# Geleitwort von Prof. Malcolm Baker
## (Professor am Finance-Institut der Harvard Business School)

When the Royal Swedish Academy of Sciences awarded the Nobel Prize to Eugene Fama, Lars Hansen, and Robert Shiller in October 2013, they noted that *„the Laureates have laid the foundation for the current understanding of asset prices. It relies in part on fluctuations in risk and risk attitudes, and in part on behavioral biases and market frictions.*"

After more than three decades of research, the impact of behavioral insights in economics and finance is hard not to recognize. In the early years, there was skepticism that behavioral models could be rigorous and normative. There was skepticism that less than fully rational agents could even „survive" to influence competitive market equilibria. Now, many of these concerns have begun to fade, and the borders between behavioral and traditional finance and economics are not so sharp. They stand together in the brief press release in 2013 that put Eugene Fama and Lars Hansen, who laid the foundation for market efficiency and rational asset pricing, and Robert Shiller, the early champion of behavioral finance, on the same stage. If „behavioral biases" have an equal place next to „risk attitudes" in the study of asset pricing, then the time has surely come for books like this one to survey the many ways that behavioral insights have been applied in a field like corporate finance.

In traditional models of economics and finance, decision makers are smart and sophisticated, gathering and processing information, forecasting the implications of their decisions for current and future well being, and solving elaborate optimization problems, all to make unemotional and rational choices. Behavioral economics and finance replaces these idealized decision makers with real and imperfect people.

Unlike the economic agents in models, real managers and investors make gut decisions that strip away potentially useful information and analysis. These intuitive decisions are not unintelligent, of course. In stable environments, intuition is highly adaptive. Quick reactions, unconscious thought, and other cognitive shortcuts avoid analysis and cumbersome computation and skip right to the answer of a complicated problem. Think of a baseball player catching a fly ball or a child using perfect grammar. But, the speed of these decisions can come at a cost in changing, uncertain, and competitive environments. Shortcuts lead to systematic mistakes. The same process of pattern recognition that smoothly governs our routine activities also finds patterns where there are none. A classic example is the unsophisticated intuition that a streak of red outcomes on the roulette wheel will surely be followed by black. These mistakes are not easily unlearned, precisely because our unconscious mind has helped us and our ancestors thrive. While our perceptual shortcuts are often out of place in modern capital markets, we would perhaps be unable to drive to work without them.

Like early surveys of the field, Manfred Frühwirth, with his contributors Elke Lerch and Konstanze Steinacker, divides behavioral corporate finance into two distinct threads in the book that follows this preface. The first traces the impact of less than fully rational investors on corporate finance, while the second highlights the impact of less than fully rational managers. Of course, real firms and markets have some of both groups, but this logical division places less demands on the reader to juggle multiple forces at once.

Taking a step back to give these ideas context – just as the authors do in the early chapters – the broader field of corporate finance seeks to explain and inform the financial contracts and real investment decisions of corporate managers and their outside investors. A critical element, then, is an understanding of the beliefs and preferences of these two sets of people. The vast majority of traditional research in corporate finance is no exception to the rule, endowing managers and investors with impressive computational skills and rationality. Practically speaking, this traditional framework of standard finance says that, in their operating and financing decisions, managers can take for granted that capital markets are „efficient", with prices reflecting fundamental values. And, in their stock selection and asset allocation, investors can take for granted that managers will act in their self-interest, making rational forecasts and decisions, and responding predictably to incentive contracts. The traditional framework has an elegance, internal consistency, and undeniable normative value. But, these basic assumptions are worth reconsidering, because rationality falls somewhat short in explaining the practical functioning of markets and firms. Understanding these limitations is critical to effective investment and corporate management.

The hypothesis of market efficiency faces two types of challenges. The first is empirical. In an efficient market, higher returns provide compensation for higher risks. Yet, many studies find so-called anomalies, where returns are predictable in a way that is hard to connect to identifiable economic risks, or where economically equivalent securities trade at significantly different prices. The second challenge is that the theoretical underpinnings of market efficiency are more fragile than they initially appear. A central idea behind market efficiency is that, if less than fully rational investors push prices away from fundamental values even momentarily, rational investors will aggressively buy undervalued securities and sell overvalued securities to the point that no mispricing remains. This process of textbook arbitrage ensures that markets are efficient. The key insight of behavioral finance is that real arbitrage entails costs and risk, and has limited effectiveness in forcing price to fundamental value. So managers cannot take market efficiency for granted.

If market efficiency is in doubt, so too is the assumption of rational managers. Moreover, as with traditional agency problems, the mechanisms for constraining management are imperfect. Board members could in principle be a part of the problem and not the solution, and takeover battles and proxy fights are a notoriously blunt tool to combat managerial misbehavior. Arguably, when management is acting with good intentions but biased expectations, matters are worse. The parallel for limits to arbitrage is limits to corporate governance. So investors cannot take managerial rationality as given.

Both of the behavioral approach of irrational investors and the behavioral approach of irrational managers have considerable appeal, but convincing a skeptic of either one is not without its challenges. In each case, there are reasonable alternative interpretations of the data. Tests of irrational investors in an inefficient market often lack power, because stock market returns are noisy. And, there is the ever-present possibility that growth opportunities, not opportunism, are at the root of both corporate decisions and capital market mispricing. Meanwhile, tests of managerial biases must rule out more standard agency problems of self-interest. Overinvestment could just as soon come from a rational empire building motive as from irrational optimism. The empirical evidence on mergers and acquisitions, financing policy, initial public offerings, stock splits, dividend policy, risk management, and corporate governance presented in this new book demonstrates the ingenuity of many different authors who attempt to distinguish the „new" view from existing and fully rational models of corporate decision making. Perhaps the strongest evidence is in the startling consistency that emerges across many different corporate decisions.

Interestingly, the two approaches themselves are somewhat in conflict, taking a different view on the role and efficacy of corporate management. In one case, corporate managers exploit an inefficient capital market, besting the average professional investment manager, who has at best a mediocre track record attempting to do the very same thing. In the other case, the judgment of corporate managers is suspect and might well be replaced by more dispassionate rules that lean heavily on market-based signals. The normative implications could not be more different: insulating management from outside pressure is either value-maximizing or value-destroying. This contrast is one reason why behavioral corporate finance – and this new book – makes for fascinating and inspiring reading. We are in the early days of understanding its implications, and we are still far from offering managers, investors, and regulators a clear roadmap.

Malcolm Baker
Finance Unit
Harvard Business School