Econ 423 Michael Salemi

“From Efficient Markets Theory to Behavioral Finance”
Robert J. Shiller, *Journal of Economic Perspectives*, Winter 2003, 83-105

**Discussion Questions**

1. What does Shiller mean by Behavioral Finance? How does Behavioral Finance contrast with Efficient Market Theory?
   a. What predictions does Efficient Market Theory make about stock prices?

   b. With which Efficient Market predictions does Behavioral Finance disagree?

   c. According to Shiller, does Behavioral Finance make its own predictions about stock price movements or does it simply object to some of the predictions of efficient market theory?

2. What does Shiller mean when he says that stock prices are too volatile for the Efficient Market Theory to be true?
   a. What does Shiller mean by “too volatile”?

   b. How does Figure 1 illustrate excess volatility of stock prices?

3. According to Shiller how can Behavioral Finance explain observed volatility in stock prices?
   a. What does Shiller mean by “feedback” and how does feedback explain stock price volatility?

   b. Why, according to Shiller, doesn’t “smart money” drive stock prices to “fundamental values”?

   c. What, according to Shiller, is the connection between “short sale constraints” and stock price volatility?

4. What, in your view, is the significance of the Shiller article and the research on which it reports?
   a. Do you agree with Shiller that it is important to “distance ourselves from the presumption that financial markets always work well and that price changes always reflect genuine information” (p. 102)?

   b. How does Shiller’s article affect your own willingness to hold equity as part of a personal portfolio?