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Individual rationality can mean collective irrationality

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Now that even the UK's chief financial regulator has started kicking the theory of efficient markets, the fun has gone out of it somehow. Moderation in all things: and it is worth remarking that just because markets are inefficient, that need not mean investors are irrational.

The point is contentious, and needs defending. As it happens, I have come across an academic paper* which does just that. But first, an observation.

Some economists insist that markets must be efficient because they are rational. And if they are not rational, the whole of economic theory collapses.

So be it, we might reply. Better no theory than a dud one. And other theories, based on behaviour rather than rationality, do a better job.

But when it comes to the big stuff, our actions belie that. When we are grappling with the subprime debacle or Chinese economic policy, we ask ourselves what people are up to – not how they behave, but how they are reasoning.

In fact, the theory of rational behaviour is a model – a schematic attempt to portray the big picture. Any such model, in or out of economics, contains anomalies. To dwell on those anomalies, as we all now enjoy doing, risks missing the point. It is only when there are enough of them that the model is more hindrance than help and must be dumped.

So to the paper, by two academics from the London School of Economics – former hedge fund manager Paul Woolley and Professor Dimitri Vayanos. In effect, they argue that markets are inefficient for perfectly rational reasons.

The key lies in the use of agents. Conventional economic theory deals with representative individuals. But in reality, those individuals generally hand their savings to institutions, who hand them on to specialist fund managers.

If those managers underperform the market, it is hard for the investor to know whether they are deliberately avoiding overvalued stocks, or simply messing up. If the situation persists, then investors infer the latter and switch their money.

The germ of the idea came to Dr Woolley a decade ago, he says, when he was running the European end of the US hedge fund GMO. The fund relied on fundamental value during the dotcom boom, when high-tech, telecom and media stocks became grossly overvalued. GMO initially shunned them, thereby underperforming hugely, and by the peak of the frenzy had lost 40 per cent of its funds under management. Until the tide turned, the only way it could stem the flow was to devote part of its funds (and the bulk of its trading) to momentum plays – that is, to the overvalued stuff.

The concept of momentum is important because efficient market theory says it should not exist. If investors decide a stock or sector is worth a price different from the present one, they should move to that price immediately.

In reality, of course, prices overshoot over long periods, then go into reverse. The dotcom example illustrates why.

As investors were bailing out of value funds such as GMO, they were gradually switching more cash into the bubble stocks. Thus those stocks were pushed up and value stocks pushed down. Why gradually? Because it takes time to sack a fund manager and because individual investors capitulate at different levels.

In a sense, this is not new. I myself have banged on for years about how fundamental value is in practice irrelevant, since fund managers who stick to the fundamentals risk losing their jobs.

But I had rather assumed that was because end-investors were behaving irrationally. This thesis suggests otherwise.

The information gap between them and their agents means they are making the best of the knowledge available to them. So it turns out that individually rational actions add up to a collectively irrational outcome. That might seem odd to mainstream economists, but not to the rest of us. Mutually destructive wars have been fought on the same basis.

What are we to do about this? Unstable and irrational markets can be socially harmful, besides wasting resources within the financial system.

Dr Woolley hopes the very fact of pointing this out will help investors to concentrate more on the long term. Failing that – and it seems a long shot – he suggests regulatory intervention.

The aim would be to reduce market turnover – perhaps through a kind of Tobin tax. This brings us back to Lord Turner, whose related suggestion caused such a furore last week.

That too is perfectly rational, since market participants are defending practices on which their livelihood depends. If the rest of us want a less irrational outcome, we must look to ourselves to make it happen.

**http://tinyurl.com/kptosd*

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