

# Understanding Speculation



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# Role of divergent expectations and information

“Keynes speaks of speculators 'knowing better than the market what the future will bring forth', suggesting either superior 'insider knowledge' or the use of a different and superior information set than that used by other market participants. Diverse (or divergent) expectations may exist both within the group identified as speculators and also between them and other market participants - indeed the stability of the market depends on diverse opinion”. (Victoria Chick, *Some Methodological Issues in the Theory of Speculation* [1990], in *Selected Essays* (1992) p. 183).

# Two ways of acting in the Stock Exchange

- In the *General Theory*, Keynes distinguishes between two ways of acting in the stock exchange: (1) "the activity of forecasting the prospective yield of assets over their whole life"; and (2) "the activity of forecasting the psychology of the market" (CWK VII: 158).
- Keynes's definitions imply an interdependent judgment that does not necessarily mean disagreeing with the current average opinion.
- Opinions that diverge from the average and assume a future change in the state of affairs are part of the convention, and, in this sense, are also conventional. This implies that conventional behavior includes both attempts to conform to the general opinion and attempts to avoid being caught by it, specifically by those (more skilled) agents who act as long-term investors.

# Keynes's speculation in practice

- Keynes was a market player who stood against general conventions by bringing his knowledge and expertise in decision-making, both when taking risks as speculator, guessing the direction of market prices and betting on market sentiments, and when patiently waiting for the yields of long-term investments.
- Keynes's practice shows that while he always kept an eye on the prevailing market sentiments (or conventions), he in fact pursued and defended the strategy of a long-term investor.
- This strategy does not mean disregarding the role of conventions and guessing what the average market opinion was, but it means that "conventions" should be understood in a broader sense.

# A passion for details

- The Keynes Papers show Keynes's need and passion to keep up to date with the markets by constantly gathering evidence.
- For Keynes, investment was a time-consuming activity in which building up a network of reliable connections and collecting sound, relevant information was a costly but decisive task.
- His choices, both personal and institutional, were the result of the juxtaposition of his general vision and systematic analysis of the entire economic system with the information he could actually obtain on sectors and individual shares.
- He relied on a huge amount of detailed information on a selection of shares from a number of sources providing him with *professional* (as distinguished from *confidential*) information and business analysis.

# Principles of Investment

- Keynes's investment approach showed a marked preference towards the choice of a carefully selected subset of assets which he held for several years. He relied heavily on information relative to each individual market and asset, weighing up the quality and reliability of that information through calculation of the relevant data, the advice of experts and his own assessment of market conditions and of other participants' opinions.
- He summarized his preferred strategy to the Chairman of the Provincial Insurance Company, F.C. Scott on 15 August 1934:
- "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes." (CWK XII: 57)

# Role of epistemology

- Keynes's epistemological approach influenced his investment behaviour.
- It may be recalled here that for him the notion of probability is not based on a frequency distribution but on deriving logical implications from given premises on the basis of information provided by the available evidence.
- In this process the strength of one's own conviction - "the weight of the argument" - plays an important role, which explains why different conclusions can be drawn according to the set of beliefs of each individual. (Keynes 1921).

# Decision-making according to probability

- For Keynes, decision-making is based on individual judgment deriving from real cognitive grounds, although these grounds are limited and partial; it is a judgment which has - as its cognitive grounds - evidence or a reason in which one really believes.
- This follows upon Keynes's approach to probability, which consists in inferring the degree of beliefs from the available evidence and his criticism of probability, identified with statistical frequency, since frequencies are only a special kind of evidence and do exhaust the set of information upon which decision-making takes place.



# Vicky's interpretation

- Vicky had a good grasp of Keynes's approach to speculation, which was not just understanding the psychology of the market, and following conventions, but was rather linked with his approach to probability and knowledge. She wrote:
- “Decisions in the real world are taken under uncertainty and limited information. Rationality entails making use of as much of the relevant information as can be gathered within a reasonable time and not willfully ignoring relevant information” (V. Chick, On Microfoundations and Keynes' Economics, *Review of Political Economy*, 28:1,p. 102)

# Conclusions

- Vicky stressed the importance of “rationality” in Keynes’s theory which was not to be identified with optimizing rationality of the neoclassical family.
- She understood the importance of information in the decision-making mechanism, which is particularly relevant in understanding what speculation entailed in Keynes’s theory and his practice as speculator and investor.
- She linked his analysis of speculation to his epistemological views, and in particular to his notion of probability, where choices are made according to the subjective evaluation of the available evidence.
- In this respect she was ahead of much of the contemporary literature, showing remarkable intuition and understanding of Keynes’s mode of thoughts and practice.