Understanding the Mind of the Market: Continuities in the Social Construction of Value

Charles W. Smith
Queens College and Graduate Center, CUNY

The Highlights of an Evolving, Half Century Fascination With Markets

- Encountering the Stock Market in the Early 1960s. A Fifty-Year Infatuation
- Discovering All Sorts of Auctions in the 1970s
- The Explosive Growth of Equity Options in the 1980s
- Computerized Option Trading in the late 1990s
- Markets as Definitional Practices & ETFs, ETNs and Other New Instruments
- Contingencies Supplanting Ambiguities

My Theoretical & Methodological Concerns & Foundations

- Not an Economist: A Theoretical Sociologist
- Theoretical?
  - Sociology of Knowledge
  - The Social Construction of Meaning
- Methodological?
  - Participant Observation/Ethnography
  - Long Term & Comparative

Back to The Market of the Early 1960s

- Serendipity: An Assignment & Some Questions
- What is the Market all about?
  - The Answer: Defining Value!
- How do you makes sense of the Market?
  - The Answer: Everyone on Wall Street can give you a great explanation of why the Market did what it did yesterday, but no one can tell you what it will do tomorrow.

Governing Market Narratives

- In hindsight, I recently realized I probably should have been more critical of these accounts, but as a sociologist, I was drawn to them, even if they were factually invalid. (More on this later.)
- 20 years later - with various side-trips - "*The Mind of The Market: A Study of Stock Market Philosophies, Their Uses, and Their Implications*" offered my account of the dominant market accounts I encountered.
- What Had I Found?

Four Dominant Market Accounts and Framings

- Economic Fundamentalists
  - Graham and Dodd
- Insiders and What They are Doing
  - Who You Know
- Cyclist-Chartist
  - The Hand of God & Wave Theories
- Traders
  - Market Action and Market Sentiment

Also Various Uses of These Narratives & Accounts

- The True Believers: Few, but Central
- Salesmen: The Market Troops
- Talking Heads: Analysts and Commentators
- The Importance of Accounts Regardless of their Factuality
- Loss of Belief: Panic and The Crowd

More Than Narratives, the Market also Entailed Practices

- Key Market Functions: Allocation & Pricing
- Echoes of Polanyi & The Great Transformation: Pre-Market, No Pricing & No Allocation Freedom; Tribal and Feudal Redistribution and Reciprocity
- But More: Financial Markets were primarily Auction Markets, Not Fixed Price or Private Treaty Markets (Cassady 1967)
- As Auctions Differ, the Need to Visit Other Types of Auctions

A Few Auctions Varieties

- Different Types of Auctions & Different Rules
  - English, Dutch, Japanese, etc.
- Differences in Prioritizing Pricing and Allocation
- Tobacco, Estate Jewelry vs. Fine Art & Racehorses
- *The Importance of Legitimacy and Social Consensus in both Pricing and Allocating
- Auctions as Evolving Processes

More Auction Differences

- Open & Closed Auctions
- Significance of Place & Time & Setting
- Different Types of Items, Different Practices
  - One of a Kind: Individual Passions
  - Collectibles: Expert Opinions
  - Commodities: Market Transactions

What "Real" Auctions Reveal

- Markets Differ in All Sorts of Ways
- Markets are Inherently Social
  - Legitimacy and Consensus
- Markets are Subject to Continual Change
- *Neo-Classical Economic Model is Wrong
  - No Single Model
- *Auctions: The Social Construction of Value* (1989)

Meanwhile Significant Changes Occurring in Financial Markets

- There had been Some Earlier Changes:
  - Mutual Funds
  - Funds of Funds
- Some "New" Governing Narratives
  - Efficient Markets
  - Momentum, Etc. (*Success & Survival* 1999)
- But All Modest in Comparison to What was Happening:
  - *A New Framing for Options (1980s)

The Transformation of Derivatives and a New Way for Framing Risk

- A Significant Transformation
  - A New Narrative/Account: Black & Scholes
  - New Financial Products: ETFs, ETNs, etc.
  - New Means of Trading: Algorithms
  - Exponential Growth in Transactions
- A Game Changer of the First Order
- But Also, in Hindsight, a Continuation

A Century Old Exchange

- Mr. Morgan, “What will the Market do?”
- Answer: “It will Fluctuate.”
- The Meaning: Market Prices will go up & down, often erratically
- The Implications: The Market entails Risk
- Options are all about Risk

Modern Options have Redefined Financial Market's Risk

- Modern Equity Options and Most Other Derivatives are Determined by Volatility
- How? The Black-Scholes-Merton 'Pricing Model'
- A New, Unique Governing Narrative in Mathematical Form : $C = S\,N(d_1) - X\,e^{-rT}\,N(d_2)$
  - $d_1 = [\ln(S/X) + (r + \sigma^2/2)\,T] / \sigma\,T^{1/2}$ $d_2 = d_1 - \sigma\,T^{1/2}$
- Volatility (σ) is J.P. Morgan's Fluctuations
- For Academics, the Pricing Model = Honor & $$$
- For the Masters of the Market = $$$$$$$

Two Decades of Exponential Growth

- 1970 = > 1,000,000 Contracts
- 1981 = < 100,000,000 Contracts
- 1987 = < 300,000,000, -- Crash dip
- 2003 = > 900,000,000
- 2011 = 4,562,748,394
- The Pricing Model Empowered Options

**Other Major Transformations

- Risk is now Understood to be in the Price
- Risk can now be Detached from the Price
- It can be Framed Backwards & Forwards
- Past (Historical) Volatility can be Replaced with Implied (Future) Volatility
- Volatility Values Allow Option Prices to be Compared and Hence more easily Traded

Other Option Fostered Financial Market Innovations

- New Option Platforms: ETFs and ETNs
- A New Index: The VIX - Indexing the Implied Volatility of the S&P 500
- New Financial Instruments Based on the VIX: The VXX
- New Ways of Trading: Algorithmic Programs & Combination Strategies: Spreads, Straddles, Butterflies, etc.

From Making Sense to Acting Sensibly in Allocating & Pricing

- From Normative Closed Systems to Semi-Normative Embedded Flexible Markets
- From Culturally Embedded Markets to the Financialization of Markets
- And Then, The Quantification and Algorithmic Market Turn
- *From Ambiguities to Contingencies

New Approaches to the Market

- Privileging Volatility as Measurement of Value
- Hedging the Hedge: Remaining Neutral
- Making the Market vs. Playing the Market
- Functioning as Croupiers, Not Victors
- Forsaking Knowing
- The Market Doesn’t Fluctuate: It is Fluctuation

Post Rational Markets

- Economic Markets have functioned as the Flag Bearers of Modernity and Rationality
- Financial Markets, perhaps the Purest of all Markets, have functioned as the Flag Bearers of Globalization and Modern Technology
- Presently, Financial Markets may be Signaling the Demise of Traditional Rationality in Favor of Pragmatic Behavioral Responses
- Buyers and Sellers Be Aware! Nobody Knows!