This book describes an approach, alternative to the theory of efficient markets, to the study of financial markets: behavioural finance. It begins by assessing the efficient market hypothesis, emphasising how some of its foundations are contradicted by psychological and institutional evidence. It then introduces the theory of behavioural finance and devotes the rest of the book to explore its main aspects, concentrating on the role and characteristics of noise traders, arbitrageurs, and investors. Chapters 2 through 4 focus on the limits imposed on arbitrage by factors such as risk aversion or agency problems. Two crucial conclusions are reached. First, plausible theories of arbitrage do not lead to the prediction that markets are efficient—quite the opposite. Second, the recognition that arbitrage is limited, even without specific assumptions about investor sentiment, generates new empirically testable predictions, some of which have been confirmed in the data. Chapters 5 and 6 centre on how investor sentiments are built, emphasising some empirical violations to the idea of efficient markets such as price bubbles. The book concludes suggesting that the theory of behavioural finance is indeed more effective that the efficient market theory in explaining some financial evidence.

Introduction
Hersh Shefrin

in Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing
Behavioral finance consists of three themes: (1) heuristic-driven bias; (2) frame dependence; and (3) inefficient markets. These themes are ubiquitous and germane, touching every corner of the financial landscape: portfolio selection, corporate finance, asset pricing, and options. Notably all the preceding areas have been recognized through the awarding of Nobel prizes in Economics. Indeed, behavioral finance was explicitly recognized with the 2002 award to Daniel Kahneman, one of the psychologists upon whose work behavioral finance is built. A key lesson for financial practitioners is to appreciate that successful investing requires taking the psychological propensities of others into account. Historically, behavioral psychologists first laid the groundwork for behavioral finance by developing the underlying psychological framework. In the 1980s a few financial economists began to apply this framework to finance. Debates with proponents of the traditional approach soon followed.

The Imperfect Knowledge Imperative in Modern Macroeconomics and Finance Theory
Roman Frydman and Michael D. Goldberg

in Rethinking Expectations: The Way Forward for Macroeconomics
Published in print: 2013 Published Online: October 2017
Publisher: Princeton University Press
DOI: 10.23943/princeton/9780691155234.003.0005
Item type: chapter

This chapter examines the imperfect knowledge imperative in modern macroeconomics and finance theory. It argues that the Rational Expectations Hypothesis (REH) has nothing to do with how even minimally reasonable profit-seeking individuals forecast the future in real-world markets. It attributes REH's insurmountable epistemological difficulties and widespread empirical problems to a single, overarching premise that underpins contemporary macroeconomics and finance theory: nonroutine change is unimportant for understanding outcomes. It also suggests that contemporary behavioral finance models rest on the same core premise as their REH-based counterparts. Finally, it introduces an alternative approach to modeling individual behavior and aggregate outcomes: Imperfect Knowledge Economics, which opens macroeconomics and finance models to nonroutine change and the imperfect knowledge that it engenders.
Open Problems
Andrei Shleifer

in Inefficient Markets: An Introduction to Behavioral Finance

Published in print: 2000 Published Online: November 2003
Item type: chapter

Summarises some of the successes of behavioural finance and shows how this field can inform the analysis of broader questions in economics. It begins with some of the open issues in security valuation. It then moves to the study of real consequences of financial markets on corporate finance and real investment, and evaluates the role of public policies. It concludes by enumerating 20 broad problems in behavioural finance.

Are Financial Markets Efficient?
Andrei Shleifer

in Inefficient Markets: An Introduction to Behavioral Finance

Published in print: 2000 Published Online: November 2003
Item type: chapter

Assesses the idea of efficient financial markets. It evaluates the theoretical and empirical foundations of the efficient markets hypothesis, emphasising the cracks that have emerged in them. Special attention is given to the rationality of investors, the randomness of the trades, and the role of arbitrageurs. Then the author suggests that an alternative theory—behavioural finance—could be more successful in explaining the evidence. The chapter concludes with a brief outline of the structure of the book.

People and the Psychology of Pension Fund Decisions
August Baker, Dennis E. Logue, and Jack S. Rader

in Managing Pension and Retirement Plans: A Guide for Employers, Administrators, and Other Fiduciaries

Published in print: 2004 Published Online: July 2005
Item type: chapter
Pension fund decision makers must make complex decisions — decisions that are made in a such way that maximizes a sound objective function (such as maximizing the probability that promised benefits will materialize), and which should be based on information that is as complete as possible and processed correctly. This chapter discusses what the field of behavioral finance says about the decision-making process, the potential pitfalls in that process, and the potential systematic mistakes and methods for avoiding them. Decision makers who are aware of the psychology of investing should be able to improve performance by avoiding mistakes and exploiting the mistakes of others.

Playing at Acquisitions
Han Smit and Thras Moraitis

It is widely accepted that a large proportion of acquisition strategies fail to deliver the expected value. Globalizing markets characterized by growing uncertainty, together with the advent of new competitors, are further complicating the task of valuing acquisitions. Too often, managers rely on flawed valuation models or their intuition and experience when making risky investment decisions, exposing their companies to potentially costly pitfalls. This book provides managers with a powerful methodology for designing and executing successful acquisition strategies. The book tackles the myriad executive biases that infect decision making at every stage of the acquisition process, and the inadequacy of current valuation approaches to help mitigate these biases and more realistically represent value in uncertain environments. Bringing together the latest advances in behavioral finance, real option valuation, and game theory, this book explains how to express acquisition strategies as sets of real options, explicitly introducing uncertainty and future optionality into acquisition strategy design. It shows how to incorporate the competitive dynamics that exist in different acquisition contexts, acknowledge and even embrace uncertainty, identify the value of the real options embedded in targets, and more. Rooted in economic theory and featuring numerous real-world case studies, the book will enhance the ability of CEOs and their teams to derive value from their acquisition strategies, and is also an ideal resource for researchers and MBAs.
The Future of Behavioral Finance
Michael Dowling and Brian Lucey

in Financial Behavior: Players, Services, Products, and Markets

The future of behavioral finance necessitates that the research areas of behavioral corporate finance and investor psychology develop richer models of financial decision-making behavior. Behavioral corporate finance requires expanding the focus from chief executive officer characteristics to those of the entire top management team, and also involves greater understanding of organizational theory. A greater focus is needed on cross-cultural factors and how they interact with behavioral influences. Investor psychology needs a more comprehensive theory of the drivers of investor behavior and better data. This need is strong for investor sentiment research, which might offer the most potential to advance understanding of psychological influences on asset pricing. The chapter expands on these ideas and discusses an overall context of the future philosophical development of behavioral finance and the inevitable push for greater openness, replicability, and reliability in research.

Practical Challenges of Implementing Behavioral Finance
Greg B. Davies and Peter Brooks

in Financial Behavior: Players, Services, Products, and Markets

Behavioral finance is useful only if it can be applied to help people make better decisions. This chapter offers reflections on the good, bad, and ugly of practical applications of behavioral finance in a commercial banking setting. It explores the difficulties of nonexperts experimenting with behavioral finance, and how effective applications require a unique mix of expert knowledge and the ability to effect change through a business. Principles of good applications of behavioral finance are also presented, with information on how to start using behavioral finance within an organization. The importance of senior management’s acknowledging that behavioral finance practitioners do not necessarily know the correct answer and that they will need to use randomized control trials to learn is also discussed.
Introduction
John Y. Campbell and Luis M. Viceira

in Strategic Asset Allocation: Portfolio Choice for Long-Term Investors
Published in print: 2002 Published Online: November 2003
Item type: chapter

The mean-variance paradigm has the strong implication that all investors should hold risky assets in the same proportion. Financial planners typically advise conservative investors to tilt their risky portfolios towards bonds and away from stocks; this has been called the “asset allocation puzzle” since it contradicts standard mean-variance analysis. Financial planners also argue that long-term investors can afford greater exposure to stock market risk. This book will show how financial planners’ advice can be justified by an inter-temporal model of a rational investor. The model ignores some important real-world issues, including diversification of individual stocks, transactions costs, taxation, and the biases identified by research in behavioural finance.

Understanding Financial Market Failures
RAJ AGGARWAL

in International Finance: A Survey
Published in print: 2012 Published Online: May 2013
Item type: chapter

Most industrialized countries suffered a major breakdown of financial markets and systems during the period 2007 to 2009. This chapter reviews the causes and consequences of this financial market failure and its relationship with market inefficiencies to develop a framework for possible corrective regulations. The analysis combines insights from multiple fields such as finance, economics, and politics to understand the many reasons for market failure. This analysis is the basis for developing five practical principles to guide regulations required to mitigate the effects of market failures. The results should be of interest to individuals, money managers, business executives, and policymakers.
The Closed End Fund Puzzle

Andrei Shleifer

in Inefficient Markets: An Introduction to Behavioral Finance

Published in print: 2000 Published Online: November 2003

Begins by describing the closed end fund puzzle and enumerating some of the standard accounts that have been used to explain it. Then, applying the model developed in the previous chapter, the author comes to the conclusion that the apparent puzzle could be interpreted in terms of the influence of (individual) investors sentiments on securities prices. This interpretation, in turn, provides some useful hypotheses that are tested with evidence from the US, proving that behavioural finance theory can provide testable predictions.

Financial Behavior

H. Kent Baker, Greg Filbeck, and Victor Ricciardi

in Financial Behavior: Players, Services, Products, and Markets

Published in print: 2017 Published Online: May 2017

Financial behavior is a complex subject because how people should behave according to traditional finance often differs from how they actually behave. Although traditional and behavioral finance play important roles in understanding investor and market behavior, this book focuses on behavioral finance. Behavioral finance uses insights largely from finance, psychology, and other disciplines to explain how people act and how their behavior affects markets and other financial applications. This chapter provides an overview of behavioral finance, followed by a brief explanation of the book’s purpose, distinguishing features, and intended audience. The chapter outlines the book’s structure of: (1) financial behavior and psychology, (2) financial behavior of major players, (3) financial and investor psychology of specific players, (4) psychology of financial services, (5) behavioral aspects of investment products and markets, (6) market efficiency issues, and (7) application and future of behavioral finance.
This chapter provides an overview of portfolio theory and management. It discusses the three major steps in the portfolio management process—planning, execution, and feedback—and the key tasks involved in each step. Next the chapter examines modern portfolio theory including such topics as asset pricing models, traditional finance models, behavioral finance, alternative investments, performance evaluation and presentation, and the recent financial crisis. Next the chapter describes the purpose of the book, its distinguishing features, and intended audience. The chapter then discusses the structure of the remaining 29 chapters and provides an abstract of each chapter. The final section offers a summary and conclusions. While the theory and practice of portfolio management have been moving ahead at a dizzying pace, this book enables readers to gain a better understanding of the existing state of knowledge and the challenges remaining in this area.
psychology in which some investors remain overly risk averse, resulting in under-investment in stocks and over-investment in cash and bonds.

**Financial Innovation**

Michael Haliassos (ed.)

Published in print: 2013 Published Online: January 2015

This collective volume is about financial innovation, its history, and its potential to cause or to prevent financial crises. In assigning blame for the recent economic crisis, many have pointed to the proliferation of new, complex financial products - mortgage securitization in particular. The prominent economists from academia, policy institutions, and financial practice who contribute to this book, however, argue that it was not too much innovation but too little innovation and the lack of balance between debt-related products and asset-related products that lies behind the crisis. Prevention of future financial crises neither requires nor is assisted by regulation that stifles financial innovation, but by a policy and regulatory framework that helps broaden the informed use of financial innovation and its positive impact on the economy. The book, which includes two contributions from Robert Shiller as well as a discussion of Shiller's "MacroMarkets" tool, considers the key ingredients of financial innovation from both academia and industry; historical and recent examples of financial innovations; the positive potential but also the risks of financial innovation, with special emphasis on housing; rationality- and behavioral-based viewpoints on the causes of the recent crisis; the link between the cycle of financial innovation and financial crisis; and how future innovation-linked crises might be avoided.

**The Financial Psychology of Players, Services, and Products**

Victor Ricciardi

in Financial Behavior: Players, Services, Products, and Markets

Published in print: 2017 Published Online: May 2017

This chapter provides an overview of the emerging cognitive and emotional themes of behavioral finance that influence individual behavior. The behavioral finance perspective of risk incorporates both qualitative (subjective) and quantitative (objective) aspects of the decision-making process. An emerging subject of research interest and
investigation in behavioral finance is the inverse (negative) relation between perceived risk and expected return (perceived return). The chapter highlights important topics such as representativeness, framing, anchoring, mental accounting, control issues, familiarity bias, trust, worry, and regret theory. It also examines the role of negative affective reactions on financial decisions. A host of biases that depend on specific aspects of the financial product or investment service influence the judgment and decision-making process of most financial players.

Behavioral Risk
M. Martin Boyer, Franca Glenzer, and Samuel Ouzan

in Investment Risk Management

This chapter examines how behavioral factors influence financial decision processes. It takes a behavioral perspective to explain phenomena in financial markets that the neoclassical view of rationally acting agents has trouble explaining. Among these puzzles are the equity premium puzzle and excess volatility. Starting from theoretical challenges to the neoclassical view of thinking including prospect theory, the chapter discusses the most important heuristics and biases in decision making that help to explain empirically observed asset prices including the role of overconfidence and noise traders on financial markets. The chapter also discusses collective behavior such as herding.

Behavioral Aspects of Portfolio Investments
Nathan Mauck

in Financial Behavior: Players, Services, Products, and Markets

Investors are inextricably linked to financial institutions, money managers, and the products they market. Mutual funds, exchange-traded funds (ETFs), hedge funds, and pension funds manage or hold roughly $55 trillion in combined wealth. This chapter examines these topics with a behavioral finance approach, focusing on two main ideas: the performance and rationality of each group, and the behavioral biases that relate to individuals’ selection of particular investments within each
Research indicates that actively managed mutual funds and hedge funds underperform passive investments. Pension funds generate alpha of roughly zero on a risk-adjusted basis. The fees involved in investing in such funds exacerbate the observed underperformance in mutual funds and hedge funds. Behavioral biases provide one perspective on sources of underperformance. Further, individuals exhibit a wide range of behavioral biases that may lead to suboptimal asset allocation, including the selection of mutual funds, ETFs, and hedge funds.

Applications of Client Behavior
Harold Evensky

in Financial Behavior: Players, Services, Products, and Markets

This chapter reviews various behavioral concepts and strategies to help clients avoid behavioral errors, with the result of increasing the probability of a successful plan design and implementation. The chapter discusses how the concepts introduced by research in behavioral finance have become integrated throughout Evensky & Katz/Foldes Financial’s practice. The chapter begins with framing for new clients, which is part of the firm’s approach to retirement planning called “anchoring on the efficient frontier.” Anchoring refers to the intersection of the client’s return requirement as determined by a capital needs analysis and the client’s risk tolerance. Framing is introduced as a powerful behavioral management tool for the practitioner. Behavioral finance lessons are integrated in the risk tolerance and return discussions, as well as the reporting process.