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Adapting financial rationality: Is a new paradigm emerging?

Mona Soufian [a], William Forbes [b], Robert Hudson [c,*]

[a] Newcastle Business School, Northumbria University, Newcastle upon Tyne NE1 8ST, UK
[b] School of Business and Economics, Loughborough University, Loughborough LE11 3TU, UK
[c] Hull University Business School, University of Hull, HU6 7RX, UK

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ABSTRACT

We discuss the implications of an alternative to the efficient market hypothesis (EMH) the adaptive market hypothesis (AMH). The AMH advances a theoretical basis for a new financial paradigm which can better model such phenomena as the recent financial crisis. The AMH regards the financial market order as evolving, tentative and defined by creative destruction in which trading strategies are introduced, mutate to survive, or face abandonment. The concept of investor rationality is less helpful than the distinction between investment strategies which are more or less well adapted to the prevailing market environment. We outline how a more systematic and grounded basis for behavioural finance can be developed in line with the latter approach. Based on this we develop testable hypotheses allowing the AMH to be distinguished from the EMH. Finally, we discuss how the AMH can aid our understanding of important issues in finance. A central insight is that in the survival of richest, as opposed to fittest, implied by the AMH there is much room for misallocation of resources as price and value uncouple. In this shifting financial market order the regulatory State features as a further market in which the vote market verifies or disrupts market conditions.

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1. Introduction

The recent global financial crisis has dealt a huge and largely unanticipated shock to the world economy. The Queen of England surely expressed the thoughts of much of the world's population in November 2008 when she asked in a visit to the London School of Economics why no one had seen the crisis coming. We believe the fundamental answer to her question lies in the dominance of the neo-classical financial paradigm. A few far-sighted people had seen problems ahead but were largely ignored[1]. The idea that markets rationally price assets and risk was so entrenched amongst influential academics, practitioners, regulators and politicians that dissenting views were completely marginalised.

Recent years have seen an almost continuous succession of financial crises including the emerging markets crisis of the late 1990s, LTCM, the bursting of the 'dot com' bubble, the accounting scandals at Enron and Worldcom, cumulating in the near collapse of the global banking system in 2008 and ongoing problems with sovereign debt. As Minsky (1986) has taught us financial crises are a recurring theme of economic history. What is so disturbing is the escalating frequency and intensity

* Corresponding author. Tel.: +44 1482 347500.
E-mail address: robert.hudson@ncl.ac.uk (R. Hudson).

[1] A good example of this is Rajan (2005). This paper was delivered in August 2005 to a gathering of top economists at Jackson Hole which that year was honouring the retirement of Alan Greenspan as Chairman of the Federal Reserve. In hindsight this paper seems remarkably prescient but it was attacked quite violently at the time. Lawrence Summers, for example, told the audience he found "the basic, slightly lead-eyed premise of (Rajan's) paper to be misguided." (Wall Street Journal, 2009). A paper by Bezemer (2010) outlines a number of research studies that did forecast a crisis and concludes that they commonly adopted accounting or flow-of-funds models rather than neo-classical equilibrium models.

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of the crises we now observe. Galbraith (1993, p. viii) states the case thus ''Recurrent speculative insanity and the associated financial deprivation and larger devastation are, I am persuaded, inherent in the system. Perhaps it is better this can be recognised and accepted.'' Recently Ferguson (2012) has portrayed the 2008 crisis as a critical point in a ''great degeneration'' of Western capitalist economies as they enter a ''stationary state'' characterised by the rule of law being replaced by the rule of lawyers. This sorry state results from intense rent-seeking amongst market participants for shares of a pie that has ceased to grow or has even entered decline.

Mainstream finance theory has clearly failed to anticipate, or even convincingly explain, the recent crises. Indeed to a large extent it might be considered to have caused them by giving intellectual authority to the ideal of unrestrained financial markets and dogmatically suppressing dissenting views. There seems a vital need to address this situation with new research programmes in Finance to better model social reality. In the terms of Kuhn's seminal work on the structure of scientific revolutions the crises are anomalies; that is a failure of the current paradigm to take into account observed phenomena (Kuhn, 1962). An accumulation of anomalies eventually leads to a change of paradigm. The current crisis may act as the breakpoint enabling serious consideration of different theoretical approaches.

Perhaps we can finally now accept the cyclical nature of financial crises and move on to explaining their consequences. Periods of trauma and destruction may intensify the speed at which differentiation based on evolutionary fitness proceeds. This suggests seeking to build financial institutions that can withstand further crises may be a misplaced effort. It may be better to try to put in place bank resolution procedures that are both easily triggered and are capable of protecting the taxpayer's purse. Taleb (2012) identifies a category of trader/entrepreneurs who thrive on volatile, if not destructive, times. Such innovators are ''antifragile'' in the sense that they enter their own in periods when pressures to survive are most intense.

As one would expect crises of the magnitude we are experiencing has given rise to enormous debate. There have been hundreds of popular and academic articles and books on the subject[2]. Different authors have emphasised different perspectives. Much of the popular coverage has personalised the issues. Often individuals have become scapegoats for behaviour they personify, for example Richard Fuld, Sean Fitzpatrick and Fred Goodwin, the CEOs who presided over the demise of Lehman Brothers, Anglo-Irish, and the need for the government rescue of RBS, respectively. A simple assertion that we have a flawed and greedy banking culture is now commonplace as a result.

Whilst it is surely prudent to rapidly address particular flaws in financial practices and regulations much of the post crisis response has been very piecemeal and ad-hoc in nature. This type of response is inevitable given the evident lack of an appropriate and credible theoretical basis to inform policy. The deficit in theory has been recognised in essentially practical and hard-headed assessments of the crisis. This is one of the primary insights of the UK's Turner Review into the failure of regulatory authorities to head off the burgeoning securitised debt crisis (Turner, 2009). Turner (2009, p. 85) concludes ''the conventional wisdom relating to the global financial system – that risks had been diversified – was widely accepted and was wrong''. If the ability to diversify as a risk reduction strategy now looks tarnished in the face of the rise of systemic risk then the very fundamentals of received professional wisdom are in doubt. In a related review of the UK's equity market's Kay (2012) explicitly demures from a view, that ''public policy should proceed as if these 'irrational' behaviours did not exist: Such an approach would not be consistent with the fundamental goals of creating high performance companies.''

This insight echoes Trichet's (2010) (the Governor of the ECB) view that many of the economic models used by advisors during the financial crisis ''seemed incapable of explaining what is happening in the economy in a convincing manner.'' Thus the EMH seems to have been discarded as the basis of sound public policy and the race is now on to gain acceptance of a credible alternative. The AMH could become such an alternative source of guidance.

In this paper we question the core assumption of the EMH which is the 'rationality' of economic agents[3]. Following Todd and Gigerenzer (2003) we argue that true evolved rationality emerges when investors' cognition is a good match to the demands of the environment in which they find themselves trading. The distinction here is between the investment strategy and its cognitive and external context, as opposed to a proposed statistical property which is conjectured to prevail regardless of context or cognition. Based on the above, in this paper we discuss directions for future research which offer some hope to build a more persuasive and useful theorisation of financial decision-making.

Initially we propose replacement of the concept of the Efficient Markets Hypothesis (EMH) that financial markets always act to set prices 'rationally' by an understanding that prices change as investors' constantly adapt their behaviour allowing markets to evolve their own internal order. The latter process is known as the Adaptive Markets Hypothesis (AMH) and was initially proposed by Lo (2004, 2005).

The AMH recognises the importance of behavioural finance and was partly designed to offer a way to reconcile this emergent literature with the mainstream. Our second, and complimentary, proposal is to work towards a more systematic and theoretically grounded basis for behavioural finance, building on the work of Herbert Simon on bounded rationality, and the research programme of Gigerenzer on heuristics. At the moment behavioural finance is somewhat compromised from a theoretical point of view by attempts to preserve many of the fundamental premises of neo-classical economics and can be

[2] Books by McLean and Nocera (2010), Sorkin (2009) are popular examples of the genre. One of the better high level overviews is a letter to the Queen seeking to answer her question written by members of the British Academy (British Academy, 2009). For diverse collections of academic papers on the crisis see special issues of the Journal of Financial Regulation and Compliance (2009), Critical Perspectives on International Business (2009).

[3] Rationality is a rather ill-defined and potentially loaded concept as we discuss later in the paper.

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