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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Craig French

THE RATIONAL INVESTOR

Indulge me for a moment while we temporarily ignore the widespread reality of irrational investing. There are at least two schools of thought about rational investing:

(1) Rational Expectations theory
(2) Rational Beliefs theory

Rational Expectations theory is popular. This model, first proposed in Muth (1961) and popularized by Lucas (1972), employs rational expectations in a dynamic general equilibrium macroeconomic model. This theory underlies the general equilibrium approach of the Capital Asset Pricing Model of Treynor (1961, 1962), Sharpe (1964), Lintner (1965) and Mossin (1966), which assumes homogeneous expectations (all investors hold the same views about future asset returns).

One compelling aspect of Rational Beliefs theory is that it is not popular. This theory was proposed by Kurz (1994a,b,c). In the Kurz model, investors hold a broad range of inaccurate but rational beliefs. This model incorporates heterogeneous expectations in a general equilibrium model. Investors have diverse beliefs that cannot be rejected by historical economic data. Such unrejectable beliefs are defined by Kurz to be rational, and lead to a continuum of Rational Belief Equilibria. The difference begins with Kurz' acceptance of the empirical and intuitive fact that agents can and do exhibit differences in beliefs even when they all possess the same information.

Rubinstein (1977) distinguishes between Rational Expectations and Rational Beliefs models with a simple taxonomy. Rubinstein segregates linear models as "Type I" models—those which place restrictions on beliefs, contrasted with "Type II" models—those which place restrictions on tastes, of Arrow–Debreau (1954), Hirshleifer (1970), and Rubinstein (1977).

Here are the rational investing stories of two New Englanders, Ronald Read of Vermont and Robert Morin of New Hampshire:

According to Weiss-Tisman (2015), Ronald Read was a World War II veteran from Vermont who worked at a gas station and as a janitor at JC Penney. He lived frugally, read the Wall Street

Journal daily, and amassed an $8 million nest egg by actively selecting, purchasing and holding individual stocks without a financial advisor. Ronald Read held his physical stock certificates in a safe deposit box. His "stockpile" grew to a 5-inch stack by the time he died in 2014 at age 92. He bequeathed most of his wealth to a library and a hospital. Read left $1.2 million to the Brooks Memorial Library, tripling its endowment, and $4.8 million to the Brattleboro Memorial Hospital.

According to MacQuarrie (2016), Robert Morin was a librarian from New Hampshire who worked at the University of New Hampshire's Dimond library. He lived frugally and invested primarily in a retirement account. Morin held nearly all of his income in a checking account, certificates of deposit, mutual funds and annuities. He also held several life-insurance policies. Morin used a financial advisor, and his wealth grew to $4 million by the time he died in 2015 at age 77. He left his entire estate to his alma mater, UNH.

Questions

(1) Do actual, human, flesh-and-bone investors have rational expectations?
(2) Do real-world investors have rational beliefs?
(3) Did Ronald Read have rational beliefs?
(4) Did Ronald Read have rational expectations?
(5) Did Robert Morin have rational beliefs?
(6) Did Robert Morin have rational expectations?
(7) Were Mr. Read and Mr. Morin outliers in terms of their frugality, patience and generosity?
(8) Is it a coincidence that Read and Morin donated millions to libraries?
(9) Will the internet cause the extinction of libraries?
(10) If Read, Morin, and other investors did not have rational beliefs nor rational expectations, what would that imply about the theories of Muth/Lucas and Kurz?
(11) Could the Theory of Rational Expectations be isomorphic to the Theory of Rational Beliefs, as conjectured in French (2012)?
(12) Is it rational to save without consuming, as Read and Morin did?
(13) Are general equilibrium models appropriate for modeling human behavior?
(14) Were Mr. Read and Mr. Morin happy? Are you happy?

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