The 1-2-3 of Investing
Part 4: Behavioral Finance

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Behavioral biases that interfere with sound financial decision-making have developed into an economic theory known as behavioral finance. It is a relatively new concept which proposes that people do not always make financial decisions that are rational and free from psychological hang-ups. Mainstream financial theory, on the other hand, assumes that people make rational decisions and are not affected by emotion or culture. A good example of behavioral finance is the liquidation of a position in stocks by investors who fear that a correction is due after a series of positive outcomes.

One of the central pioneers of behavioral finance is Robert Shiller. During his undergraduate studies at the University of Michigan, he had the idea that psychological factors should be included in economic analysis. Believing that economics had become too rigid and mathematical, the Yale professor argued in a game-changing 1981 paper that the stock market is mostly driven by non-economic factors such as people's fears, prejudices, reactions to news stories and elections. Confirmation of his innovative approach to economics came in the form of the 2013 Nobel Prize in Economic Sciences. (The author of this FLIP contribution extended the idea of behavioral finance to sports-betting in a 2022 paper, where he shared the belief of some that bettors prefer to wager on popular football teams since any losses would not be peculiar to them.)

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As a subfield of behavioral economics,[1] behavioral finance encompasses five main components. One, *mental accounting* refers to the tendency of people to categorize money by source or use. For example, people will more likely spend money from a tax refund than from their regular paycheck. Two, *herd behavior* translates into the desire of people to mimic the actions of the majority. Illustratively, people will choose a restaurant based on crowds. Three, *emotional gap* is decision-making based on extreme emotions such as anxiety, anger, fear or excitement. Investors who sell stocks fearing a recession would serve as an example. Four, *anchoring* alludes to the human tendency to rely too heavily on the first piece of information. A doctor who bases a diagnosis on early symptoms would be an example. Five, *self-attribution* refers to the tendency to make choices based on overconfidence in one's own knowledge or skill. In other words, some people will attribute successful outcomes to their own skills and failures to external factors.

In truth, no decision is completely void of error. However, a professor who splits her time between the University College London and MIT has prepared a checklist of queries that are designed to minimize the obstacles to productive decision-making. According to Dr. Tali Sharot, decision-makers should answer the following questions:

1. Are the reasons I want to take this action emotional or rational?
2. Do I have all the information I need to make the decision now?
3. Have I carefully weighed the gains and losses that could result from this decision?
4. What is the long-term outcome if I make this decision now?
5. Is this decision consistent with the factors that led to the financial plan?
6. Is the decision something that I want to repeat going forward?

[1] Behavioral economics includes financial decisions but also encompasses consumer choices and pricing strategies.