

Behavioural Finance An Introduction

Behavioural finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets.

Sewell (2005)

"I think of behavioral finance as simply "open-minded finance"."

Thaler (1993)

"This area of enquiry is sometimes referred to as "behavioral finance," but we call it "behavioral economics." Behavioral economics combines the twin disciplines of psychology and economics to explain why and how people make seemingly irrational or illogical decisions when they spend, invest, save, and borrow money.'

Belsky and Gilovich (1999)

"This paper examines the case for major changes in the behavioral assumptions underlying economic models, based on apparent anomalies in financial economics. Arguments for such changes based on claims of "excess volatility" in stock prices appear flawed for two main reasons: there are serious questions whether the phenomenon exists in the first place and, even if it did exist, whether radical change in behavioral assumptions is the best avenue for current research. The paper also examines other apparent anomalies and suggests conditions under which such behavioral changes are more or less likely to be adopted."

Kleidon (1986)

"For most economists it is an article of faith that financial markets reach rational aggregate outcomes, despite the irrational behavior of some participants, since sophisticated players stand ready to capitalize on the mistakes of the naive. (This process, which we call poaching, includes but is not limited to arbitrage.) Yet financial markets have been subject to speculative fads, from Dutch tulip mania to junk bonds, and to occasional dramatic losses in value, such as occurred in October 1987, that are hard to interpret as rational. Descriptive decision theory, especially psychology (see D. Kahneman et al., 1982), can help to explain such aberrant macrophenomena. Here we propose some behavioral explanations of overall market outcomes—specifically of financial flows, that are of considerable practical consequence to both policymakers and finance practitioners.

Patel, Zeckhauser and Hendricks (1991)

"Because psychology systematically explores human judgment, behavior, and well-being, it can teach us important facts about how humans differ from traditional economic assumptions. In this essay I discuss a selection of psychological findings relevant to economics. Standard economics assumes that each person has stable, well-defined preferences, and that she rationally maximizes those preferences. Section 2 considers what psychological research teaches us about the true form of preferences, allowing us to make economics more realistic within the rational choice framework. Section 3 reviews

research on biases in judgment under uncertainty; because those biases lead people to make systematic errors in their attempts to maximize their preferences, this research poses a more radical challenge to the economics model. The array of psychological findings reviewed in Section 4 points to an even more radical critique of the economics model: Even if we are willing to modify our familiar assumptions about preferences, or allow that people make systematic errors in their attempts to maximize those preferences, it is sometimes misleading to conceptualize people as attempting to maximize well-defined, coherent, or stable preferences."

Rabin (1996)

"Market efficiency survives the challenge from the literature on long-term return anomalies. Consistent with the market efficiency hypothesis that the anomalies are chance results, apparent overreaction to information is about as common as underreaction, and post-event continuation of pre-event abnormal returns is about as frequent as post-event reversal. Most important, consistent with the market efficiency prediction that apparent anomalies can be due to methodology, most long-term return anomalies tend to disappear with reasonable changes in technique."

Fama (1998)

"Recent literature in empirical finance is surveyed in its relation to underlying behavioral principles, principles which come primarily from psychology, sociology and anthropology. The behavioral principles discussed are: prospect theory, regret and cognitive dissonance, anchoring, mental compartments, overconfidence, over- and underreaction, representativeness heuristic, the disjunction effect, gambling behavior and speculation, perceived irrelevance of history, magical thinking, quasimagical thinking, attention anomalies, the availability heuristic, culture and social contagion, and global culture."

Shiller (1998)

"The field of modern financial economics assumes that people behave with extreme rationality, but they do not. Furthermore, people's deviations from rationality are often systematic. Behavioral finance relaxes the traditional assumptions of financial economics by incorporating these observable, systematic, and very human departures from rationality into standard models of financial markets. We highlight two common mistakes investors make: excessive trading and the tendency to disproportionately hold on to losing investments while selling winners. We argue that these systematic biases have their origins in human psychology. The tendency for human beings to be overconfident causes the first bias in investors, and the human desire to avoid regret prompts the second."

Barber and Odean (1999)

"Behavioral Economics is the combination of psychology and economics that investigates what happens in markets in which some of the agents display human limitations and complications. We begin with a preliminary question about relevance. Does some combination of market forces, learning and evolution render these human qualities irrelevant? No. Because of limits of arbitrage less than perfect agents survive

and influence market outcomes. We then discuss three important ways in which humans deviate from the standard economic model. Bounded rationality reflects the limited cognitive abilities that constrain human problem solving. Bounded willpower captures the fact that people sometimes make choices that are not in their long-run interest. Bounded self-interest incorporates the comforting fact that humans are often willing to sacrifice their own interests to help others. We then illustrate how these concepts can be applied in two settings: finance and savings. Financial markets have greater arbitrage opportunities than other markets, so behavioral factors might be thought to be less important here, but we show that even here the limits of arbitrage create anomalies that the psychology of decision making helps explain. Since saving for retirement requires both complex calculations and willpower, behavioral factors are essential elements of any complete descriptive theory."
Mullainathan and Thaler (2000)

"Behavioral finance is a rapidly growing area that deals with the influence of psychology on the behavior of financial practitioners."
Shefrin (2000)

"Behavioral finance is the application of psychology to financial behavior—the behavior of practitioners."
Shefrin (2000)

"Behavioral finance is the study of how psychology affects financial decision making and financial markets."
Shefrin (2001)

"Behavioral finance argues that some financial phenomena can plausibly be understood using models in which some agents are not fully rational. The field has two building blocks: *limits to arbitrage*, which argues that it can be difficult for rational traders to undo the dislocations caused by less rational traders; and *psychology*, which catalogues the kinds of deviations from full rationality we might expect to see. We discuss these two topics, and then present a number of behavioral finance applications: to the aggregate stock market, to the cross-section of average returns, to individual trading behavior, and to corporate finance. We close by assessing progress in the field and speculating about its future course."
Barberis and Thaler (2001)

"This essay provides a perspective on the trend towards integrating psychology into economics. Some topics are discussed, and arguments are provided for why movement towards greater psychological realism in economics will improve mainstream economics."
Rabin (2001)

"The basic paradigm of asset pricing is in vibrant flux. The purely rational approach is being subsumed by a broader approach based upon the psychology of investors. In this approach, security expected returns are determined by both risk and misvaluation. This

survey sketches a framework for understanding decision biases, evaluates the a priori arguments and the capital market evidence bearing on the importance of investor psychology for security prices, and reviews recent models."

Hirshleifer (2001)

"**Behavioral finance** and **behavioral economics** are closely related fields which apply scientific research on human and social cognitive and emotional biases to better understand economic decisions and how they affect market prices, returns and the allocation of resources."

Wikipedia (2005)