The Park Place Economist

Volume 22 | Issue 1 Article 8

5-2014

Work in Asset Prices Earns Nobel Prize

Nick Huskisson '17
Illinois Wesleyan University, nhuskiss@iwu.edu

Work in Asset Prices Earns Nobel Prize

Work in Asset Prices Earns Nobel Prize

by Nick Huskisson

Five years after the worst financial crisis since the Great Depression plummeted the stock market and the financial security of the nation, economists Eugene F. Fama and Lars Peter Hansen of the University of Chicago and Robert J. Shiller of Yale University were awarded the Nobel Memorial Prize in Economic Sciences for their work in asset-price predictions. These three economists represent very different economic ideologies with Fama being renowned for emphasizing efficient markets, Shiller for emphasizing investor psychology and inefficient markets, and Hansen for high-tech econometric techniques. What these three Nobel Prize winners share is their unifying interest in the predictability of asset pricing. As evidenced by the latest financial crisis, it is incredibly difficult to predict the price of stocks and bonds over the course of days or weeks. The award comes with a touch of irony as the award winning findings by Fama contradict his earlier theories. However, the surprising work of the motley trio consisting of Fama, Hansen, and Shiller demonstrate that contrary to popular opinion, it is very much possible to predict the long term behavior of these prices.

What Fama, Hansen, and Schiller suggest is that over longer periods of time, such as the next three to five years, stock prices fluctuate at a higher rate than corporate dividends, and that the ratio of prices to dividends consistently falls when it is high and increases when it is low. This pattern, which was discovered over the course of over fifty years of research and asset monitoring, holds not only for stocks, but also for bonds and other assets.

The significance of these findings have had an extensive impact on the economy and will continue to serve as a foundation for more reliable asset-pricing predictions. This impact is already seen in the presence of index-prices in the market. It will undoubtedly have influence over the typical shareholder's decision to invest or sell. While the promise of the prize winners' work in asset-price prediction has certainly excited the financial community, some find that granting the award to economists whose theories differ extensively illustrates the uncertainty in predicting market behavior. Robert Solow, winner of the Nobel Economics Prize in 1987 and professor emeritus at the Massachusetts Institute of Technology in Cambridge found that Fama's efficient market theory which asserts that financial markets are always efficient with people taking all available information into consideration to be in interesting company among the other award winners because Schiller is very much a critic of Fama's work. Solow exclaimed the granting of the nobel prize to both Schiller and Fama was, " like giving a prize to the Yankees and the Red Sox" comparing the competing theories to the bitter baseball rivals. "What it suggests is there really isn't a settled doctrine" in finance.

While a truly validated and consistent statistical method for predicting asset prices and overall market behavior may not come to fruition for quite some time, the work of Fama, Hansen and Schiller gives a strong foundation for the current understanding of asset prices no matter how much they disagree. The three economists who at times have provided research that contradicts the other, have had their efforts culminate into improved forecasting of asset prices in the long term and helped the emergence of index funds in stock markets.