pricing Model, a number of investment strategies are discussed and subsequently related to the efficient-market theory. Interestingly, KEW asks himself and the reader what ‘hidden knowledge’ means in today’s society with such powerful mass media, a question that becomes all the more relevant in light of the recent Enron scandal. In Chapter 3, KEW focuses on the investor’s formation and change of expectations. He presents a model in which earlier experience, interaction with others, and new information drive investor expectations. KEW points out that the expectations of investors might be heterogeneous, which is hard to reconcile with the theory of efficient markets. In doing so, KEW forces his readers to think about the behavior of investors. Risk and risk attitude have been key constructs in explaining investors’ decision-making behavior. In Chapter 4, KEW reviews work, such as Prospect Theory, that (partly) explains the anomalies in decision-making under risk, and methods to measure attitudes towards risk. Chapter 5 deals with the investor’s cognitive errors and simple behavioral rules of thumb that facilitate decision-making. KEW argues that investors use fast and frugal heuristics, which are smart, rather than irrational deviations from the ideal model. Chapter 6 introduces the concept of emotions, explaining investors’ overreactions to information. Feelings of optimism and self-confidence might drive investor behavior. In this chapter psychological concepts, such as self-control, play an important role. Our understanding of investors’ stock-buying behavior is enhanced in Chapter 7, by the recognition that other people influence our behavior. KEW discusses four types of social influence: small group influence, interpretation of other people’s behavior, reports in the news media, and the bandwagon effect. The latter is closely related to the now-popular concept of herd behavior.

In the chapters previously discussed, KEW has given an excellent review of the existing literature, fitting the pieces of the puzzle in the right places. Only in the last three chapters of the book, do we see more of his own views. Here, KEW indicates a need for individual data on finance behavior. These data sets, he argues, are necessary to track and target different investor segments. In this context, KEW misses a key question about the nature of the heterogeneity that occurs between investor segments: is segment heterogeneity caused by the so-called observable variables (such as age, income level, etc.), or by the decision-making process itself? In the latter case, it would be useful to group investors with similar behavior as to their decision-making process. This segmenting would then be based on latent heterogeneity (i.e., unobservable by the researcher prior to analysis), reflected in the estimated coefficients of each group. A mixture regression-modeling framework identifies latent heterogeneity and simultaneously infers the number of segments from the data. Such a framework allows us to investigate simultaneously the relationship between the behavior of investors and the variables hypothesized to determine the decision-making process. In terms of KEW’s expectation framework, this would imply that different
segments put different weight on the different beliefs discerned by KEW. It would be interesting to apply this modeling technique to KEW’s panel data, for he argues that private investing depends on images of the future that investors have and that are influenced by others. These images, or scenarios, driven by expectations, give direction and guide investor’s behavior. Scenarios are composed of past experiences, new information, social influence etc. KEW raises a very fundamental question: ‘To what extent is it possible to understand and predict the scenarios that will determine an individual investor’s behavior, or to aggregate the scenarios of different persons into something that can predict what will happen at the market level?’ (p. 279). This is an issue that future research should address. To do that one has to gain insight in how financial scenarios are constructed. KEW mentions different concepts that might help to answer his question. KEW does not take the beta sciences into account when dealing with this question, which seems to be a crucial one, although maybe beyond the scope of the book. To better understand complex phenomenon like scenario construction that are the result of human behavior, one has to open the black box of the decision-maker’s inferential machinery. It seems valuable for economists and psychologists to look at the recent findings in neurobiology and neurophysiology that is beginning to discern how the brain transforms inputs (stimuli) into behavior. Using an interdisciplinary approach to gain insight into the financial decision-making process using findings from the gamma and the beta (neurobiology and neurophysiology) sciences seems promising when addressing KEW’s research question.

Stock-market Psychology is a comprehensive overview of the behavior of investors in the stock market. As such, this book is valuable for the classroom. What is more, KEW succeeds in triggering the reader’s mind by taking different angles to a problem. In conclusion, Stock-market Psychology provides researchers with numerous ideas for future research and readers with useful and fun tips, without taking away our hopes of ever becoming rich from investing in stocks. What more is there to ask from a book?

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