An Introduction to Behavioral Finance

It's really hard not to think of the stock market as a person: it has from time to time a human behavior. Moods that can turn from irritable to euphoric; it can also react hastily one day and make amends the next. That is what inspired theories mixing the elemental principles of psychology into the markets. But is it really that efficient?

This field of study pretends that people are not as rational as traditional finance theory makes out. For investors who are curious about how emotions and biases drive share prices, behavioral finance offers its point of view.

The idea that psychology drives stock market movements flies in the face of established theories advocating the efficiency of the markets. Proponents of efficient market hypothesis say that any new information relevant to a company's value is quickly priced by the market through the process of arbitrage. But for anyone who has been through the Internet bubble and the subsequent crash, this efficient market theory is pretty hard to swallow. Behaviorists explain the "anomalies" of the market as the irrational behavior of brokers. In fact, researchers have regularly reproduced market behavior using very simple experiments.

Losses versus Gains, their importance: this is a fundamental notion in the behavioral theory. Let's illustrate it with a very simple example: one offers someone a choice of a sure $50 or, on the flip of a coin, the possibility of winning $100 or winning nothing. Chances are the person will choose the most secure option. Conversely, one offers a choice of a sure loss of $50 or, on a flip of a coin, a loss of $100 or nothing. This time, the coin toss would the chosen with great probability. The chance of the coin flipping either way is equivalent for both scenarios, yet people will go for the coin toss to prevent a loss even though this coin flip could mean an even greater loss. People tend to view the possibility of recouping a loss as more important than the possibility of greater gain.

The necessity of knowing how to cut the losses holds true also for investors. Just think for example of Nortel Networks shareholders who watched their stock's value fall dramatically from over $100 a share in early 2000 to less than $2. No matter how low the price drops, investors, believing that the price will eventually come back, often hold onto stocks.

Beware of the sheep*:* Herd instinct explains the imitation behavior. When a market is moving up or down, investors are subject to a fear that others possess more significant information about the market than they do. As a consequence, investors develop a behavior of imitation.

Behavior finance has also found that investors tend to trust unwisely judgments derived from small samples of data or from single sources. For instance, investors in front of a winning position of their colleague see his skills rather than his luck. On the other hand, investors' beliefs cannot be removed easily. One belief that gripped investors through the late 1990s was that any sudden drop in the market means an appropriate time to buy. And this error of judgment persists. Investors are often overconfident in their judgments and tend to pounce on a single "telling" detail rather than the more obvious average.

However, we can ask ourselves if these studies will help investors beat the market. After all, rational shortcomings ought to provide plenty of profitable opportunities for wise investors. In practice, however, few if any value investors are deploying behavioral principles to sort out which cheap stocks actually offer returns that can be taken to the bank. The impact of behavioral finance research still remains greater in academia than in practical money management.

To conclude, the behavioralists have yet to come up with a first coherent model of the impact of psychology. This model represents the potential of these studies because it can actually predicts the future rather than merely explains what the market did in the past. The big lesson is that theory doesn't explain how the traders can beat the market. Instead, it tells us that psychology causes the market prices.

Do not believe that behavioral finance is a miracle maker in the Stock Exchange. But perhaps it can help investors control their behaviors and analyze the quality of their judgments. That should avoid a great share of human mistakes.