

“A Survey of Behavioral Finance” by Nicholas Barberis and Richard H. Thaler

This paper was the first essay in the book entitled *Advances in Behavioral Finance* by Thaler and serves as an introduction to the field of behavioral finance. The essay covers recent work done in the field of behavioral finance, which only began in the 1980s. What I found most noteworthy was that there is a series of theoretical papers on the “limits to arbitrage”, which says that irrationality can have a substantial and long-lived impact on prices. If this holds true, then this defeats the idea that market prices always reflect the fundamental values of its underlying investments or that rational agents would always correct irrational agents in the market through arbitrage. As exemplified by Royal Dutch/Shell, which were two identical stocks that were priced differently, it is now understood that prices can be very wrong without somehow creating any profit opportunities. The author seems a little biased in his conclusions at times because I found some claims to not have enough evidence to back it up.

“Reconciling Efficient Markets with Behavioral Finance: The Adoptive Markets Hypothesis” by Andrew Lo

This paper covers the conflict between Efficient Markets Hypothesis and behavioral finance. By studying the apparent contradictions between these two views, it creates a foundation for Adaptive Markets Hypothesis, which is an evolutionary view of financial markets. By taking on fewer assumptions about the rationality of market agents, AMH is able to (in theory at least) produce more realistic results and fewer exceptions. This article provided several important applications of AMH as well as a useful section on suggested readings. It answers my questions of how relevant AMH is for the practice of investment management (very) and is it practical to apply this new theory to model economic behavior (yes). Although AMH appears to be a more qualitative analysis than EMH, quantitative implications can be derived through an empirical analysis of evolutionary forces in financial markets.

“Risk Management for Hedge Funds: Introduction and Overview” by Andrew Lo

Hedge funds have provided above market returns by taking on "alternative investments", which include private equity, risk arbitrage, commodity futures, convertible bond arbitrage emerging market equities, statistical arbitrage, and foreign currency speculation, among others. The reason risk management is important is that modern finance dictates that there is a trade-off between risk and expected return. In this paper, Lo argues that the current measures of risk, mean-variance, beta, and Value-at-Risk, does not accurately reflect the risk exposures of hedge funds, due to higher liquidity and credit. In addition, greater risk causes survivorship bias, which skews the risk/expected return factor. This explains why a hedge fund would generate a higher return over more traditional investment strategies. I found that Lo did not go into enough detail about the risk preferences of investors. The 2%/20% fixed and incentive fee structure of most hedge funds use provides incentive to produce high returns while taking on more risk. The author writes that the hedge fund's investors dictate the amount of risk a manager would take on, but I would think that the reverse is true. Given the payoff scheme, investors should invest in hedge funds that reflect their own risk preferences.