Valuing financial assets out of markets

A case for disconnecting the valuation function from the exchange function of financial markets

Jacques-Olivier CHARRON

Associate researcher, IRISSO, Paris-Dauphine University

jacques-olivier.charron@dauphine.fr

Abstract: The paper argues in favor of a radical disconnection between the exchange function and the valuation function of financial markets. It defends it from an investee's point of view, mainly on the grounds that valuing financial assets is a matter of judgment. Financial assets do not have any intrinsic utility; hence allowing markets to price them implies their price changes are determined by expectations. These latter rely on information that can be variously framed and interpreted, hence no a priori and stable valuation criteria can prevail. Consequently, investees bear the consequences of judgments that do not meet basic criteria of justice. Insulating the valuation function from the transaction function of financial markets through the creation of independent valuation institutions could be a way to tackle this problem.

Key words: financial markets, valuation, judgment, investor, investee.

Introduction

The financial crisis of 2007-2008 has revived old controversies on financial theory and financial markets. Since then, very little has changed, though, in what is taught and institutionally recognized in this area of knowledge. Financial regulation, its latest developments included, remains embedded in concepts deriving from mainstream financial theory. One reason for such an inertia is certainly the strength of institutional constraints. But there also theoretical reasons.

When asked why they didn't see "this" coming, mainstream financial theorists can rightly answer that the central prediction of efficiency theory is that no one can. Besides, that's not their job to see anything coming: their job, so the story goes, is to test assumptions against historical data. Then, when faced with the fact such market swings as those seen in 2007-2008 illustrate the idea that market prices may not reflect fundamental value, they can also rightly answer that no one can tell what it is, and then ask who we are to dare and say what asset prices *should* be.

But then, these assets are priced; they have to be, one way or another. The crucial point is: which is the best one? Crucial, for if we can demonstrate that non-market settings would be better than markets at pricing financial assets, then we would have deprived the aforementioned theorists of any line of defense.

For this, we don't need to test assumptions against historical data. It would be pointless, for, if a fundamental value is not objective – and it is not – then no test of that kind can tell us if a market is good at reflecting it. We don't have figures to compare the prices with, so we can't test this[1]. Only logical reasoning, based on practical evidence, can help us.

This is the way the first part of the paper will try to show that financial assets' price changes are determined by expectations, which implies their prices are driven by a self-referential market dynamics. The second part will argue this way of pricing financial assets does not meet basic criteria of justice, by considering financial markets as de facto political institutions that exert a form of power through judgment. The third part outlines what could be an alternative way of pricing these goods and answer major objections to it. The conclusion tries to put this paper in perspective.

[1] To be honest, Shiller (1981) tried to do this, but one can always argue, as was the case, that his fundamental "benchmark" is not the good one.