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The Irrationality Rationale

It amazes me how people are often more willing to act based on little or no data than to use data that is a challenge to assemble. – Robert Shiller

Mr. Shiller is probably my favorite writer and thinker. He is a professor of Economics at Yale University and a 2013 winner of the Nobel Prize in Economics. He is fascinated by how prices are determined. From the price of houses to stocks to Bitcoins, his work focuses on deciphering the complexity of human behavior.

The field of Economics, like other hard sciences, attempts to build models that explain various phenomena. Unlike hard science though, economic theory has a fairly uneven track record of predicting outcomes. Economic theory is much better at explaining behavior than predicting it. Like the alchemist trying to create gold from lead, economic theorists are committed to finding the algorithm that explains the mystery of human behavior as it relates to markets. Mr. Shiller understands the futility of this mission.

During my time at the University of Wisconsin business school the prevailing economic doctrine was predicated on the “rational man”. The theory goes like this; all economic activity can be explained by parties (people) acting in their own self-interest, each maximizing the utility (benefit) of each transaction. If only.

It was also widely accepted that markets were “efficient”, instantaneously reflecting all known information in asset prices. Because of this, no one could conceivably “beat” the market over a sustained period of time without luck or deceit. Hmmm.

The rational man theory and the efficient markets hypothesis fall woefully short when trying to explain typical market events.

If markets are truly efficient there would be no one that could capitalize on them. Yet people like George Soros, Mitt Romney and Warren Buffet have made careers (and fortunes) out of exploiting the inherent inefficiency of markets. It is true that there is plenty of information available today (much more readily obtained than when this theory was in vogue), but it is in the interpretation of that information that separates winners from the losers.

If man were truly rational he wouldn’t take dangerous drugs, bet on the lottery, or overpay for houses or stocks. But of course he (and she) does. If man were truly rational there would be no huge market run-ups the likes of which we witnessed in the late 90’s followed by sell-offs. There would be no market bubbles. The stock market would not have crashed in 1929, 1987 or 2007. Markets would be orderly, consistent, boring.

This, of course, is not the way we are wired. We need stimulation, the hope for a better tomorrow, the dream that a one in a million (billion) shot is worth taking. It is this restlessness, this irrationality that spurs creation. If Steve Jobs and Mark Zuckerberg did the rational thing - finished college and found jobs, who knows if we would all be walking around with a piece of hardware the size of a pop tart that connects us to that high school friend that we lost touch with some 30 years ago who currently resides in India. God bless the irrational.