

Introduction to Behavioral Finance

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Key concepts, why it matters, and how it differs from traditional finance.

1. What Is Behavioral Finance?

Definition	Focus
A sub-field of finance that integrates insights from psychology, sociology, and neuroscience with economic theory.	How real people make financial decisions, rather than how “rational agents” are assumed to behave in classic models.
Seeks to explain market anomalies, investor mistakes, and the formation of asset-price bubbles.	The systematic biases and heuristics that influence saving, investing, and risk-taking.

2. Why Traditional Finance Falls Short

Traditional Assumption	Reality (Behavioral Insight)
Rational expectations – investors process all information perfectly and maximize utility.	Bounded rationality – limited cognitive capacity leads to shortcuts (heuristics).
Efficient markets (EMH) – prices instantly reflect all available information.	Market inefficiencies – mispricings persist because of herd behavior, over-/under-reaction, etc.
Risk-neutral pricing – investors care only about expected returns and variance.	Loss aversion & reference dependence – the pain of losses outweighs the pleasure of gains.

3. Core Psychological Concepts

Concept	Description	Typical Financial Impact
Heuristics	Mental shortcuts (e.g., representativeness, availability) used to simplify decisions.	Overweighting recent news ? momentum trading.

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Concept	Description	Typical Financial Impact
Prospect Theory (Kahneman & Tversky)	People evaluate outcomes relative to a reference point; they are loss-averse and overweight small probabilities.	Holding losing stocks too long, selling winners early.
Overconfidence	Overestimation of one's knowledge or predictive ability.	Excessive trading, under-diversification.
Anchoring	Relying heavily on an initial piece of information (the "anchor") when making judgments.	Sticking to a purchase price despite new data.
Mental Accounting	Segregating money into separate "accounts" (e.g., "vacation fund" vs. "retirement").	Inconsistent risk-taking across accounts.
Herd Behavior	Tendency to follow the actions of a larger group.	Asset-price bubbles, panic selling.
Disposition Effect	Preference to realize gains quickly and defer losses.	Frequent selling of winners, holding losers.

4. Common Market Anomalies Explained

Anomaly	Traditional View	Behavioral Explanation
January Effect	Seasonal risk-adjusted returns should be flat.	Tax-loss selling and mental accounting create a January price boost.
Momentum	Prices should revert to fundamentals quickly.	Availability heuristic & extrapolation of recent trends.
Value vs. Growth	No systematic outperformance expected.	Overconfidence in growth stories; neglect of fundamentals leads to undervaluation of "value" stocks.
Equity Premium Puzzle	Expected return on equities should align with risk-aversion parameters.	Loss aversion and fear of rare catastrophic losses inflate required equity returns.

5. Implications for Investors

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1. **Self-Awareness** – Recognize personal biases (e.g., overconfidence) and monitor trading behavior.
2. **Diversification** – Counteract the tendency to concentrate holdings due to mental accounting.
3. **Long-Term Focus** – Reduce the impact of short-term anchoring and