NTPU
國立臺北大學
National Taipei University

Investing Psychology and Behavioral Finance

1111AIFQA03
MBA, IM, NTPU (M6132) (Fall 2022)
Tue 2, 3, 4 (9:10-12:00) (B8F40)

https://meet.google.com/paj-zhhj-mya

aws educate Cloud Ambassador 2020 Cohort

aws academy Accredited Educator

aws certified Cloud Practitioner

aws certified Solutions Architect Associate

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Associate Professor

Institute of Information Management, National Taipei University

https://web.ntpu.edu.tw/~myday

2022-09-27

Syllabus

Week	Date	Subject/Topics
1	2022/09/13	Introduction to Artificial Intelligence in Finance and Quantitative Analysis
2	2022/09/20	AI in FinTech: Metaverse, Web3, DeFi, NFT, Financial Services Innovation and Applications
3	2022/09/27	Investing Psychology and Behavioral Finance
4	2022/10/04	Event Studies in Finance
5	2022/10/11	Case Study on AI in Finance and Quantitative Analysis I
6	2022/10/18	Finance Theory

Syllabus

Week	Date	Subject/Topics
7	2022/10/25	Data-Driven Finance
8	2022/11/01	Midterm Project Report
9	2022/11/08	Financial Econometrics
10	2022/11/15	AI-First Finance
11	2022/11/22	Industry Practices of AI in Finance and Quantitative Analysis
12	2022/11/29	Case Study on AI in Finance and Quantitative Analysis II

Syllabus

Week	Date	Subject/Topics
13	2022/12/06	Deep Learning in Finance; Reinforcement Learning in Finance
14	2022/12/13	Algorithmic Trading; Risk Management; Trading Bot and Event-Based Backtesting
15	2022/12/20	Final Project Report I
16	2022/12/27	Final Project Report II
17	2023/01/03	Self-learning
18	2023/01/10	Self-learning

Investing Psychology and Behavioral Finance

Outline

- Investing Psychology
  - Investor Sentiment
  - Consumer Psychology and Behavior
- Behavioral Finance
  - Prospect Theory: An Analysis of Decision Under Risk
  - Behavioral Heuristics and Biases in Decision Making
  - Herding Behavior in Finance

Investor Sentiment

CNN Money

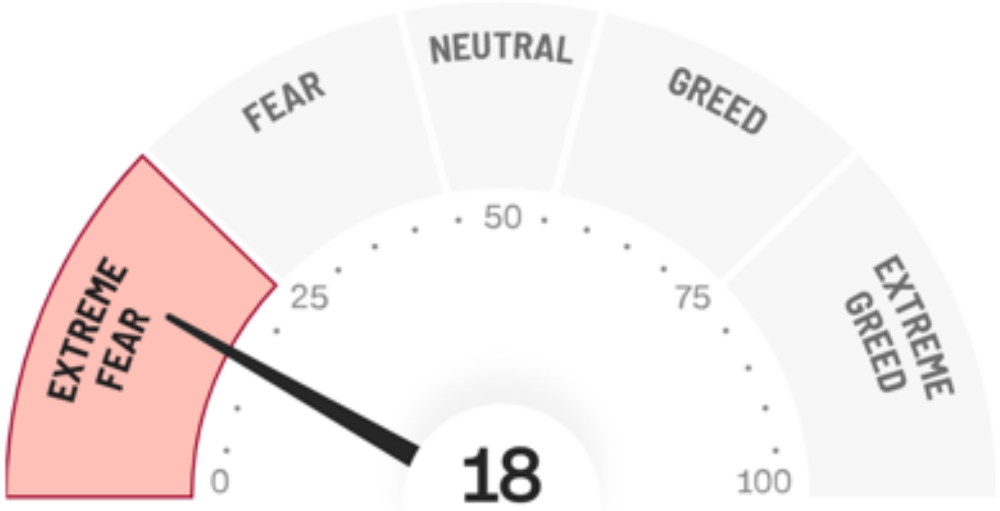
Fear & Greed Index

What emotion is driving the market now?

CNN Money

Fear & Greed Index

What emotion is driving the market now?
Learn more about the index



Overview | Timeline

Previous close Extreme Fear	24
1 week ago Fear	36
1 month ago Neutral	55
1 year ago Extreme Fear	23

Last updated Sep 26 at 5:00 PM EDT

Source: https://money.cnn.com/data/fear-and-greed/

Consumer Psychology and Behavior

How consumers think, feel, and act

Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Fintech: Technology Innovation in Financial Services

Fintech Impact on Consumer Behavior

Source: http://bitcoinist.com/fintech-impact-consumer-behavior-mobile-payments/

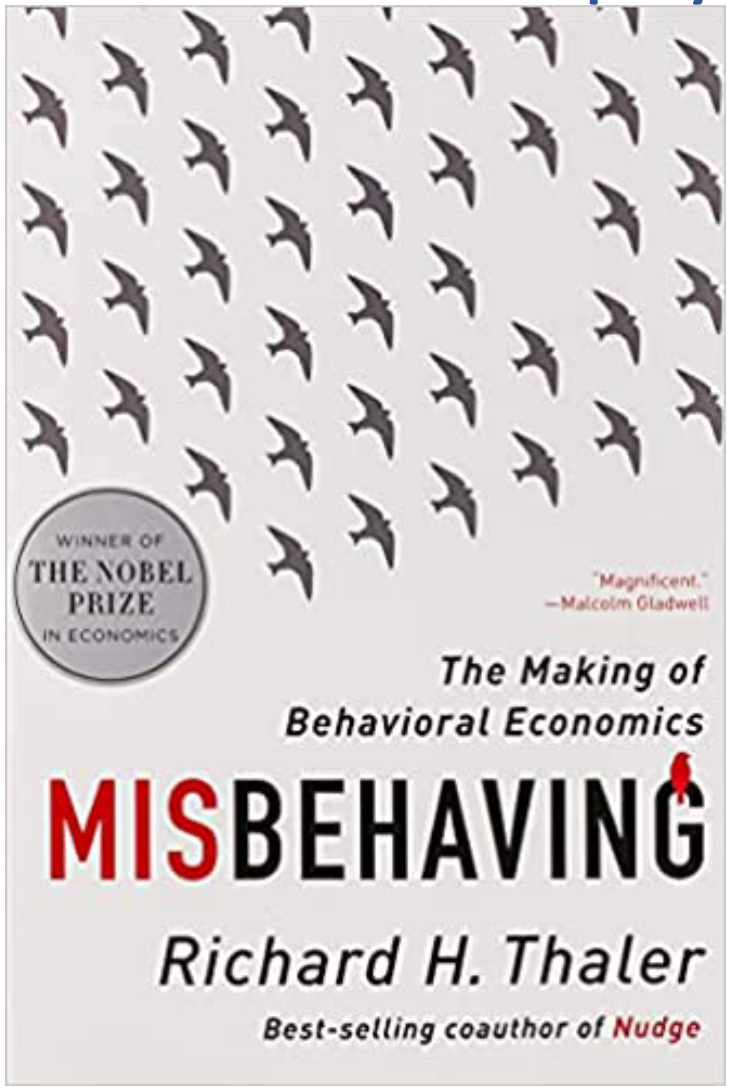
Behavioral Finance

Richard H. Thaler (2016),

Misbehaving: The Making of Behavioral Economics,

W. W. Norton & Company

Richard H. Thaler



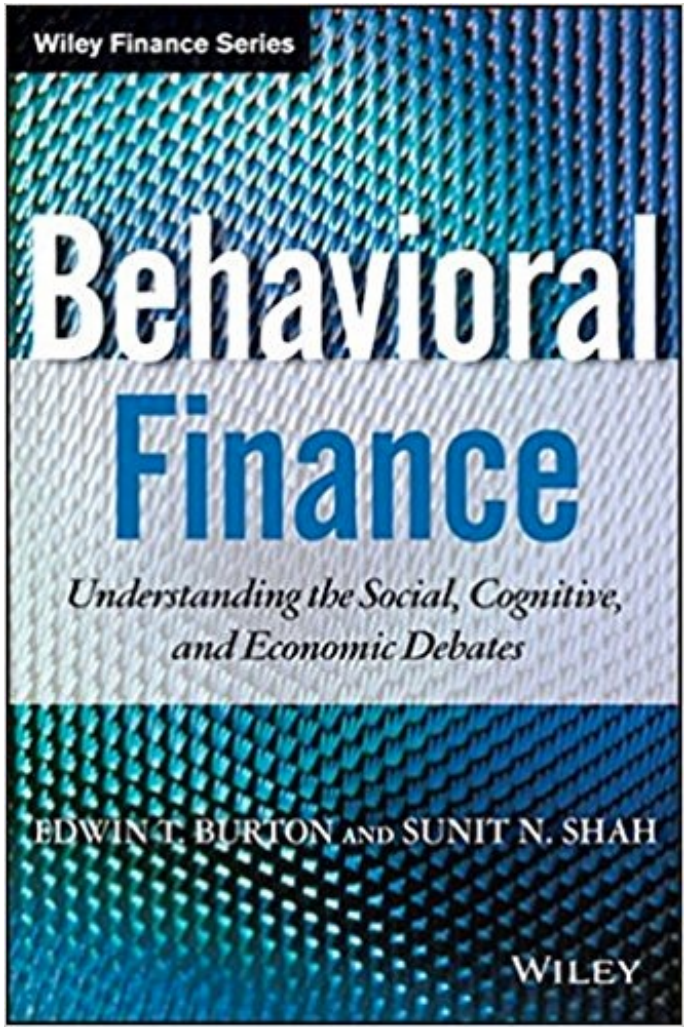
Source: https://www.amazon.com/Misbehaving-Behavioral-Economics-Richard-Thaler/dp/039335279X

Edwin Burton and Sunit N. Shah (2013)

Behavioral Finance:

Understanding the Social, Cognitive, and Economic Debates,

Wiley

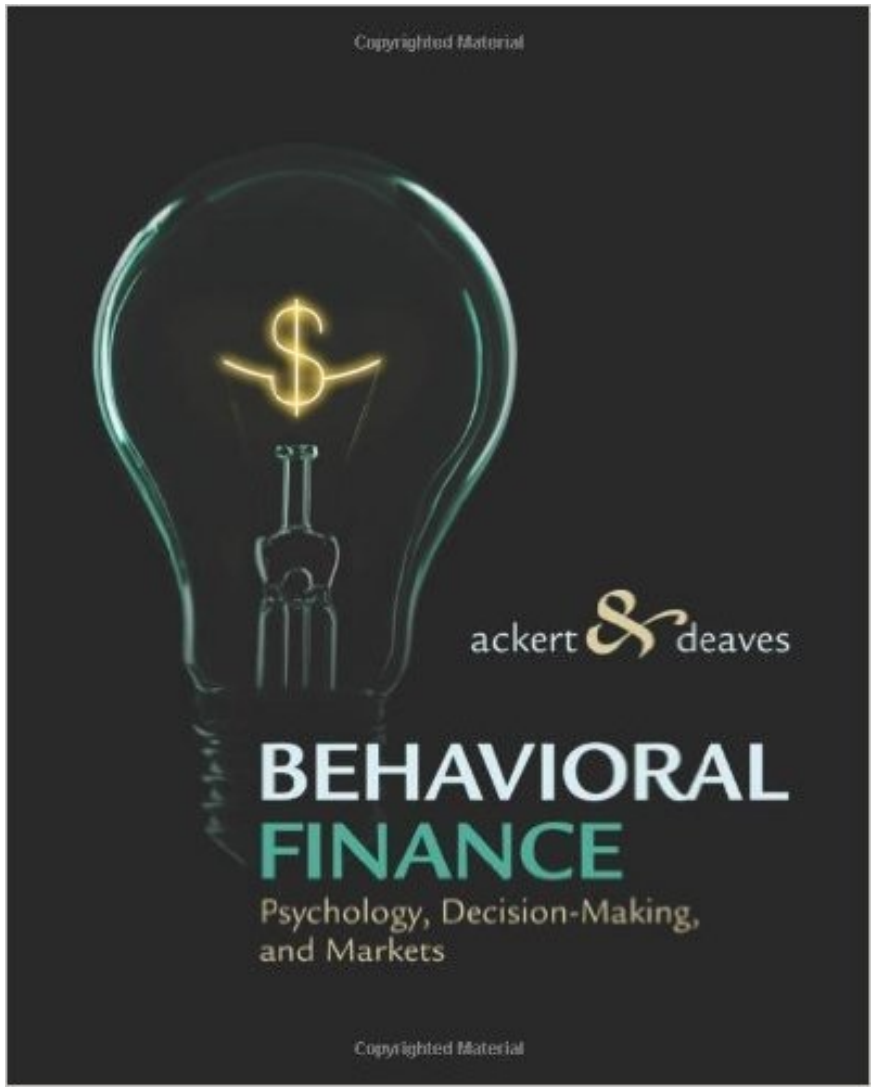


Source: https://www.amazon.com/Behavioral-Finance-Understanding-Cognitive-Economic/dp/111830019X

Lucy Ackert and Richard Deaves (2009),

Behavioral Finance: Psychology, Decision-Making, and Markets,

South-Western College Pub



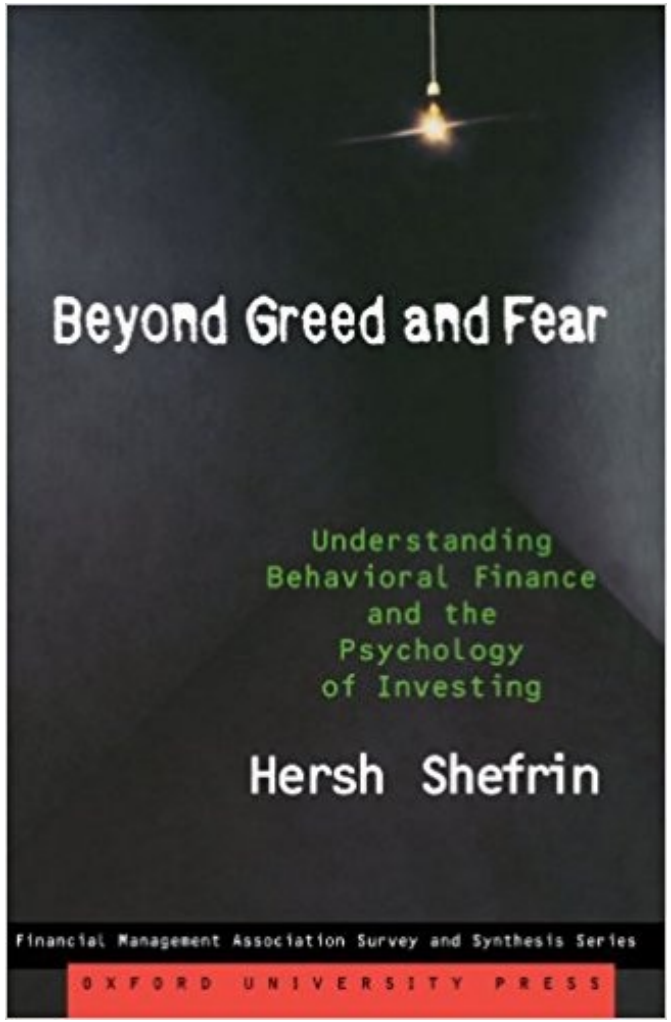
Source: https://www.amazon.com/Behavioral-Finance-Psychology-Decision-Making-Markets/dp/0324661177

Hersh Shefrin (2007),

Beyond Greed and Fear:

Understanding Behavioral Finance and the Psychology of Investing,

Oxford University Press

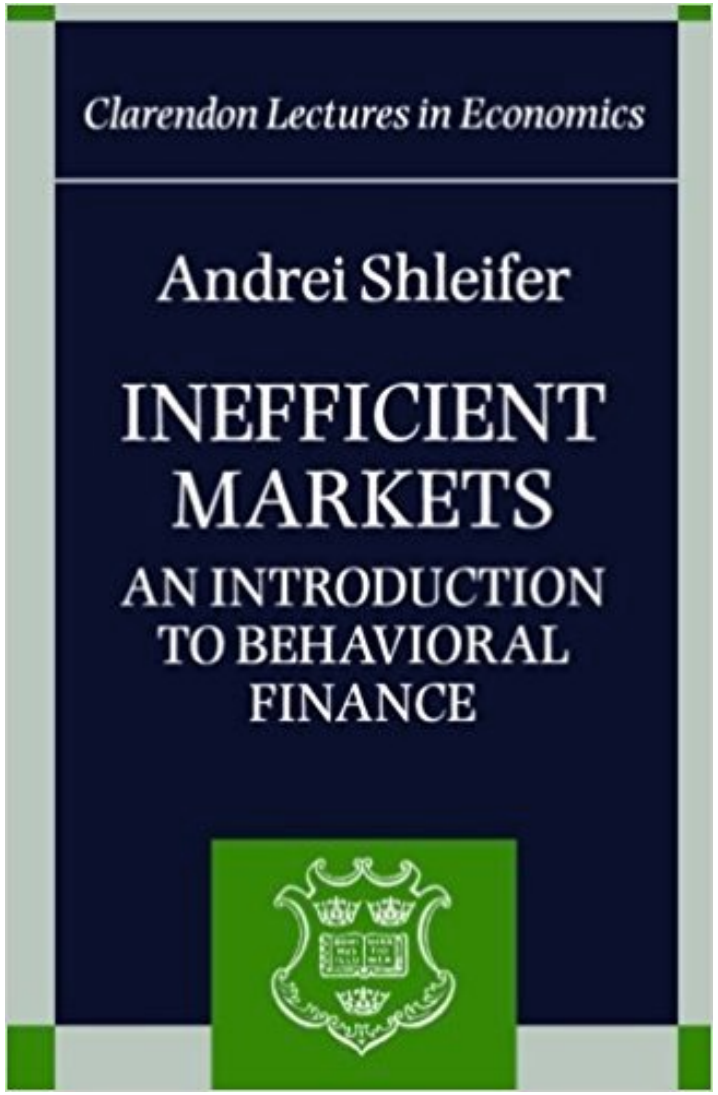


Source: https://www.amazon.com/Beyond-Greed-Fear-Understanding-Association/dp/0195304217

Andrei Shleifer (2000),

Inefficient Markets: An Introduction to Behavioral Finance,

Oxford University Press



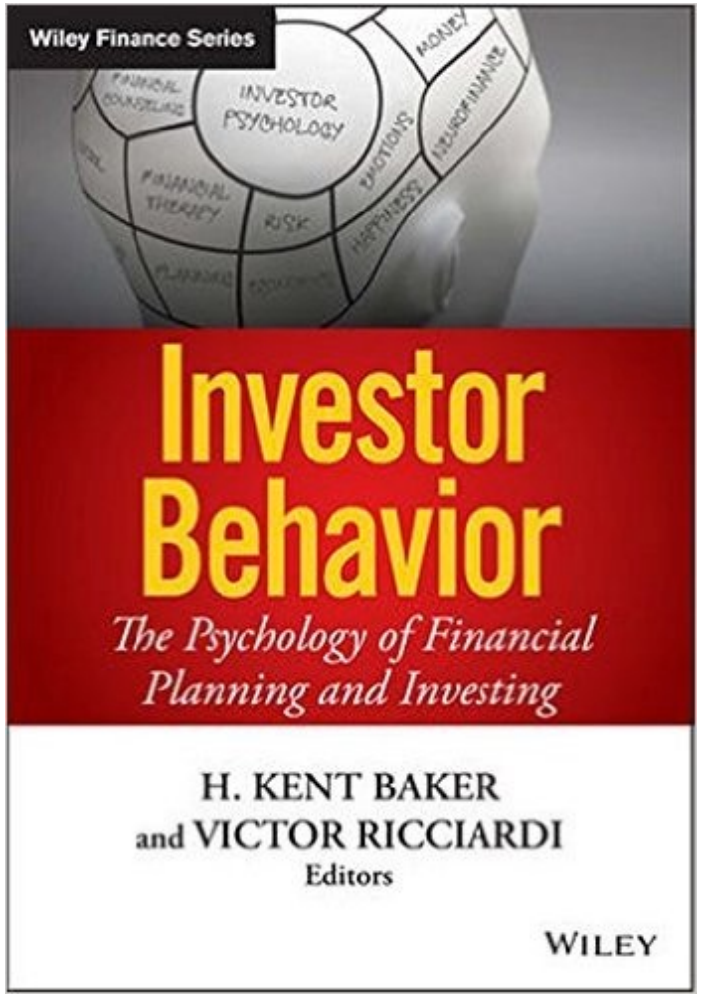
Source: https://www.amazon.com/Inefficient-Markets-Introduction-Behavioral-Clarendon/dp/0198292279

H. Kent Baker and Victor Ricciardi (2014)

Investor Behavior:

The Psychology of Financial Planning and Investing,

Wiley



Source: https://www.amazon.com/Investor-Behavior-Psychology-Financial-Investing/dp/1118492986

Marketing

“Meeting needs profitably”

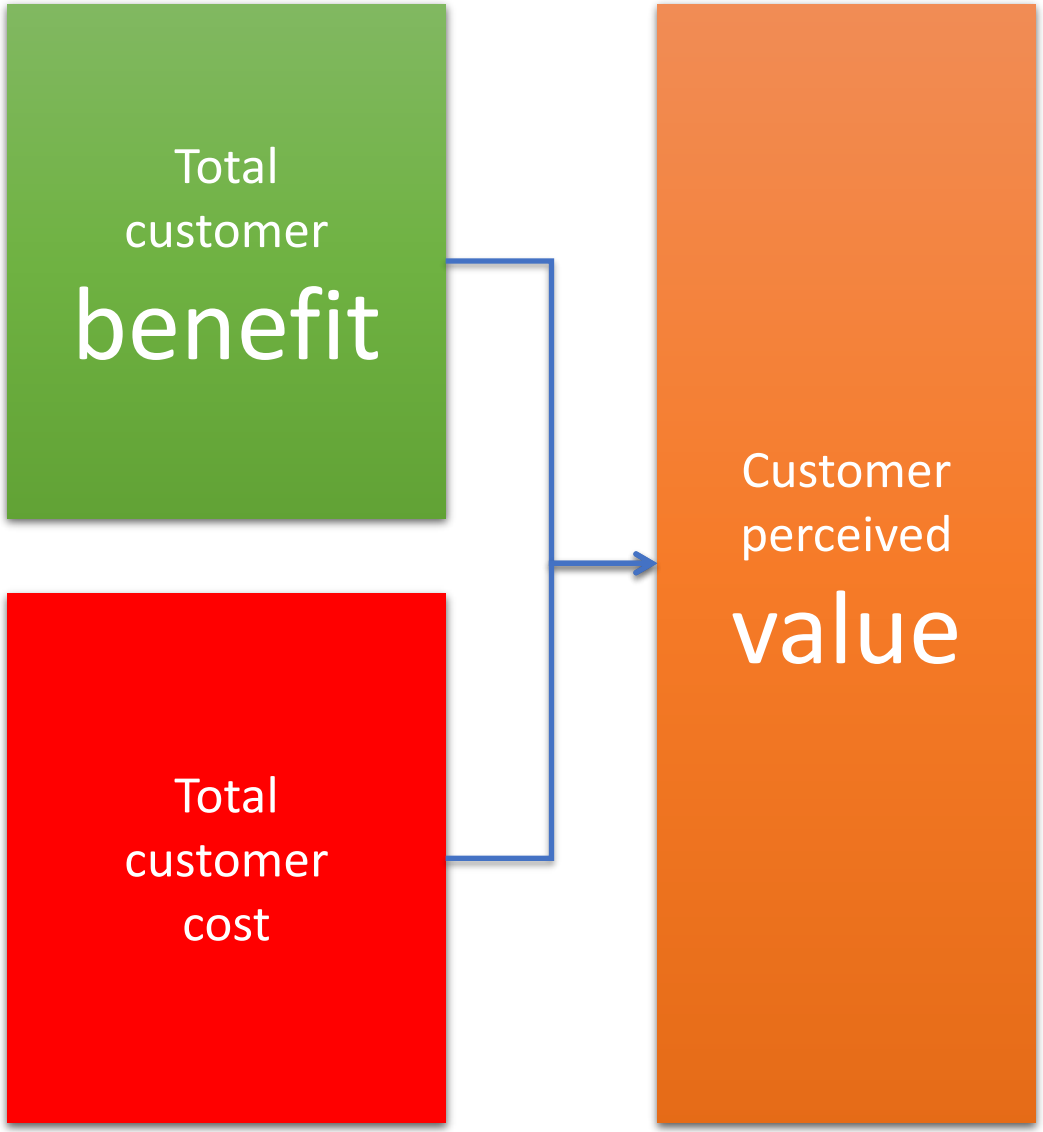
Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Value

the sum of the tangible and intangible benefits and costs

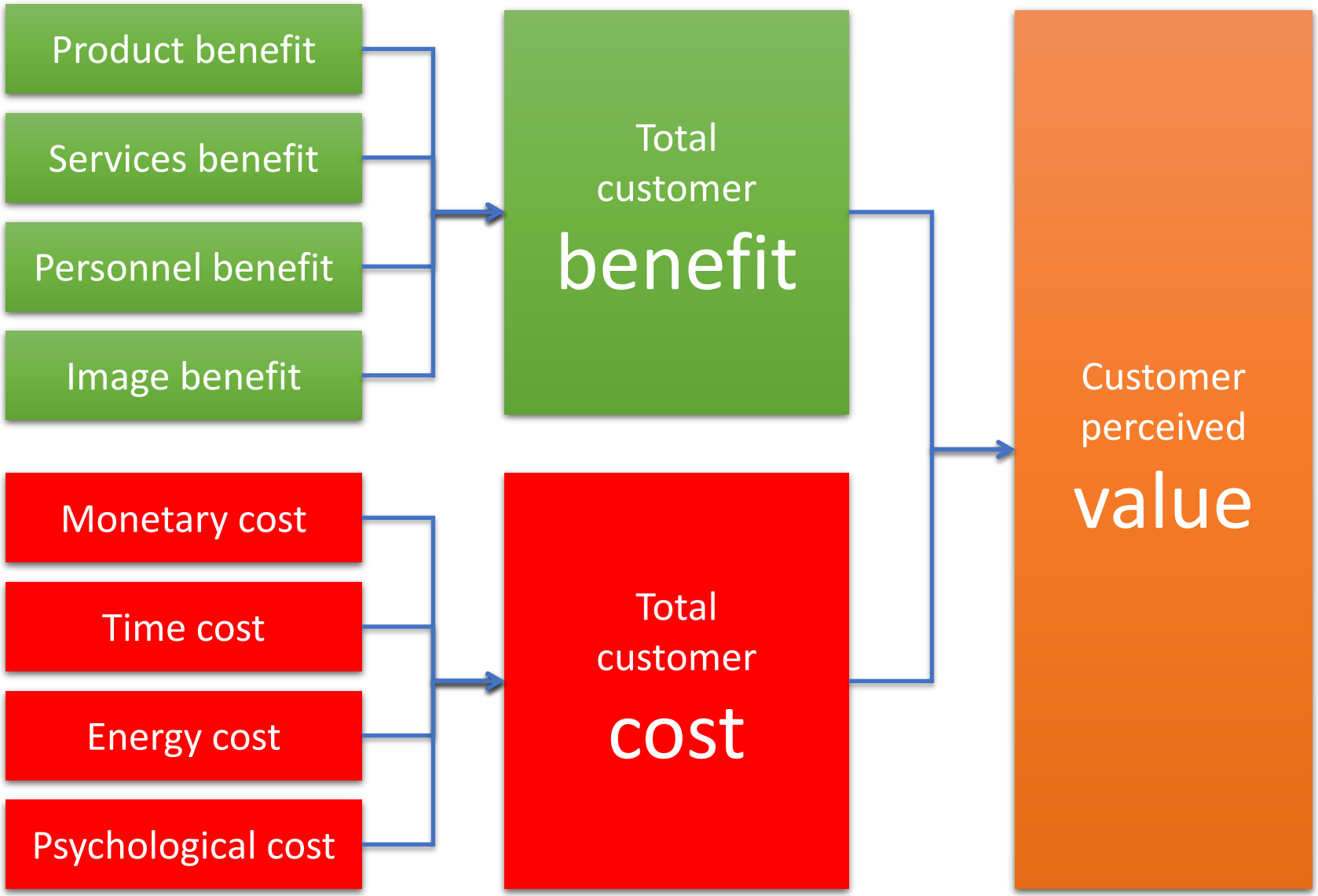
Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Value



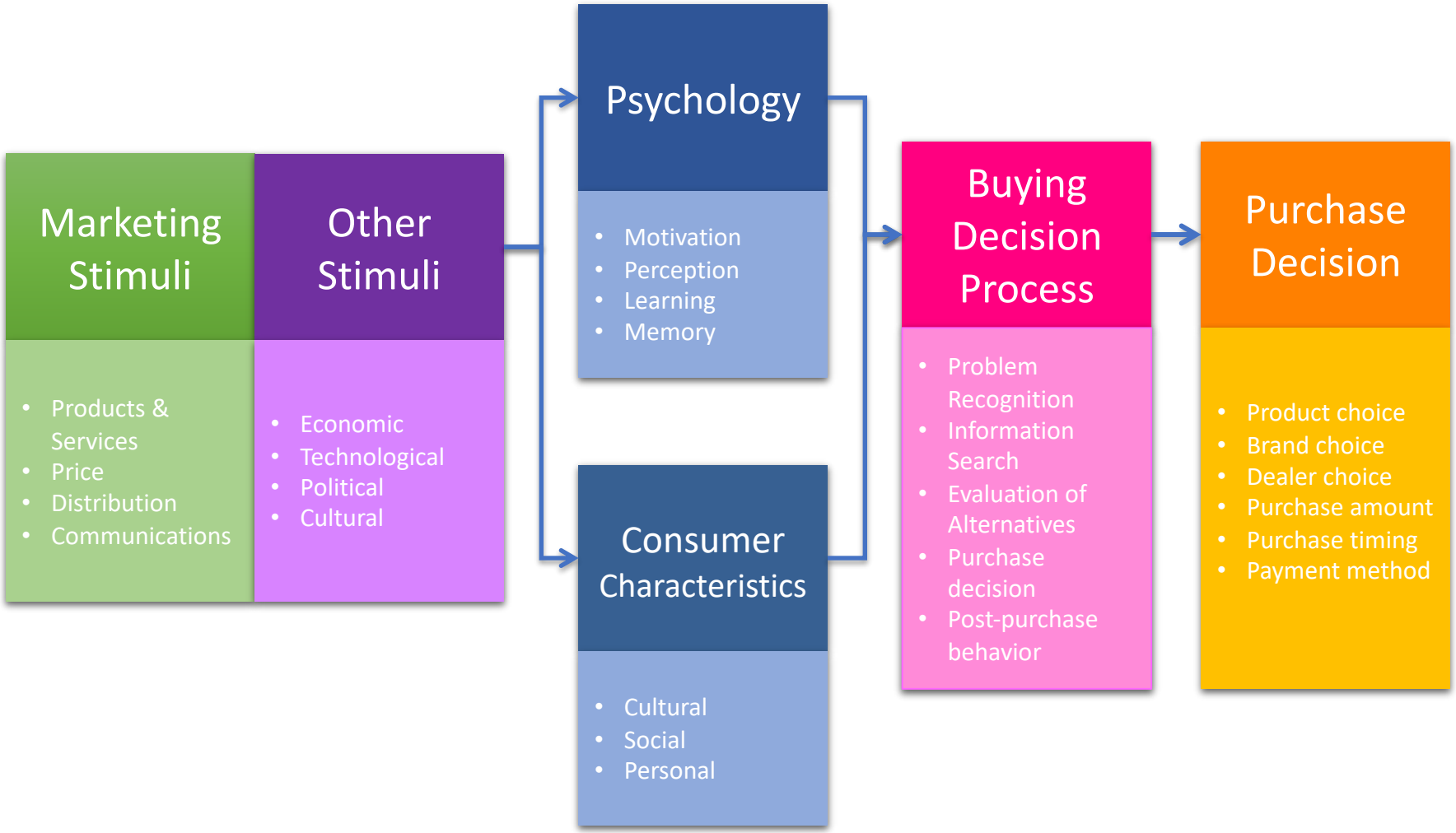
Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Customer Perceived Value



Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Model of Consumer Behavior

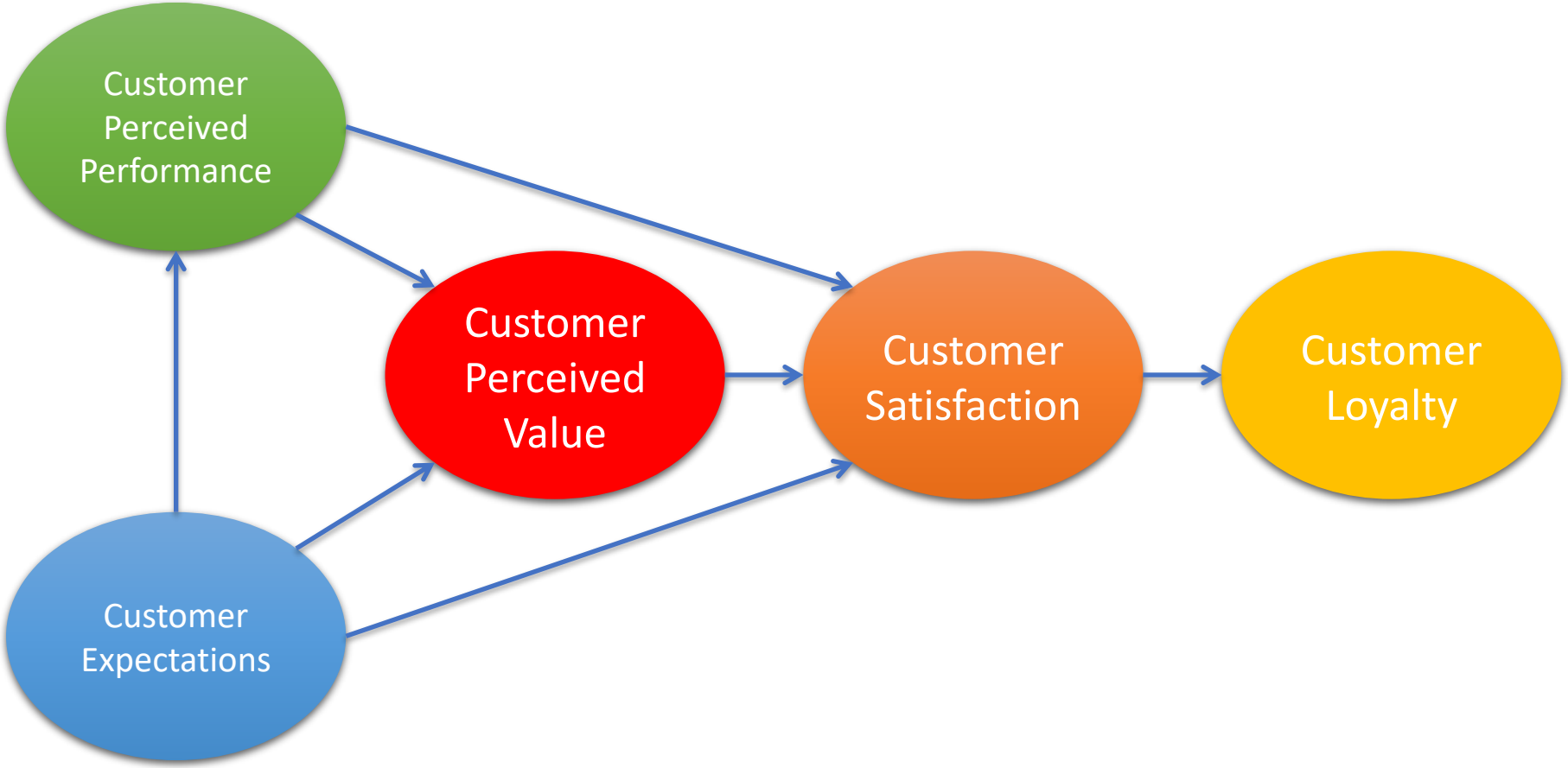


Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Building Customer Value, Satisfaction, and Loyalty

Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Customer Perceived Value, Customer Satisfaction, and Loyalty



Source: Philip Kotler & Kevin Lane Keller, Marketing Management, 14th ed., Pearson, 2012

Theory of Reasoned Action (TRA)

Source: Fishbein, M., & Ajzen, I. (1975). Belief, Attitude, Intention, and Behavior: An Introduction to Theory and Research. Reading, MA: Addison-Wesley.

TRA (1975)

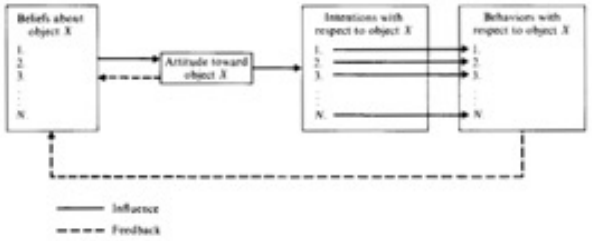


Fig. 1.1 Schematic presentation of conceptual framework relating beliefs, attitudes, intentions, and behaviors with respect to a given object.

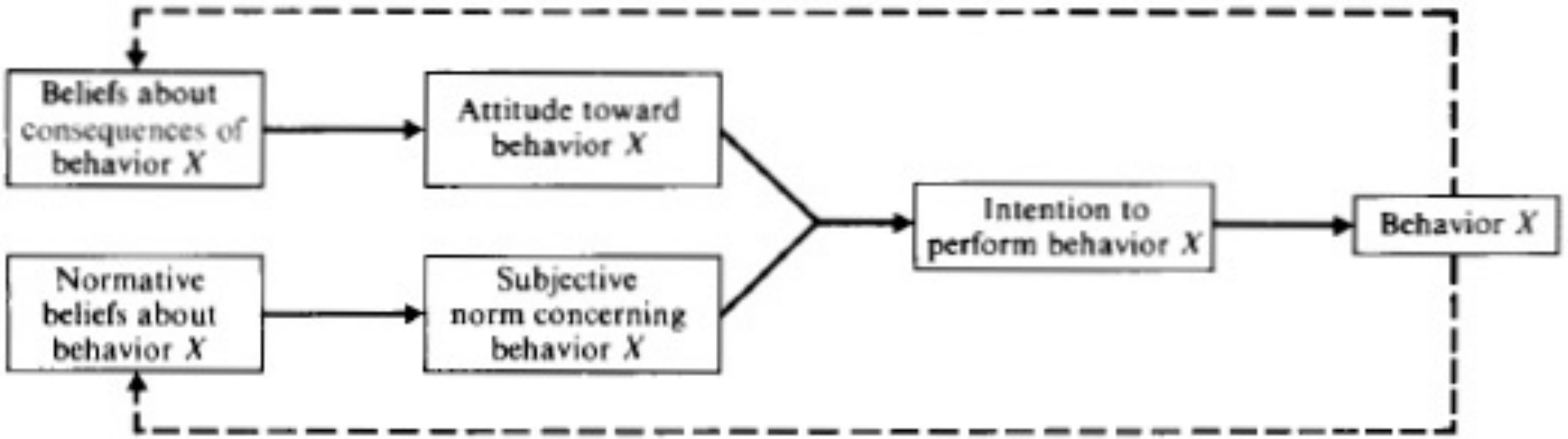
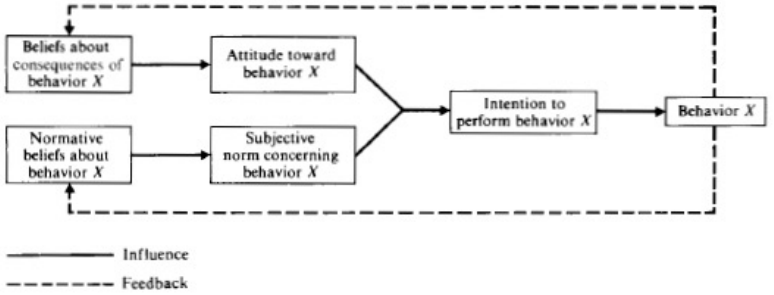


Fig. 1.2 Schematic presentation of conceptual framework for the prediction of specific intentions and behaviors.

Source: Fishbein, M., & Ajzen, I. (1975). Belief, Attitude, Intention, and Behavior: An Introduction to Theory and Research. Reading, MA: Addison-Wesley.

TRA (1989)



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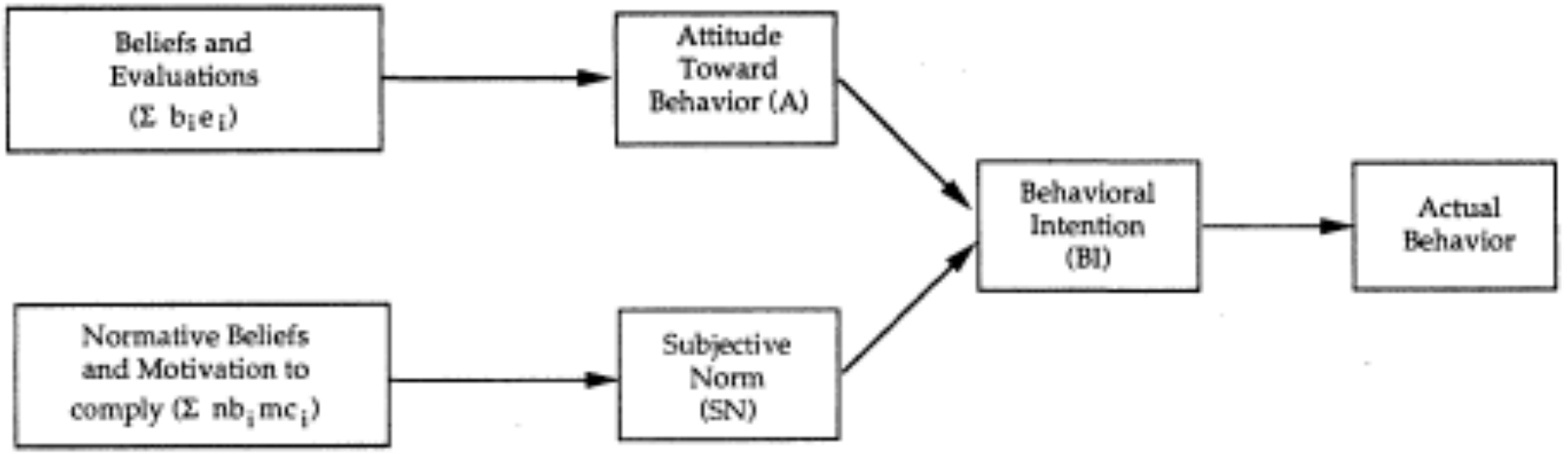


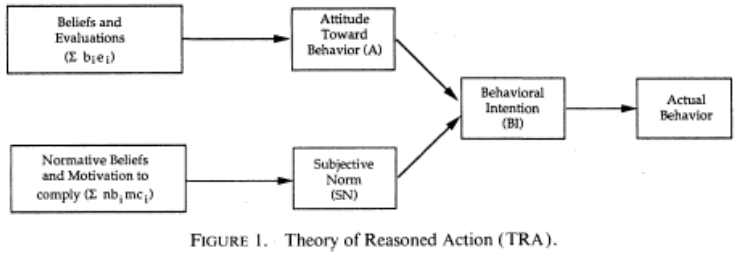
FIGURE 1. Theory of Reasoned Action (TRA).

Davis,F.D.,R.P.Bagozzi and P.R.Warshaw,"User acceptance of computer technology : A comparison of two theoretical models ",Management Science,35(8),August 1989,pp.982-1003

Theory of Planned Behavior (TPB)

Source: Ajzen, I., (1985) “From Intentions to Actions: A Theory of Planned Behavior,” in J. Kuhl and J. Beckmann (Eds.) Action Control: From Cognition to behavior, Springer Verlag, New york, 1985, pp.11-39.

TPB (1985)



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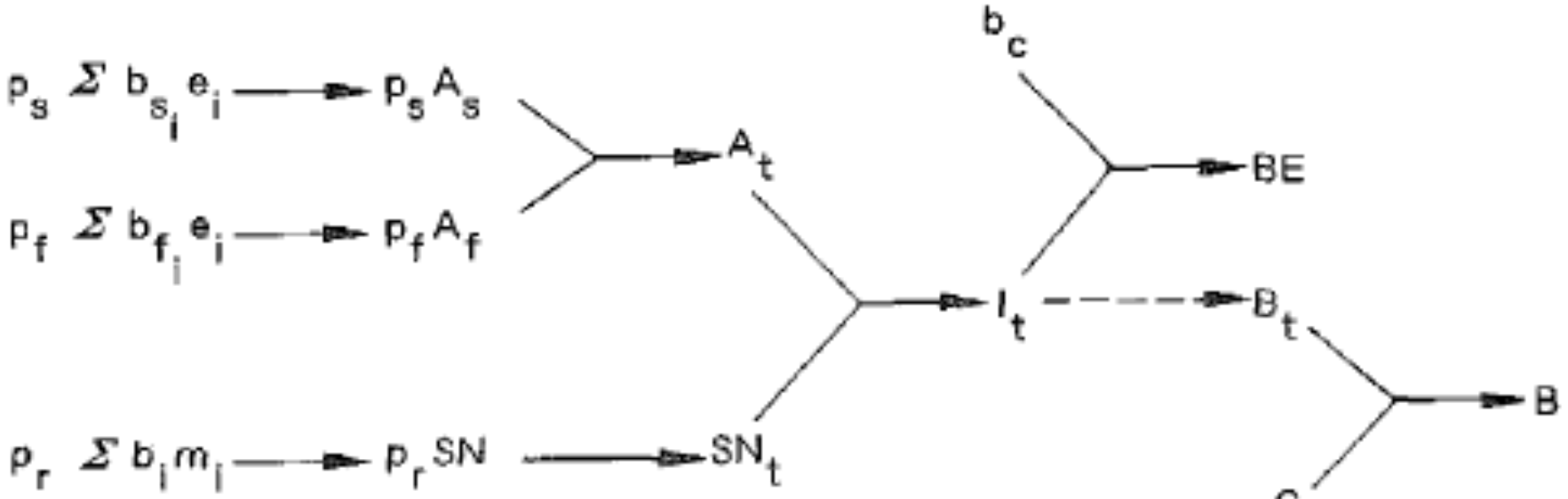
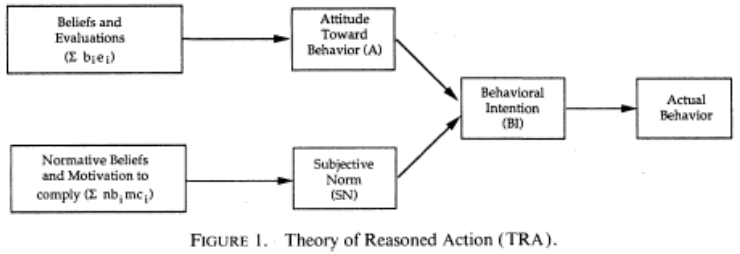


Fig. 2.1. Schematic presentation of the theory of planned behavior

Ajzen, I., (1985) "From Intentions to Actions: A Theory of Planned Behavior," in J. Kuhl and J. Beckmann (Eds.) Action Control: From Cognition to behavior, Springer Verlag, New york, 1985, pp.11-39.

TPB (1989)



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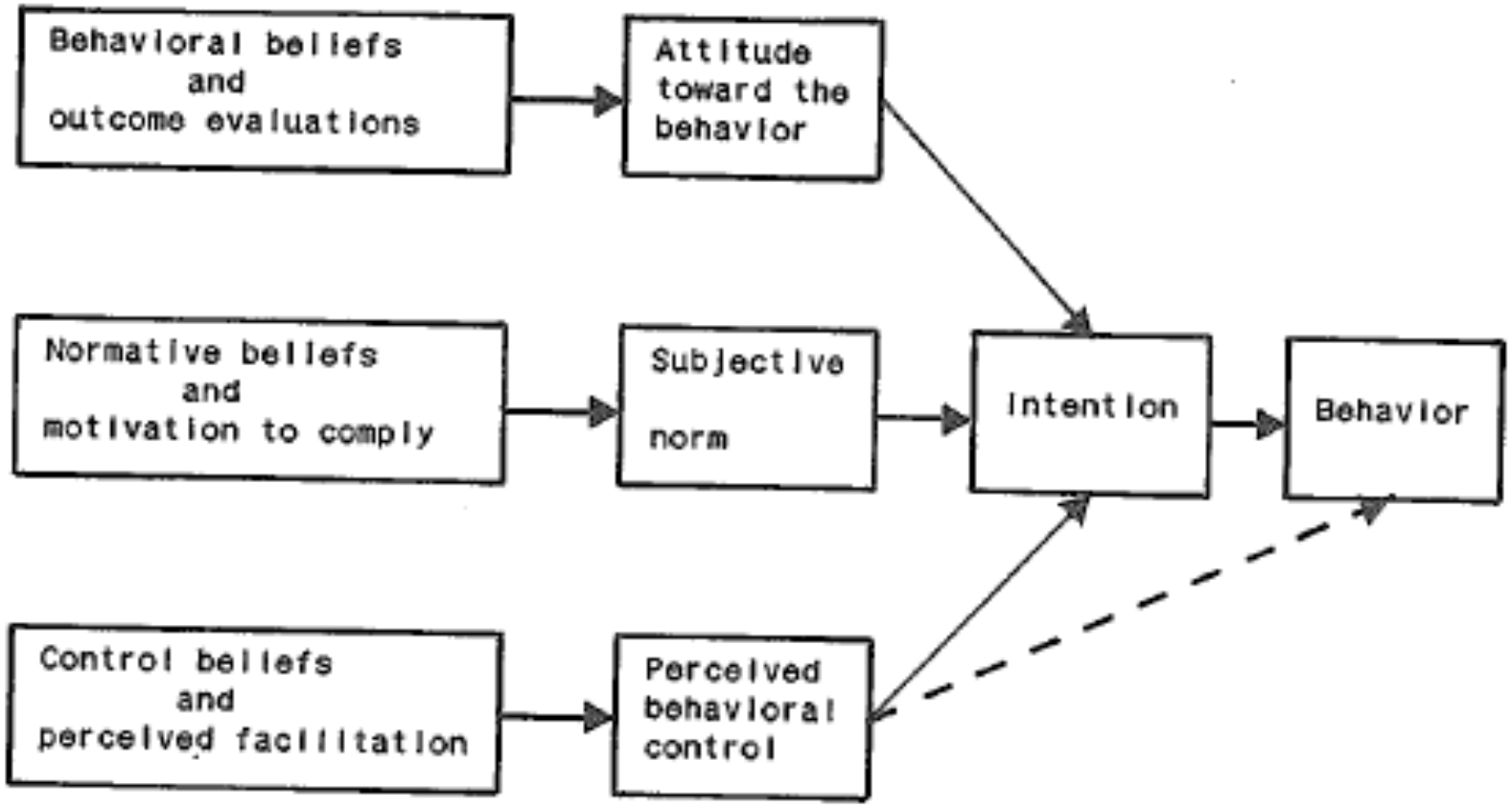
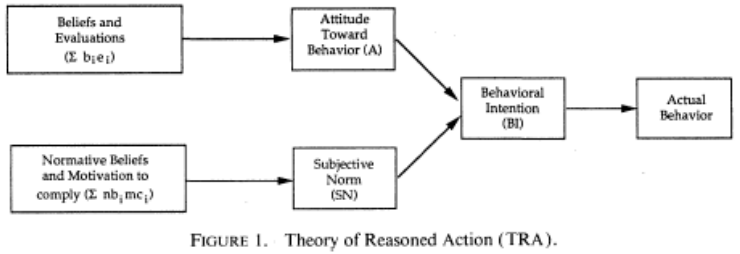


FIG. 10.2. Theory of planned behavior.

Ajzen, I., (1989) "Attitude Structure and Behavior," in A. R. Pratkanis, S. J. Breckler, and A. G. Greenwald(Eds.), Attitude Structure and Function, Lawrence Erlbaum Associates, Hillsdale, NJ, 1989, pp.241-274.

TPB (1991)



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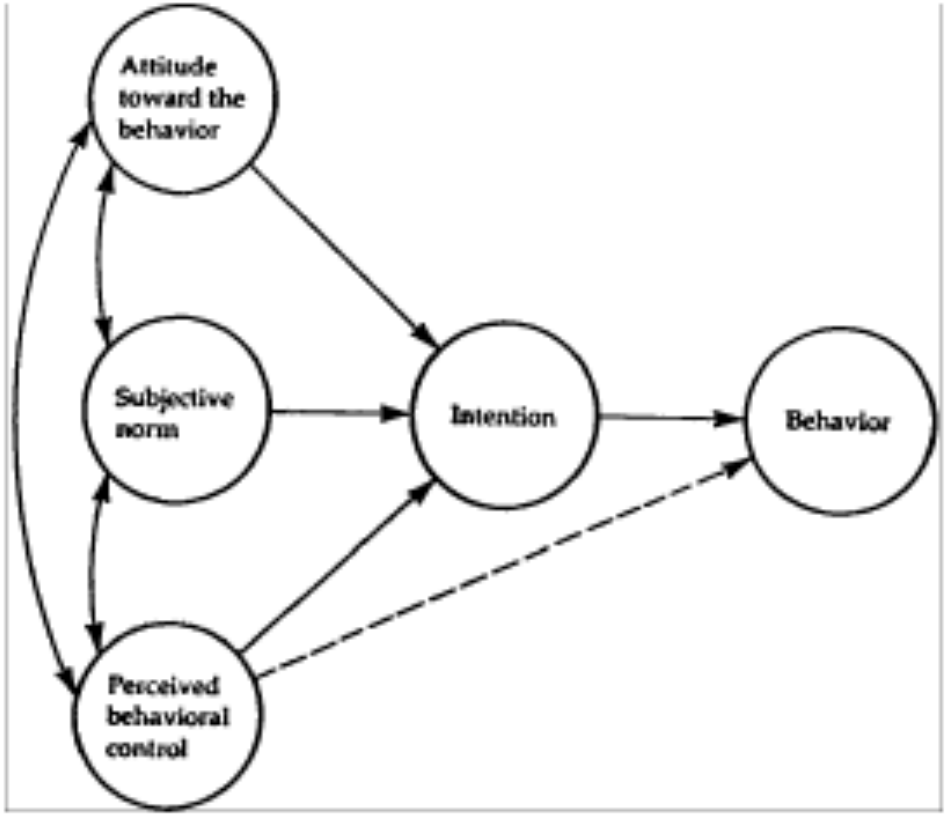
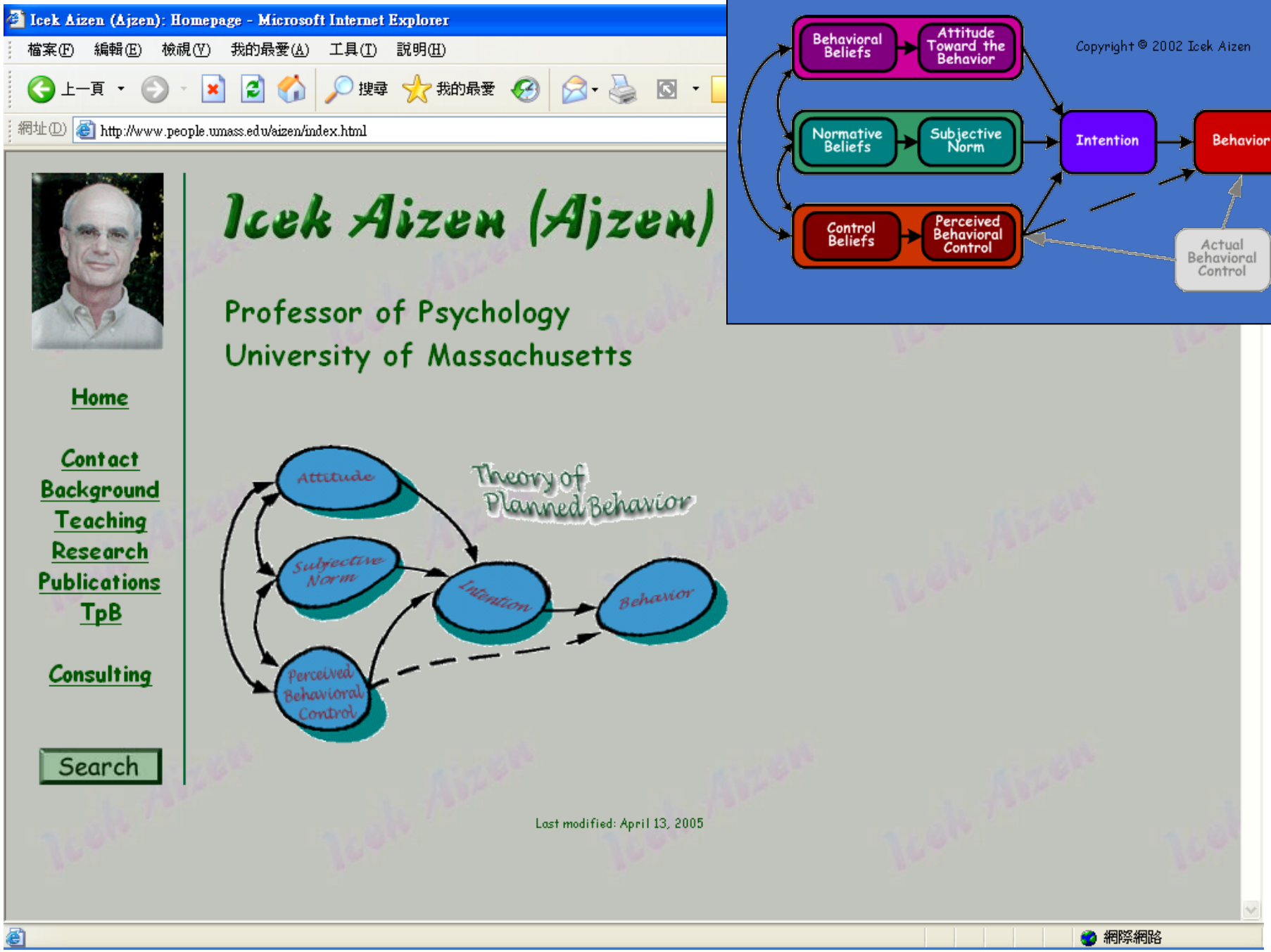


FIG. 1. Theory of planned behavior

Ajzen, I. (1991). The theory of planned behavior. Organizational Behavior and Human Decision Processes, 50, 179-211.

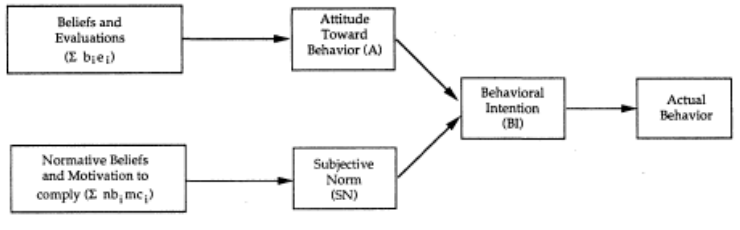


http://www.people.umass.edu/aizen/index.html

Technology Acceptance Model (TAM)

Source: Davis,F.D.,R.P.Bagozzi and P.R.Warshaw,“User acceptance of computer technology : A comparison of two theoretical models ”,Management Science,35(8),August 1989,pp.982-1003

TAM (1989)



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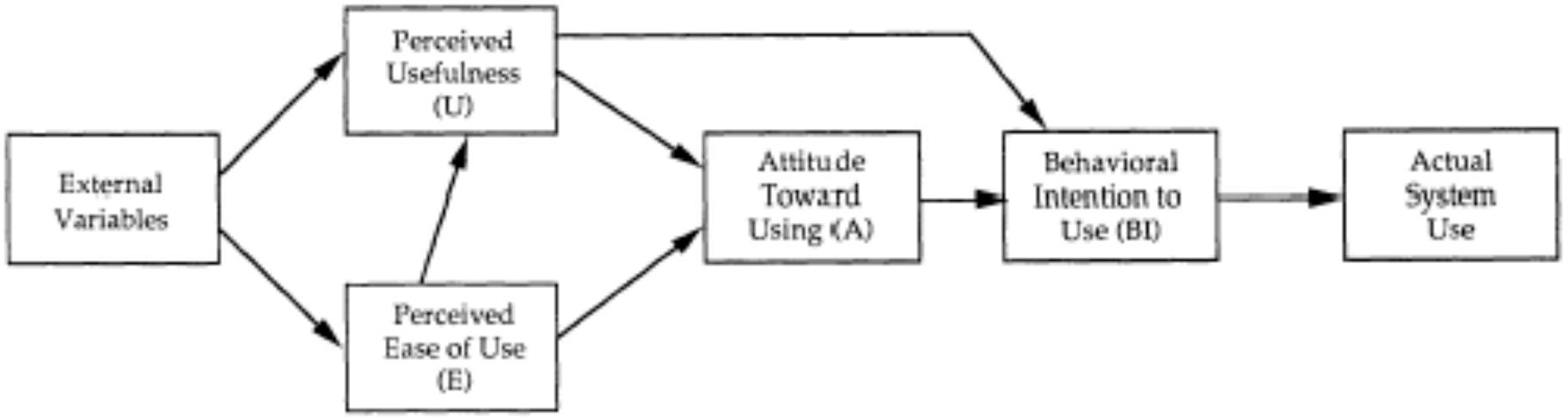


FIGURE 2. Technology Acceptance Model (TAM).

Davis,F.D.,R.P.Bagozzi and P.R.Warshaw,"User acceptance of computer technology : A comparison of two theoretical models ",Management Science,35(8),August 1989,pp.982-1003

TAM2 (2000)

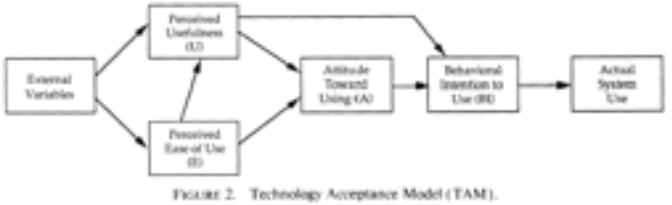
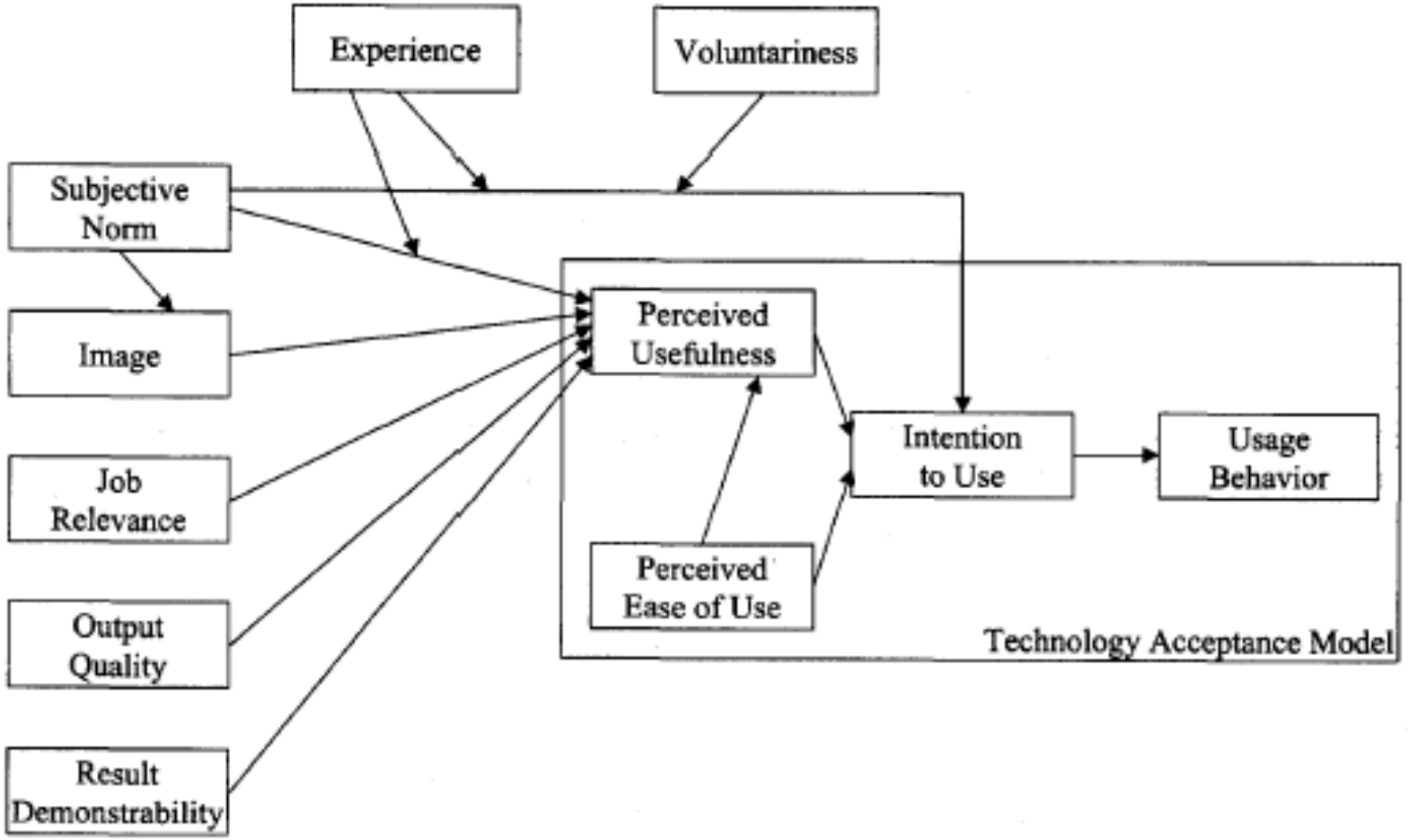


FIGURE 2. Technology Acceptance Model (TAM).

Figure 1 **Proposed TAM2—Extension of the Technology Acceptance Model**



Venkatesh, V., & Davis, F. D. (2000) "A theoretical extension of the technology acceptance model: Four longitudinal field studies", Management Science, 46(2), pp. 186-204.

Behavioral Finance

Rational Behavior

Irrational Behavior

Emotion

Sentiment

Modern Financial Research

- **Theoretical Finance**
  - **study of logical relationships among assets.**
- **Empirical Finance**
  - **study of data in order to infer relationships.**
- **Behavioral Finance**
  - **integrates psychology into the investment process.**

Source: Robert A. Strong (2004), Practical Investment Management, South-Western

Psychology in Behavior Finance

- **Beliefs**
- **Preferences**
  - **Prospect theory**
  - **Ambiguity aversion**

Source: Barberis, Nicholas, and Richard Thaler. "A survey of behavioral finance." *Handbook of the Economics of Finance* 1 (2003): 1053-1128.

Behavioral Finance Themes

- **Heuristic-Driven Bias**
- **Framing Dependence**
- **Inefficient Markets**

Source: Hersh Shefrin (2007), “Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing”, Oxford University Press.

Herding Behavior

- **Herding refers to the lemming-like behavior of investors and analysts looking around, seeing what each other is doing, and heading in that direction.**
- **There may not have been safety in numbers, but there probably was some comfort in them.**

Source: Robert A. Strong (2004), Practical Investment Management, South-Western v

Herding Behavior in Finance

- Youssef, M. (2022).
  What drives herding behavior in the cryptocurrency market?.
  Journal of Behavioral Finance, 23(2), 230-239.
- Manahov, V. (2021).
  Cryptocurrency liquidity during extreme price movements: is there a problem with virtual money?
  Quantitative Finance, 21(2), 341-360.
- Hsieh, S. F., Chan, C. Y., & Wang, M. C. (2020).
  Retail investor attention and herding behavior.
  Journal of Empirical Finance, 59, 109-132.
- Christoffersen, J., & Staehr, S. (2019).
  Individual risk tolerance and herding behaviors in financial forecasts.
  European Financial Management, 25(5), 1348-1377.
- Frijns, B., & Huynh, T. D. (2018).
  Herding in analysts' recommendations: The role of media.
  Journal of Banking & Finance, 91, 1-18.

Efficient Market Hypothesis (EMH)

Source: Hersh Shefrin (2007), “Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing”, Oxford University Press.

Expected Utility Theory (EUT)

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory: An analysis of decision under risk

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect Theory

(Kahneman and Tversky, 1979)

ECONOMETRICA

VOLUME 47 MARCH, 1979 NUMBER 2

PROSPECT THEORY: AN ANALYSIS OF DECISION UNDER RISK

BY DANIEL KAHNEMAN AND AMOS TVERSKY[1]

This paper presents a critique of expected utility theory as a descriptive model of decision making under risk, and develops an alternative model, called prospect theory. Choices among risky prospects exhibit several pervasive effects that are inconsistent with the basic tenets of utility theory. In particular, people underweight outcomes that are merely probable in comparison with outcomes that are obtained with certainty. This tendency, called the certainty effect, contributes to risk aversion in choices involving sure gains and to risk seeking in choices involving sure losses. In addition, people generally discard components that are shared by all prospects under consideration. This tendency, called the isolation effect, leads to inconsistent preferences when the same choice is presented in different forms. An alternative theory of choice is developed, in which value is assigned to gains and losses rather than to final assets and in which probabilities are replaced by decision weights. The value function is normally concave for gains, commonly convex for losses, and is generally steeper for losses than for gains. Decision weights are generally lower than the corresponding probabilities, except in the range of low probabilities. Overweighting of low probabilities may contribute to the attractiveness of both insurance and gambling.

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision Making under Risk

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Which of the following would you prefer?

- **A:**
  - **50% chance to win 1,000,**
  - **50% chance to win nothing;**
- **B:**
  - **450 for sure.**

Which of the following would you prefer?

A: 50% chance to win 1,000, 50% chance to win nothing;

B: 450 for sure.

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 1: Choose between

A:	2,500 with probability	.33,	B:	2,400 with certainty.
	2,400 with probability	.66,		
	0 with probability	.01;		

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 1: Choose between

A:	2,500 with probability	.33,	B:	2,400 with certainty.
	2,400 with probability	.66,		
	0 with probability	.01;		
$N = 72$	[18]			[82]*

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 2: Choose between

C:	2,500 with probability	.33,	D:	2,400 with probability	.34,
	0 with probability	.67;		0 with probability	.66.

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 2: Choose between

C:	2,500 with probability	.33,	D:	2,400 with probability	.34,
	0 with probability	.67;		0 with probability	.66.
$N = 72$	[83]*			[17]	

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Expected Utility

$$u(2{,}400) > .33u(2{,}500) + .66u(2{,}400) \text{ or } .34u(2{,}400) > .33u(2{,}500)$$

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 3:

A: (4,000,.80), or B: (3,000).

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 3:

A: (4,000,.80), or B: (3,000).

$N = 95$ [20] [80]*

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 4:

C: (4,000,.20), or D: (3,000,.25).

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 4:

C: (4,000,.20), or D: (3,000,.25).

$N = 95$ [65]* [35]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 5:

A: 50% chance to win a three-week tour of England, France, and Italy;

$N = 72$ [22]

B: A one-week tour of England, with certainty.

[78]*

PROBLEM 6:

C: 5% chance to win a three-week tour of England, France, and Italy;

$N = 72$ [67]*

D: 10% chance to win a one-week tour of England.

[33]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 7:

A: (6,000, .45), B: (3,000, .90).

$N = 66$ [14] [86]*

PROBLEM 8:

C: (6,000, .001), D: (3,000, .002).

$N = 66$ [73]* [27]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Preferences Between Positive and Negative Prospects

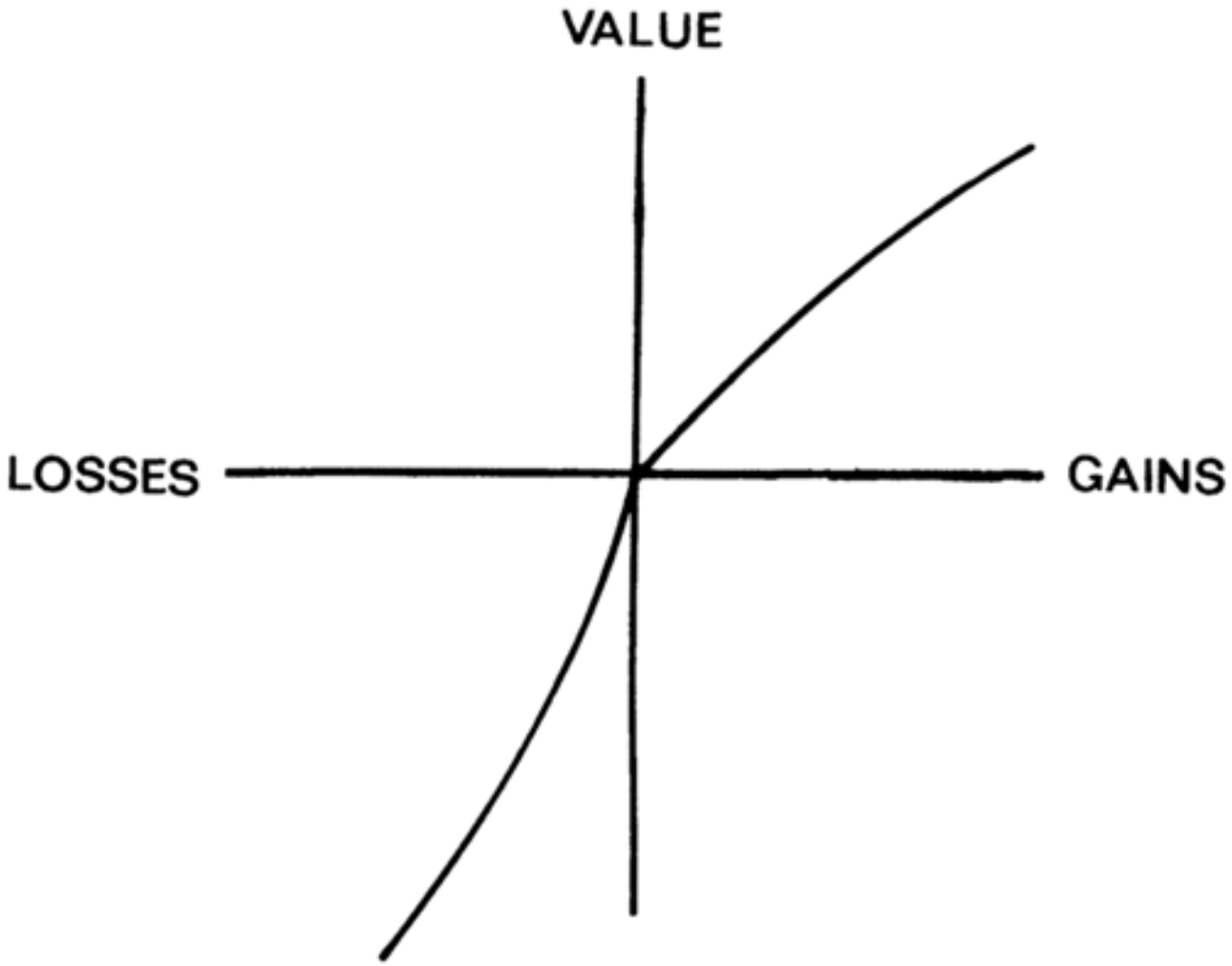
Positive prospects				Negative prospects			
Problem 3:	(4,000, .80)	<	(3,000).	Problem 3′:	(−4,000, .80)	>	(−3,000).
$N = 95$	[20]		[80]*	$N = 95$	[92]*		[8]
Problem 4:	(4,000, .20)	>	(3,000, .25).	Problem 4′:	(−4,000, .20)	<	(−3,000, .25).
$N = 95$	[65]*		[35]	$N = 95$	[42]		[58]
Problem 7:	(3,000, .90)	>	(6,000, .45).	Problem 7′:	(−3,000, .90)	<	(−6,000, .45).
$N = 66$	[86]*		[14]	$N = 66$	[8]		[92]*
Problem 8:	(3,000, .002)	<	(6,000, .001).	Problem 8′:	(−3,000, .002)	>	(−6,000, .001).
$N = 66$	[27]		[73]*	$N = 66$	[70]*		[30]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Certainty, Probability, and Possibility

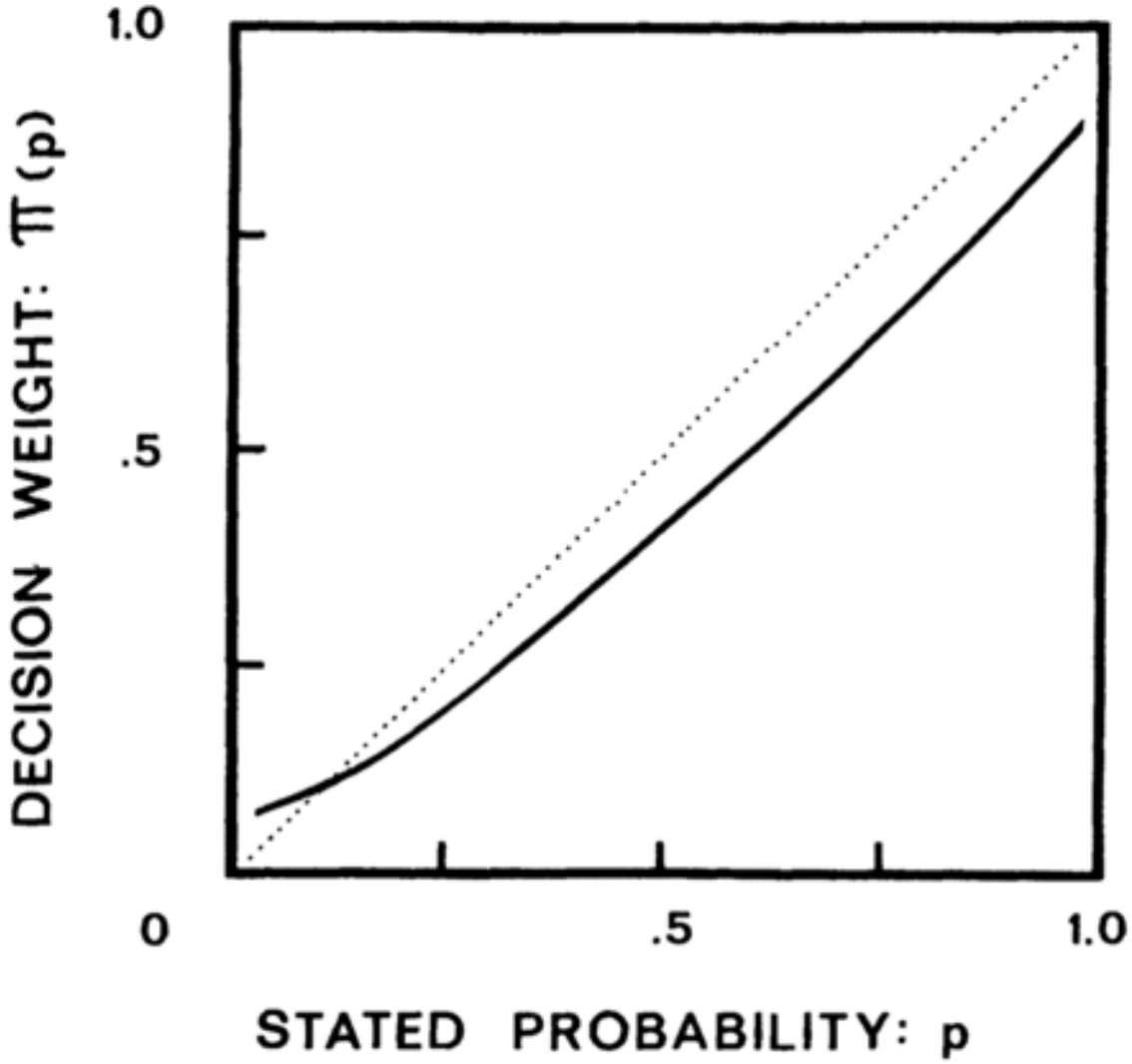
Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory
Value Function



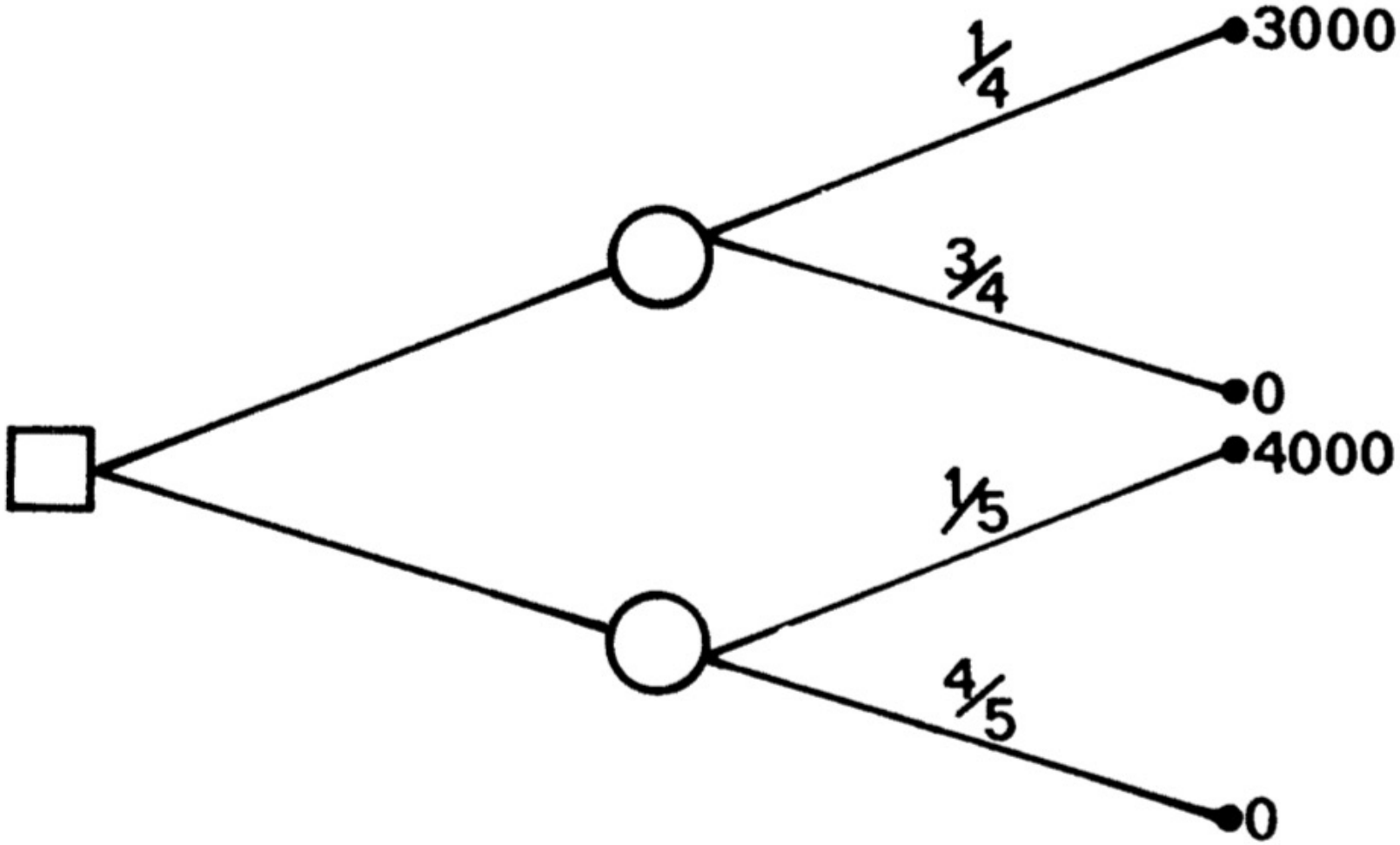
Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory Weighting Function



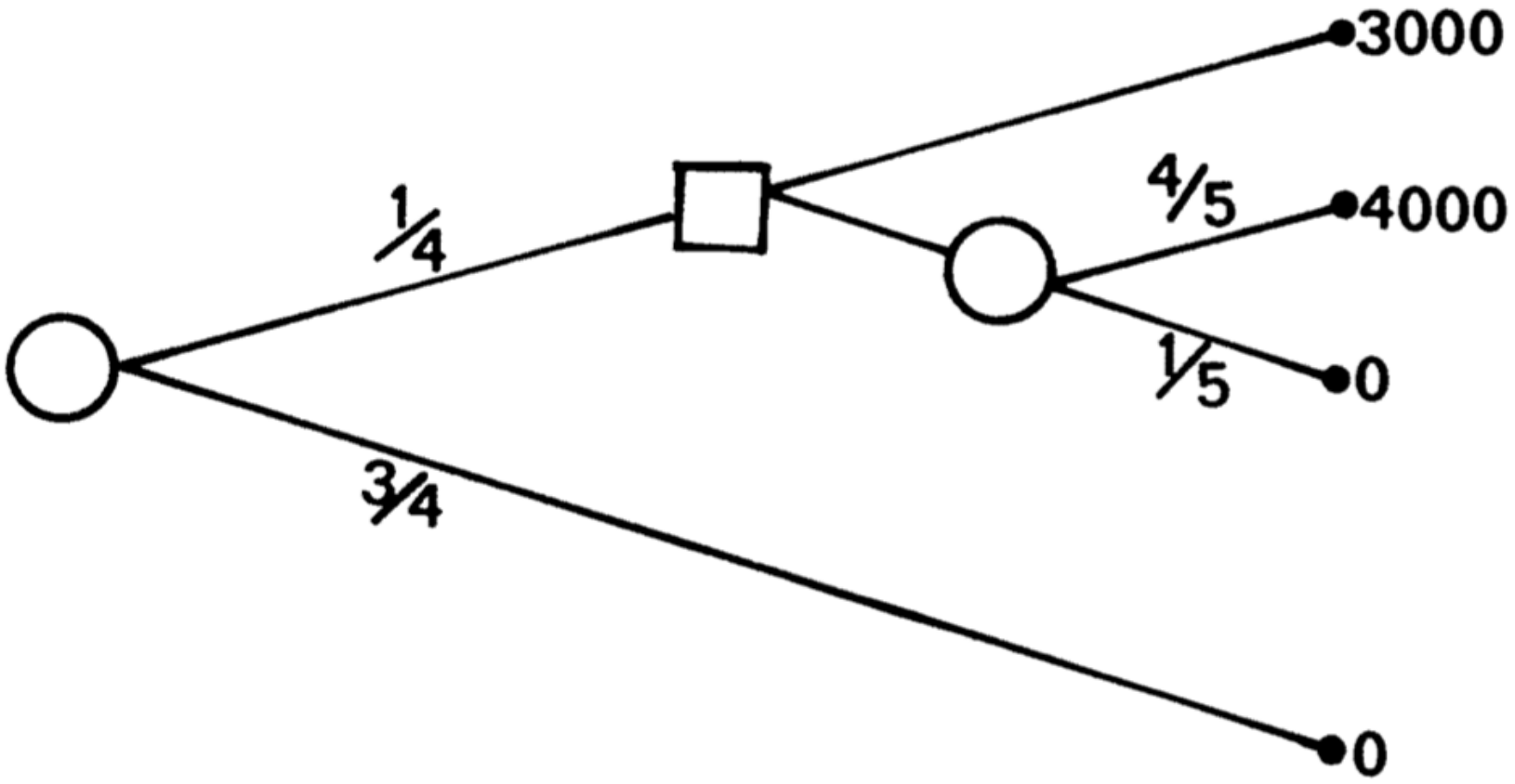
Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Problem 4 as a decision tree (standard formulation)



Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Problem 10 as a decision tree (sequential formulation)



Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 11: In addition to whatever you own, you have been given 1,000. You are now asked to choose between

A: (1,000, .50), and B: (500).

$N = 70$ [16] [84]*

PROBLEM 12: In addition to whatever you own, you have been given 2,000. You are now asked to choose between

C: (−1,000, .50), and D: (−500).

$N = 68$ [69*] [31]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 13:

(6,000, .25), or (4,000, .25; 2,000, .25).

$N = 68$ [18] [82]*

PROBLEM 13′:

(−6,000, .25), or (−4,000, .25; −2,000, .25).

$N = 64$ [70]* [30]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Decision

PROBLEM 14:

	(5,000, .001),	or	(5).
$N = 72$	[72]*		[28]

PROBLEM 14′:

	(−5,000, .001),	or	(−5).
$N = 72$	[17]		[83]*

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory

- **People underweight outcomes that are merely probable in comparison with outcomes that are obtained with certainty.**
  - **This tendency, called the certainty effect, contributes to risk aversion in choices involving sure gains and to risk seeking in choices involving sure losses.**

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory

- **People generally discard components that are shared by all prospects under consideration.**
  - **This tendency, called the isolation effect, leads to inconsistent preferences when the same choice is presented in different form .**

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory

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Prospect theory

- **Value is assigned to gains and losses rather than to final assets and in which probabilities are replaced by decision weights.**
- **The value function is normally concave for gains, commonly convex for losses, and is generally steeper for losses than for gains.**

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Prospect theory

- **Decision weights are generally lower than the corresponding probabilities, except in the range of low probabilities.**
- **Overweighting of low probabilities may contribute to the attractiveness of both insurance and gambling.**

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." *Econometrica: Journal of the econometric society* (1979): 263-291.

Behavioral Heuristics and Biases in Decision Making

Behavioral Finance Anomalies

- The Rational Man
  - Consumer Choice with Certainty
  - Consumer Choice with Uncertainty
  - The Allais Paradox

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Prospect Theory

- **The Reference Point**
- **The S-Curve**
- **Loss Aversion**

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Behavioral Finance Anomalies

- **Perception Biases**
- **Inertial Effects**
- **Causality and Statistics**
- **Illusions**

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Perception Biases

- Saliency
- Framing
- Anchoring
- Sunk Cost Bias

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Inertial Effects

- **Endowment Effect**
- **Status Quo Effect**
- **Disposition Effect**

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Causality and Statistics

- Representativeness
- Conjunction Fallacy
- Reading into Randomness
- Small Sample Bias
- Probability Neglect

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Illusions

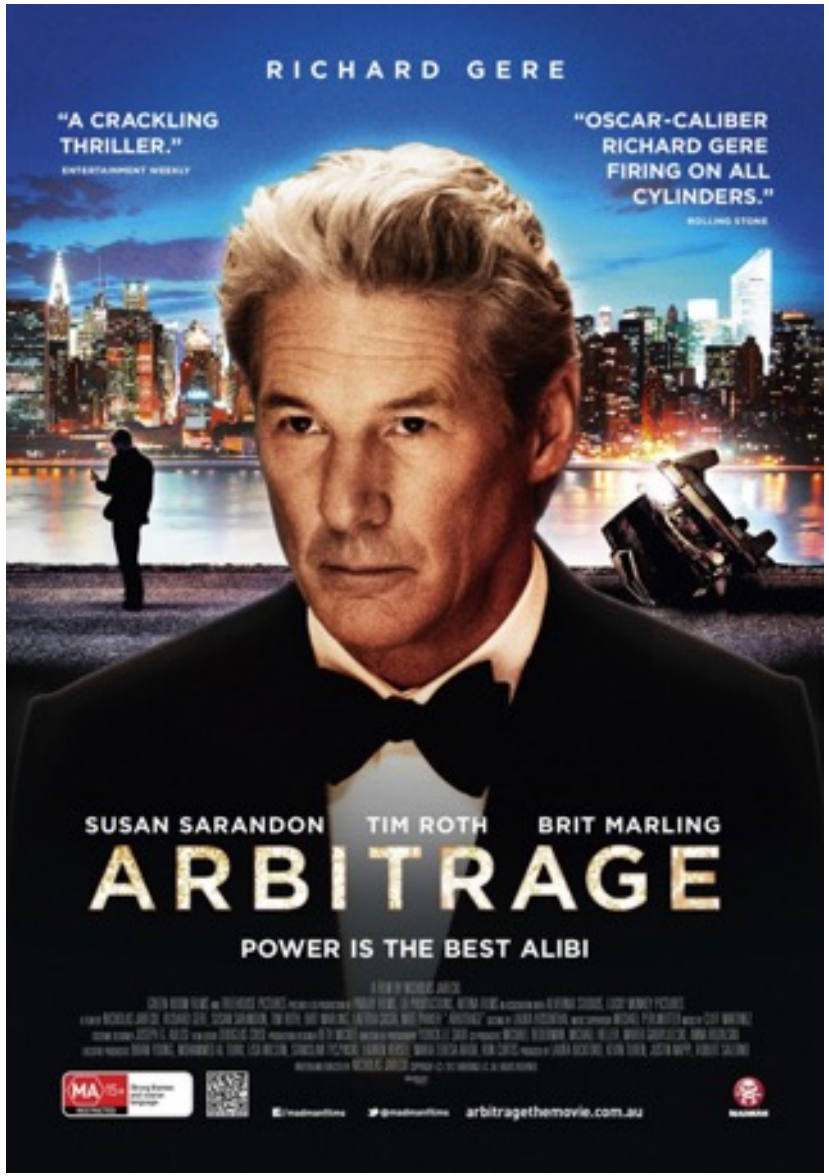
- Illusion of Talent
- Illusion of Skill
- Illusion of Superiority
- Illusion of Validity

Source: Edwin Burton and Sunit N. Shah (2013), “Behavioral Finance: Understanding the Social, Cognitive, and Economic Debates”, Wiley.

Behavioral Finance: Two Major Foundations

- **Investor Sentiment**
  - **creates disturbances to efficient prices.**
- **Limited arbitrage**
  - **arbitrage is never riskfree, hence it does not counter irrational disturbances.**
    - Prices may not react to information by the “right” amount.
    - Prices may react to non-information.
    - Markets may remain efficient.

Arbitrage



Source: http://www.beliefnet.com/columnists/moviemom/2012/09/interview-nicholas-jarecki-of-arbitrage.html

Arbitrage

Heuristics

- **Overconfidence**
  - **people overestimate the reliability of their knowledge.**
- **Excessive trading**
- **Framing Effect**

Heuristics

- Regret Aversion
  - anticipation of a future regret can influence current decision.
- Disposition Effect
  - sell winners, hold on to the losers.
- Anchoring and adjustment: can create under-reaction.

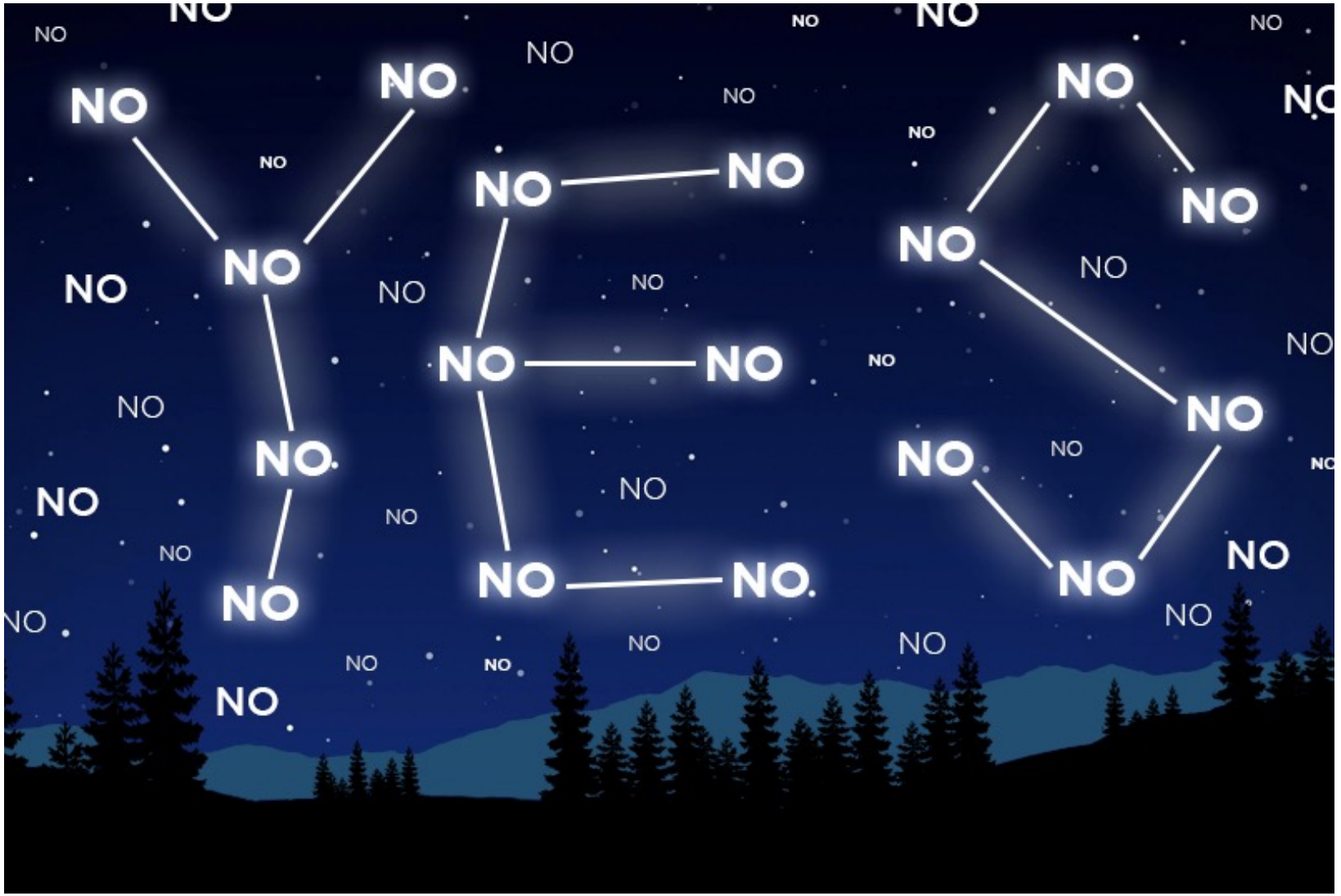
Fashions and Fads

- People are influenced by each other. There is a social pressure to conform.
- Herding behavior: “safety-in-numbers”.
- Informational Cascades
- Positive Feedback
- Example: excessive demand for internet IPOs. Extremely high opening day returns.

Social Influences

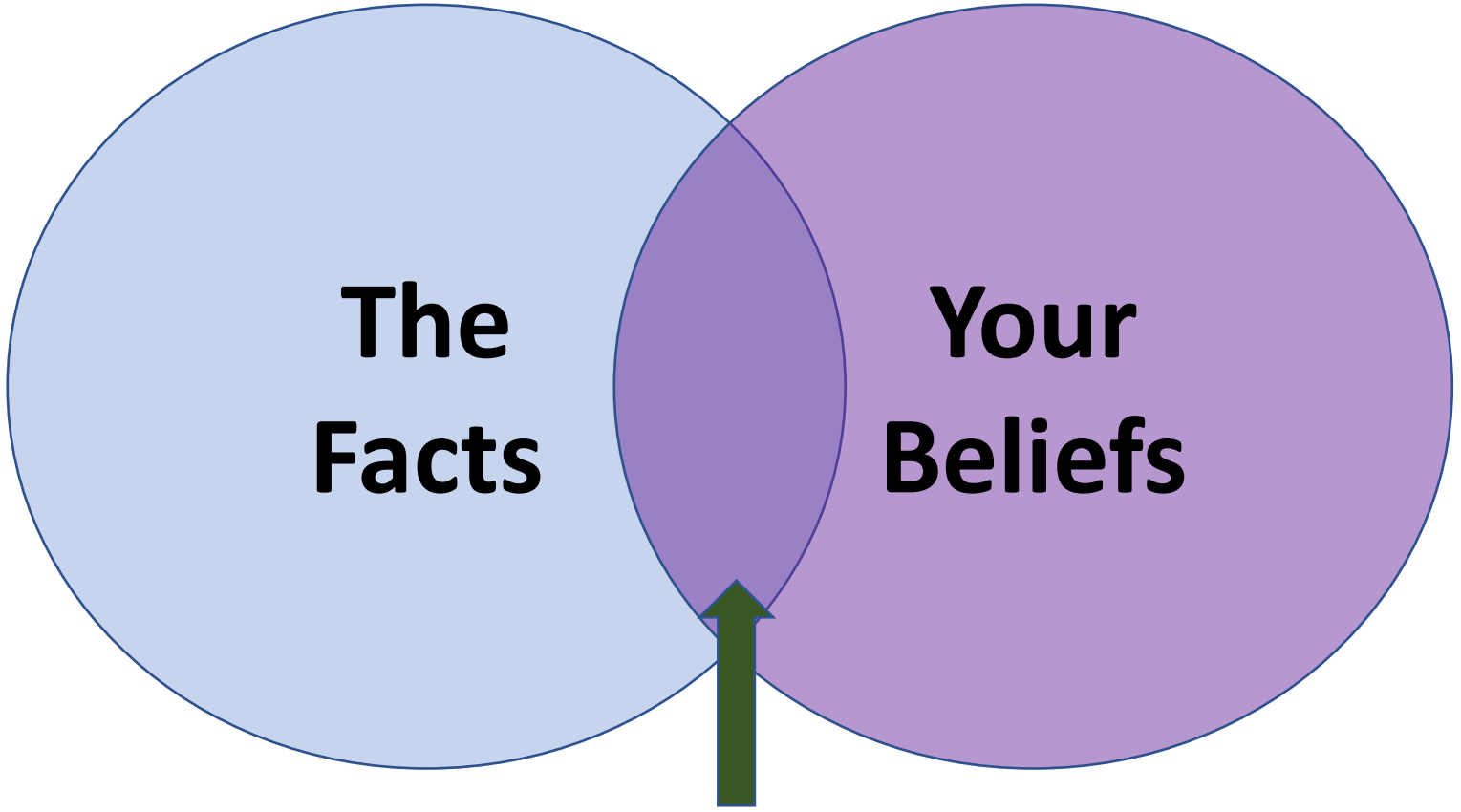
- **Social norms**
  - **The informal opinions, rules, and procedures of a group.**
  - **Your piers and social groups influence your investment participation**
- **Herding Behavior**
  - **The movement into or out of a stock or industry of companies by large groups of investors.**

Psychology of Belief
Confirmation Bias



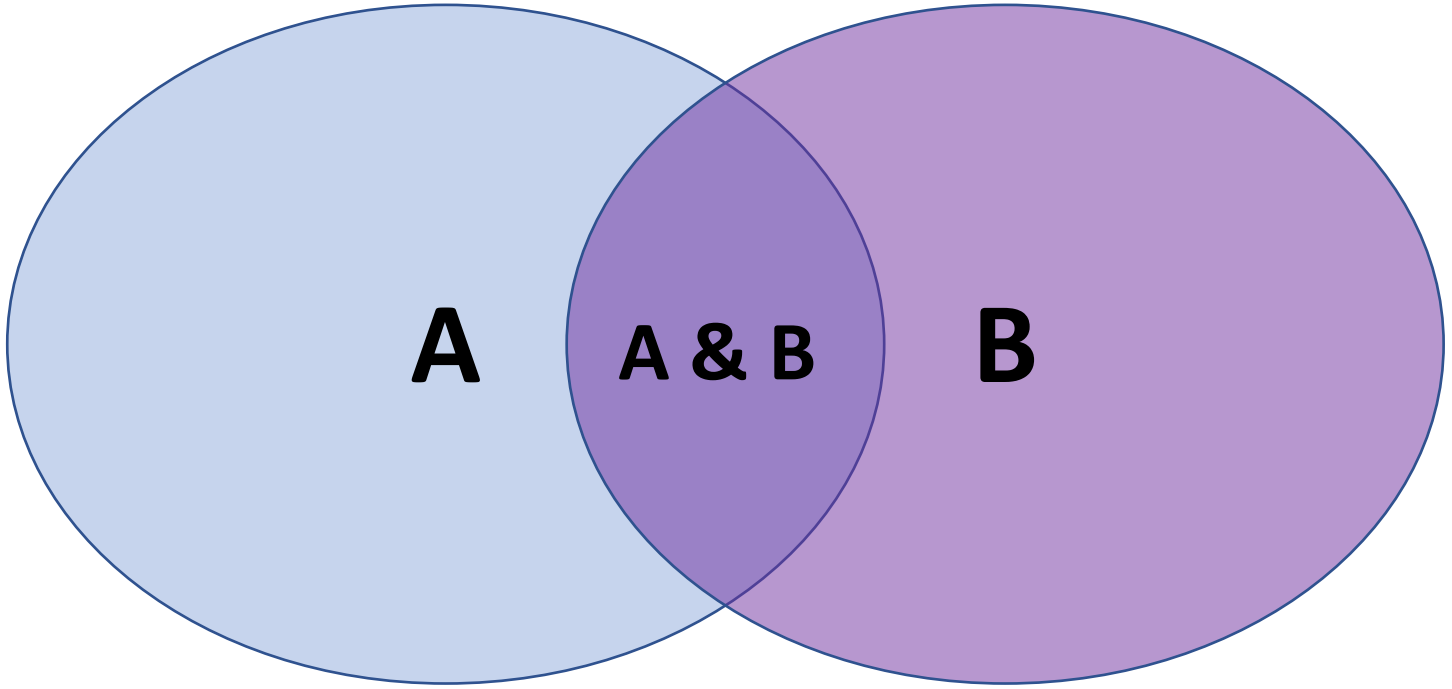
Source: https://www.interaction-design.org/literature/article/confirmation-bias-it-s-not-what-we-think-we-know-that-counts

Confirmation Bias



Source: Robert A. Strong (2004), Practical Investment Management, South-Western

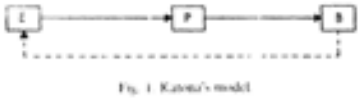
Representativeness Heuristic

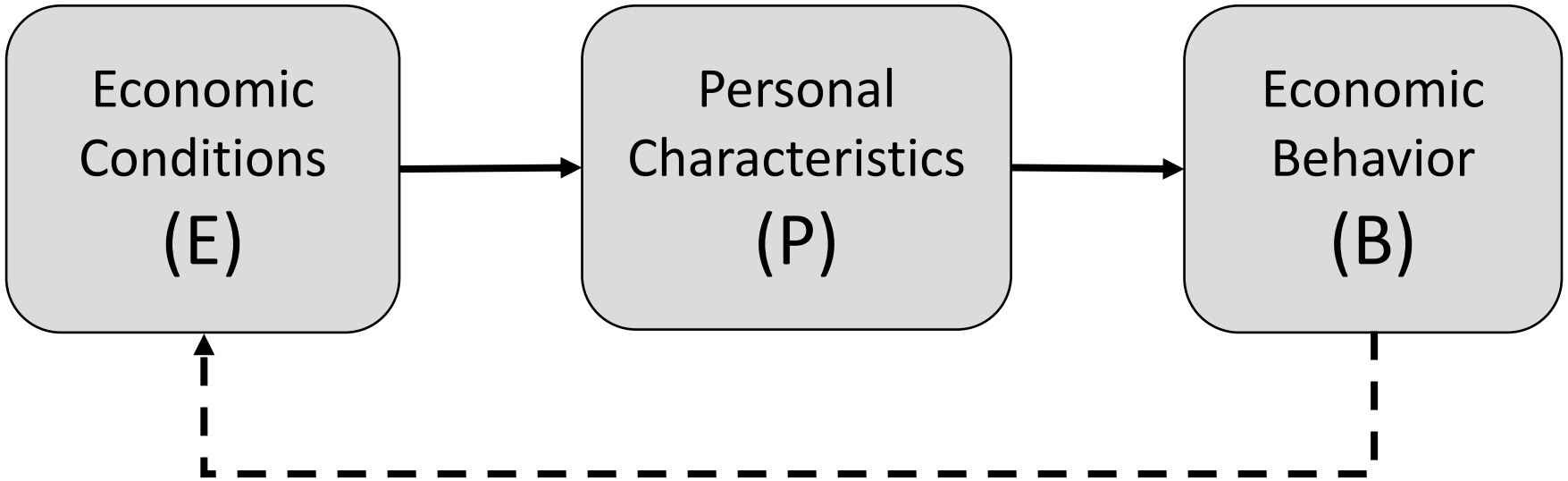


P (A & B) < P (A) or P (B)

Source: Robert A. Strong (2004), Practical Investment Management, South-Western

Katona's Economic Psychology Model

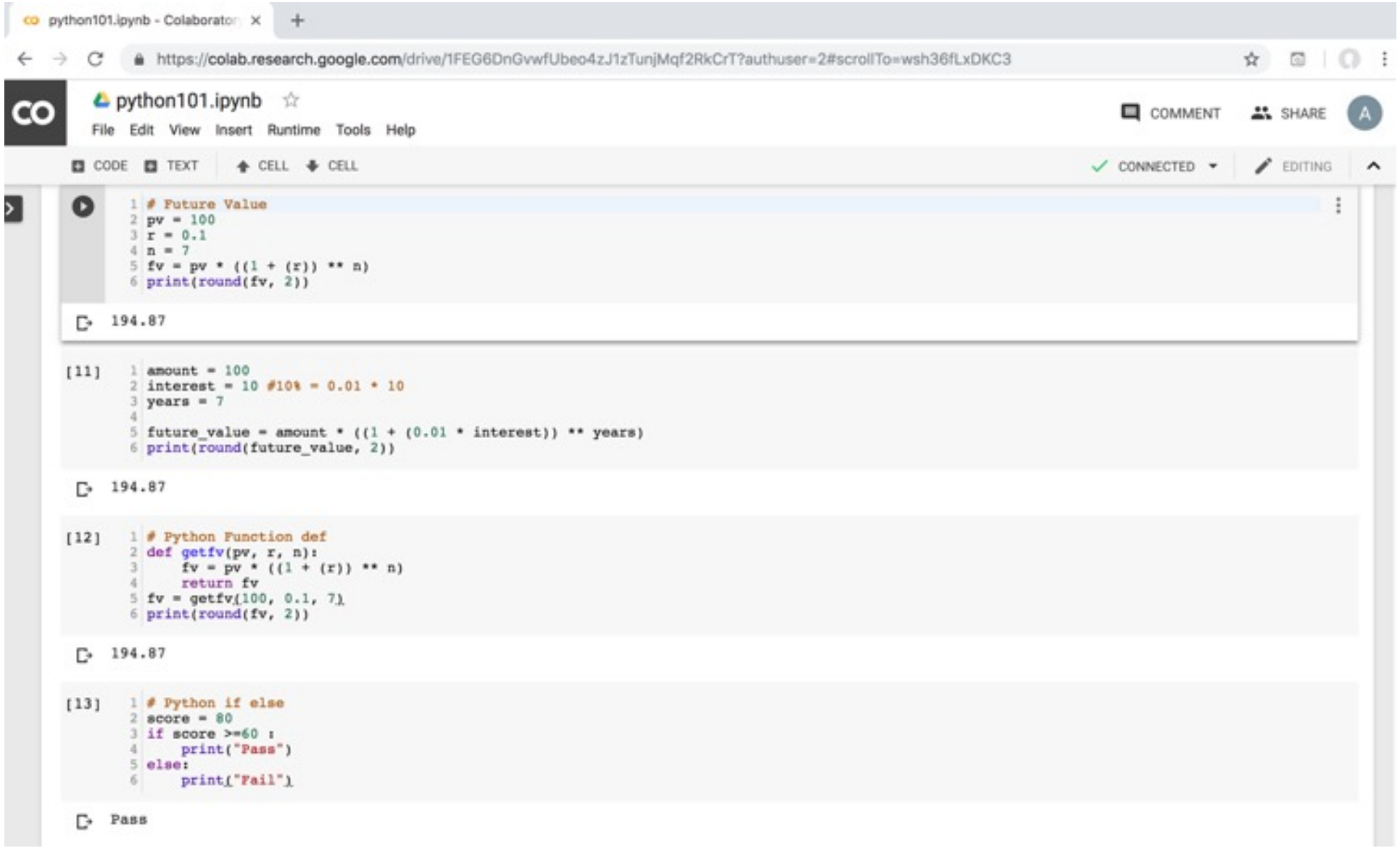




Source: Van Raaij, W. Fred. "Economic psychology." *Journal of Economic Psychology* 1, no. 1 (1981): 1-24.

Python in Google Colab (Python101)

https://colab.research.google.com/drive/1FEG6DnGvwfUbeo4zJ1zTunjMqf2RkCrT



https://tinyurl.com/aintpupython101

Summary

- Investing Psychology
  - Investor Sentiment
  - Consumer Psychology and Behavior
- Behavioral Finance
  - Prospect Theory: An Analysis of Decision Under Risk
  - Behavioral Heuristics and Biases in Decision Making
  - Herding Behavior in Finance

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