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FINANCIAL FAQs

THE PITFALLS OF PRIVATE INVESTING
Irrational Economic Behavior

Economists have debated since Adam Smith whether economic behavior is rational. That means, in essence, does the average—and not so average--investor know what is best for them, and knowing, are able to act on it? Much research, as well as the 2000 bursting of our stock market bubble—in which investors lost $4 trillion in stock equity—tell us that most investors do not act rationally. And because greater numbers of seniors are becoming investors, whether they have the knowledge and education to manage the risks inherent in private Social Security accounts should be debated, but is not.

Part of the debate is based on varying definitions of rational behavior. Dr. Robert Shiller in his book, Irrational Exuberance (Princeton U. Press, 2000), maintains that most investors either do not have the educational background, or are too lazy to do the research needed to rationally evaluate a market investment. His studies show that investors usually rely on wishful thinking, others' opinions, or hearsay for their information.

Most classical economists (meaning those who espouse Adam Smith's free-market postulations), on the other hand, lean towards an assumption of rational behavior. For if humans cannot or will not act rationally, then fundamental questions of utility—i.e., preferences—come into play. An investor has to act on the knowledge that is at hand, in other words, in order to make intelligent choices. Classical economists could not otherwise justify free market principles that advocate minimal market regulation, since irrational economic behavior needs greater regulation, by definition.

Growing cadres of behavioral economists have begun to measure psychological traits that cause irrational decisions—such as herd behavior in financial markets. Herd behavior is generally defined as allowing the actions and opinions of others to overrule one's own judgment and common sense. This is at the same time that financial markets in their view are not very open and transparent in their operations. Markets are therefore seen to be prone to manipulation by insiders.

That is why we talk so much about the danger of asset bubbles—whether in stock, real estate, commodities, or currencies. Any asset class that seems to be overvalued based on some "fundamental" or "objective" measure could be in a bubble. Our recent stock market is the best example—whose price-to-earnings ratio rose to 44:1 in Jan. 2000, one-third higher than the previous high that preceded the Crash of 1929 (It hit 32.6:1 in Sept. 1929.) and three times the 15:1 long-term historical average. The consolidated P/E ratio of the S&P 500 today is back down to 18:1, a combination of lower stock prices and 3 years of rising earnings.

Next week's column will discuss the pitfalls of real estate investing.

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