

## ECONOMICS THESIS PROPOSAL

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General Field: Finance  
Proposal Title: Adaptive Financial Markets  
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### **Question**

What advantages does the Adaptive Markets Hypothesis have over Efficient Market Hypothesis and what new insights will this approach provide? How well does this theory fit data from financial markets?

### **Area**

Efficient Market Hypothesis, Behavioral Finance

### **Relevance**

Despite the popularity of EMH among academic theorists (possibly due to its simplicity), this view has not been adopted by those actually participating in the financial markets. In fact, most investors follow strategies (value, momentum) because they presume that markets are not efficient. There must be a reason for this discrepancy between empirical evidence and theory.

### **Theory**

Rather than taking a neoclassical approach of attempting to maximize expected utility and assuming rational expectations, AMH has an evolutionary perspective and views agents (investors) simply as dynamic organisms that have adapted through generations of natural selection and have a goal of maximizing returns. Individuals act in their own self interest, make mistakes, learn, and adapt. In addition, competition drives adaptation and innovation, natural selection shapes market ecology, and evolution determines market dynamics. A related field is Behavioral Finance, which is primarily concerned with the rationality, or lack thereof, of economic agents.

### **Methods**

I will adopt the AMH agent model of the financial system and use it to analyze some historical financial market anomalies. I will note if/when the market inefficiencies are persistent and try to uncover the extent to which an evolutionary view of financial markets can explain market behavior over a rational view of financial markets.

### **Issues**

AMH (2004) is a relatively new field of economics and has only a few published case studies and theoretical research articles. Behavioral Finance is more established and has much more existing research. I am particularly interested in studying the irrationality of investors, so Behavioral Finance will definitely apply to my research. On the other hand, the advantage is I get the excitement of pioneering research in a new field, which will definitely drive me to get more work done. In addition, I want to have a balance of theory and applications in this paper, so it may be more time consuming to write than a paper concerned with just one or the other.

### **Faculty Input**

Prof. Woglom recommended a few behavioral finance essays for me to read and suggested I also read some responses from the EMH side as well.

## **References**

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