

RATIONAL ECONOMIC AGENTS ARE OFTEN CRAZY

Capitalism -and price- highs and lows seem to boil down to one behavioral sin: going with the crowd. Sure there is room for the virtues of going your own way and differentiating, in line with what Alan Kay, an engineer at Palo Alto Research Center, said: *“Don’t worry about what anybody else is going to do... The best way to predict the future is to invent it.”* Still, me-tooism can go from banal to raving to damaging. How many buy a new car, or house, just to keep up with the Joneses? Why do some companies acquire or merge? Sometimes just because the nearest competitor did it. Why should a Dow Jones or any other index sneeze be followed with fever and a cold on other exchanges? Why do many of those supposedly creative branding agencies just build (?) post-merger brands based on a copy-and-paste of two or more names, as well as they take a leaf from others’ books? Want a quick name check, whatever the industry? One of the most famous (now infamous) was DaimlerChrysler. But the list also includes the unpalatable Anheuser-Busch InBev, and others such as AstraZeneca, Bank of New York Mellon, BNP Paribas, ConocoPhillips, GlaxoSmithKline, Repsol YPF, Thomson Reuters, etc. The net result (after huge rebranding costs) goes from banal to not inspirational.¹ Oh, but we had forgotten that branding should be (mostly) emotional and not (always that) rational! Why did so many bankers jump onto ABS (asset-backed securities), CDOs (collateralized debt obligations, once named *“financial weapons of mass destruction”* by Warren Buffett himself), and other so-called “sophisticated” schemes? Some dare giving the real answer: if others do it, why wouldn’t we? Why shouldn’t we follow the crowd? A typical behavior in the financial sector, by the way. It’s just that this time the write-downs and -offs were higher –much higher.

As far as stock markets -and other markets too- are concerned, the herd instinct prevails over sophisticated economic models. J.M. Keynes used to say that *“Investing is trying to predict how other investors will behave.”* It is always amazing to see a stock -and the company that lies behind- penalized just because another in a similar or related industry is marked down, sometimes just because the earnings (per share, of course!) haven’t met quarterly expectations. It is baffling to watch how a craze for a stock can impact on its performance and investment decisions. In July 2000, when the “Dot-com bubble” was deflating, Fortune magazine pointed out that over a recent period *“of the 33,169 buy, sell and hold recommendations made by stock analysts... only 125 were pure sells. That’s 0.3%... Just over a third of the ratings... were strong buys...”* Eight years and thousands of

¹ Not to mention that some branding exercises clearly reflect embarrassment or avoid addressing the cultural or identity clashes between two or more corporate cultures.

buys later, a New York Times article noted that, among others, Merrill Lynch analysts were finally learning to say “sell”.² Too slow, too late.

So if you are kind -or you are an analyst- you may consider that markets have their own rationality. And if you are realistic -or you are another analyst- you will regard markets as sinfully irrational. We (well, not everyone) already knew the limits of homo economicus, aka the rational economic agent.³ Now, among the bubbles that the latest crises (plural) have burst is the myth of the “Sophisticated investor”. You know, the one, among other species, who calls for -or creates- derivatives, before putting them down after having securitized, structured and (de)leveraged, if you catch the drift. Definitely not a simple man or woman! The bubble, and another kind of Minsky moment⁴, if you prefer, burst twice. First, as investments –from SPEs to SIVs etc.; second, as the investors themselves went bust –from Merrill marauders to Madoff crooks et al. *“The next time you read that a financial advisor or hedge fund manager is a “sophisticated investor”, make sure to take it with a grain of salt,”* writes Peter J. Henning.⁵

Anyway (any way), some analysts, fund managers, investors are more informed than others. Writing about the corporate scandals of the early 2000s, the authors of *“Freakonomics”* remind us that *“Though extraordinarily diverse, those crimes all have a common trait: they were sins of information...; in each case the experts were trying to keep the information asymmetry as asymmetrical as possible.”*⁶ In other words, some get the means to act, supposedly, more rationally than others. If possible, than a majority.

In your desperate search for rationality, against “overreaction”, for instance, ensure a good rating too. Bank of America’s long-term debt was downgraded from A+ to A by Standard & Poor’s in March 2009. What is most remarkable? The lower rating or the fact that the bank is still rated A with such a load to carry? And what is this worth? Republican Senator Jim Bunning probably didn’t give the worst definition of ratings agencies’ job: *“That is like a movie studio paying a critic to review a movie, and then using a quote from his review in the commercials.”*⁷ As the Leuven-based economist Paul De Grauwe writes: *“Having made systematic type I errors (i.e. “excessive faith in the*

² Fortune, July 24, 2000; The New York Times, May 21, 2008.

³ The author feels closer to the concept of *“bounded rationality”* developed by the American psychologist Herbert Simon than to excessive quantification models in behavioral economics. For a summary, see *“Theories of Bounded Rationality”*, in *“Decision and Organization”* (North-Holland Publishing, 1972).

⁴ Hyman Minsky was a Chicago-born economist who created a model for credit-driven asset bubbles. To be fair, not all the analysts behave like sheep: Simon Wilson asked in MoneyWeek magazine and website (www.moneyweek.com) in April 2007: *“Have we reached a Minsky moment?”* Not many paid heed at that time.

⁵ *“The Myth of the Sophisticated Investor”*, in *“The Deal Professor”* blog, managed by Steven M. Davidoff for The New York Times (<http://dealbook.blogs.nytimes.com>), February 2, 2009). Read also, e. g. about the role of JP Morgan and AIG, the gripping *“Genesis of the debt disaster”* by Gillian Tett in the Financial Times.

⁶ *“Freakonomics”*, by Steven D. Levitt and Stephen J. Dubner (Penguin Books, 2005).

⁷ Quoted on <http://marketplace.publicradio.org/>.

soundness of private companies’), they are now more likely to make type II errors –finding risks where few exist. In the past, they were over-optimistic; they now react by being over-pessimistic.’⁸ The (coming and) going rate...

Continued in **“The Seven Deadly Sins of Capitalism”**

⁸ *“Warning: rating agencies can do you harm”*, in the Financial Times (January 22, 2009). For those who would have forgotten, Paul De Grauwe reminds in his article that in statistics, a type I error occurs when a hypothesis is rejected (e.g. *“a company is risky”*) when it should have been accepted; a type II error occurs when a hypothesis is accepted (e.g. *“a company is risky”*) when it should have been rejected.