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**Decision Theory Compared and Contrasted with Efficient Market Theory**

Efficient market theory dictates that asset prices in efficient markets reflect all of the available public information at a given time. Single-person decision theory “takes the viewpoint of an individual who must make a decision under conditions of uncertainty (Scott 60).” This theory outlines a formal procedure to a decision making process by selecting from a set of alternatives. The implication of such a theory is that the end user can benefit from decision theory in terms of risk adjusted investment return. The efficient market theory is contradictory to decision theory because there is no utility in a formal procedure of decision if all publically known variables are already included in the public asset price. I will argue that decision theory can aid in personal financial planning decisions, but not in investment returns. The performance of broad market stock indices compared to institutional mutual fund managers provides us with enough evidence to show that indeed, that the price of market securities reflect the cumulative public knowledge at a given point in time.

I believe decision theory could be best applied in the area of personal financial management, rather than seeking out market beating investment choices. While humans may tend to act in their own self interesting, average investment returns appear to the contrary. Even if a person could effectively apply decision theory to their own portfolio the result would be the outcome of subjective probabilities. Furthermore, once the investment decision has been made, nothing is in place to stop an otherwise rationale investor to make irrational decisions as market and political climates change. I believe that the best investment choices for individuals mostly depend on human nature rather than the underlying assets.

My ideal decision theory would take into account the likelihood of irrational actions that the average investor does. Early withdrawal from defined benefit plans, selling stock at the worst time, and hording cash under the mattress are just a few examples of seemingly irrational investors. In hard time, the investor caveman brain takes over and bad decisions are made. Decision theory based upon accounting for such irrationalities could provide guidance that is more successful than simply reviewing the underlying investment decision. I cite the example of a client who cannot stand to witness losses within a portfolio. No matter how irrational it is to pass up other investment allocations with high risk adjusted returns, such a client would likely benefit from a bank CD.

Decision theory should focus not on the underlying asset decisions, but rather, take into account a client’s goals, tax liabilities, and human nature to formulate a plan. Time spent analyzing the best stock or bond for a portfolio is a waste of valuable resources. Today’s stock market is highly efficient and liquid, that is a fact. The vast majority of investors and even mutual fund managers cannot beat underlying benchmark indices over a long period of time. This has been well established by the founder of the index fund, John Bogle, author of The Little Book of Common Sense Investing.

The case for market efficiency is a well worn path for index investing advocates such as John Bogle. If the vast majority of mutual fund managers, even those with vast resources, cannot beat the index over substantial periods of time, it should be clear; Markets are highly efficient and don’t waste time trying to beat them.

*In a 1976 interview Graham said, “I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. In the old days, any well trained security analyst could do a good job of selecting undervalued issues through detailed studies; but in light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost.” –* Benjamin Graham Father of value investing. (<http://www.gurufocus.com/news.php?id=8758>, 2010-3-08, retrieved by John Gillingham)

While value investing is different from decision theory on the surface, they both share the similarity in the attempt to maximize investor returns. The father of value investing denies the utility of his own investment masterpiece, *The Intelligent Investor*. If Graham could no longer use techniques to achieve greater utility than the overall market, it is time for the average twenty-first century investor to buy some index funds and government bonds at varying yields. I argue that such an investor achieves the best returns, good sleep, and low fees by applying efficient market theory by purchasing index funds. In the words of Ron Popeil, Founder of the in home chicken rotisserie, you can take that chicken (money), “*Set it* (into indices) *and forget it*.”

Decision theory is still vital in determining investments *types* that will most likely suit the individual investor the best. The underlying assets in a given allocation become easy to select when using efficient market theory and index funds. Decision theory can be applied to individual investment *behavior* in order to establish a strategy that an irrational human will not deviate from. The efficient market theory has been well established by viewing past results. However, there is no guarantee that the efficient market theory will be as useful in the future. As always I remain an advocate of what works for the average irrational human. This usually results in a basic index allocation with enough cash and safety to comfort the average caveman brain.