Advances in Behavioral Finance & Economics: The Journal of the Academy of Behavioral Finance Volume 1, Issue 1, Winter 2011 27-42
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ISSN: 1551-9570

Metanoia and the Market

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Abstract

If investors randomly switch between being rational and irrational, then eventually the market will be half rational and half irrational, even if all investors start off rational, no matter how low the switching probability is. Thus, mispricings can persist even with continued volume between two fundamentally identical investments. Multiple survey results for hypothetical investment scenarios support this metanoia model. In addition, the dynamics of a large market discrepancy in HSBC shares from 1992-1999 are consistent with metanoia. In short, the law of one price will be violated so long as there is any probability of switching: identical assets will have different prices.

Keywords: behavioral, law of one price, irrational, mispricing, arbitrage

JEL Classifications: G14, G10, G19

Acknowledgments: *I am grateful to comments and suggestions from Richard Thaler, Ľuboš Pástor, Robert Durand, Bidisha Chakrabarty, an anonymous referee, and conference participants at the Second Annual Meeting of the Academy of Behavioral Finance and Economics.*

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