

**THINKING FAST AND SLOW IN FINANCIAL DECISION-MAKING**

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**ABSTRACT**

Much of modern economic and finance theory is based on the assumption that economic man is rational, has access to all relevant information, and acts in complete self-interest. Beginning with classical economists such as Ricardo, Malthus and Smith in the late 18th century, a theory of free markets developed where unregulated markets lead to efficient resource allocation and unbiased valuations in an efficient, smooth, and rapid process. This theory has had a major impact on the direction of academic research, business practice, and public policy. In finance, the assumption of economic rationality is critical to the “efficient market” hypothesis, which states that financial market prices reflect all available information making it impossible to achieve excess rates of return. The efficient market theory provides the cornerstone of modern financial theory and conceptualizations of the risk-return tradeoff driving market valuations. The implications of free market and efficient market theories for government regulation of the economy and financial markets are clearly important. For example, Federal Reserve chairman Alan Greenspan, a proponent of unregulated financial markets, reportedly told Brooksley Born, the Commodity Futures Trading Commissioner at the time, that financial markets were so efficient that laws against fraud were unnecessary.<sup>1</sup> Even after the collapse of Long Term Capital Management in 1998 threatened the international financial system, Born lost the battle to regulate over-the-counter financial derivatives when Congress specifically prohibited the CFTC regulations on these derivatives. These unregulated derivatives were major contributors to the financial collapse in 2008 and remain substantially unregulated today. Since the mid-seventies, economic and financial theories based on rational economic man have come under challenge from research in psychology, behavioral economics, and financial anomalies. As is commonly the case when established scientific theory comes under challenge, the revisions come in often-contradictory bits and pieces. A major unifying component of challenges to efficient market theory rests on the implicit assumption of rationality in human behavior. Much of what we observe in the real world suggests irrationality, but not randomness. Predictable irrationality is the result of human data processing that makes use of heuristics and biases that represent psychological regularities. The initial groundbreaking work in this area came from Tversky & Kahneman (1974, 1981, & 1986), Kahneman & Tversky (1979), Thaler (1980), Thaler & Johnson (1990), and Shefrin & Statman (1985). Nofsinger (2008) and Ariely (2008) offer concise overviews of anomalies to rational thought and the foundations for behavioral finance research. For example, there is a propensity to place too much emphasis on the most recent observation in a data series. Other anomalies include the house money effect, where a dollar of winnings is perceived differently from a dollar of earned income, and regret aversion, which leads to a “follow the leader” response rather than an expression of individuality. The long list of anomalies to the theory of rational thought suggests that an alternative theory of the decision process is needed.

Keywords: