Book review on behavioral finance

Business, Marketing

Introduction

The book " Greed and Fear" is a very powerful account of the impacts of psychology on economics. This book takes an insight overview of the investor irrationalities and its effects on the market prices and returns. The author gives an account of how the effects contradict the efficient market hypothesis. According to the author, the phrase " hope and fear" gives a better description of the reactions and the behavior of different market players. From the book it can be established that all financial practitioners eventually let bias, overconfidence and emotion influence their judgment and actions. The author uses the latest psychological research to help the reader understand the human behavior which guides stock selection, financial services and corporate financial strategy. He adds that any financial practitioner must acknowledge and understand behavioral finance. If this is upheld, then most of the mistakes which are caused by human error can be easily avoided. The author states that if the financial community deliberately or unknowingly ignores the psychology of investing then they are likely to suffer both short term and long term consequences. The book can help the financial practitioners avoid bias and errors in the process of decision making and hence improve their overall investment strategies.

Chapter 1

Hersh Shefrin defines behavioral finance as a progressively growing area which deals with the influence of psychology on the actions/behavior of the financial practitioners. According to the author, psychology rules the stock market. He gives an account on how bias, view of different stakeholders and other aspects of psychology constantly jangle investors and move the stocks. The concept of behavioral finance can be felt in any setting that involves the making of financial decisions. Psychology affects almost every corner of the financial setting. There is need for the financial practitioners to understand the impact of psychology on them either directly or indirectly. In this book, the author establishes that psychology is as important as market fundamentals. The author gives an illustration on how investors are affected by fear, hope, overconfidence and the need for short-term satisfaction. This book several examples of investment mistakes and gives an analysis from a behavioral point of view. The themes being addressed in the book are: Heuristic-Driven Bias, Frame Dependence and Inefficient Markets. All these themes are meant to explain the investor behavior from a psychological point of view. This book takes a look at the way psychology can be used to predict the market trends of different commodities at different times. There is need for the satisfaction of every investor both financially and psychologically. Most investors will make a decision depending on the perception that they have pertaining to a given market segment. Investors will tend to put in more resources on the areas whereby they feel that they are likely to get a return for their investments. They will in turn shy off from areas marred with uncertainties. The author analyses the behavior of different stakeholders by taking a look at the three themes as indicated in the following analysis.

Chapter 2: Heuristic-driven bias: The First Theme

The first theme of the book, “ Heuristic-driven bias” focuses on the decisions that are made by the investors and their effects. The heuristic balance is the improper influence of imperfect postulation and imperfect decision strategies that can lead investors to making mistakes in their judgment. It includes behavioral concepts like availability, representativeness, anchoring-and-adjustment, overconfidence and aversion to ambiguity.

A heuristic decision making strategy is a kind of an informal and tentative form that is usually used for making decisions. This approach influences the way people make judgments by affecting the way information is processed from a complex environment. This approach can be helpful at times but is not always accurate. This approach allows for a greater chance of errors as it is based mainly on speculations. It makes the work of making decisions lighter. The human mind is limited in the way it handled information and the process of decision making. It cannot handle a lot of information at once. The human mind's working memory will give a chance of considering just a few operations at one instance and the rest later.

There are several types of heuristic driven bias. They include:

a) Availability heuristic

This type of heuristic occurs when we make judgments on the basis of how easily we can call to mind what we perceive as relative instances of a given phenomenon. This part involves the emotions a lot and it is more credible and clearer than the actual statistical probability of the event which is occurring. This type of heuristic causes the following biases:

i) Ease of recall – this is based on the vividness/clarity of an instance

ii) Retrievability – this is based on memory structures

iii) Presumed associations – based on the processing actions of the memory.

b) Representativeness Heuristic

In this kind of heuristic, people are concerned with some traits that an individual or an event may have which correspond to some previously formed pigeonhole. This type of heuristic causes the following types of biases:

i) Insensitivity to sample size

ii) Misconceptions of chance

iii) Regression to the mean

Overconfidence

This states that people tend to believe in themselves so much and are imperfect at gauging their own levels of accuracy. People also fail to appreciate the difficulty of questions and will try to handle it even if they are not sure with the responses that they are giving. They usually do not decrease their confidence as their knowledge about the subject or question decreases. It also states that people tend to be more overconfident when asked to respond to questions of moderate to extreme difficulty than when they are asked to respond to simpler questions. They will not accept that they are incapable of answering some set of questions that they are asked.

Anchoring and Adjustment

This is a psychological form of heuristic which influences the way people make asses probabilities by instinct. In this approach, people will start with some reference point which is also known as the anchor and then make adjustments to the reference point so as to reach or tend to reach the estimated point. People will respond conservatively. In this approach, people respond predictably to new information especially if the new information increases the level of uncertainty.

Aversion to Ambiguity

This describes an approach of favoritism for known risks over unknown risks or a preference of familiar risks to unfamiliar risks.

Chapter 3 - Frame Dependence: The Second Theme

Frame dependence means that people make decisions which are influenced by the manner in which information is presented to them. This approach manifests itself in the way that people form different attitudes towards gains and losses. A person will make different decisions if a problem is framed differently in terms of gains and losses. When a problem is framed in terms of a loss, the decision which will be made by a person will be totally different with the decision which will be made if the same person is framed with the same problem but now in terms of a gain. The main reason for this kind of behavior is the loss of aversion/distaste. A process of hedonic editing involves choosing frames that are more attractive than others. In this scenario, more attractive frames will be preferred to the less attractive ones. Hedonic editing is commonly used by those people who have self-control problems so as to help them in dealing with the problem of self control. There is evidence that some investors use dividends in this way so as to have the best value for their investments. Other illustrations of framing issues which can be found in the chapter are: money illusion and incorrect factoring in of inflation and deflation.

Chapter 4 – Inefficient Markets: The Third Theme

Many markets that are in existence are inefficient in different ways. A market can be said to be efficient only if the prices of the commodities coincide with their intrinsic values. The first two themes of the book; " Heuristic-driven and frame dependence" when combined together, make markets inefficient. In this section of the book we find representativeness which leads to the winner-loser effect. Winner loser effect is a situation whereby the investor overreaction causes a prior long term winners to become future long term losers. The prior long term losers also get a chance to become future short term winners.

We also encounter conservatism which leads to security analysts to underreact to the surprises in earnings. This results into the generation of short term momentum in stock prices. The frame dependence makes investors to frame stock returns in terms of short horizons instead of long horizons. This will make the investors to require a larger equity premium than what they could have required if they framed the returns using longer horizons.

Conclusion

Psychology is a very important aspect of life and should not be ignored under what circumstances. It can be felt in almost all aspects of our lives. The book takes an account on how psychology affects different parts of the economy and the most appropriate actions that need to be taken to ensure that investments are not affected negatively. Different decisions which are made by the investors affect them in different ways. Heuristic-driven bias for instance focuses on the effects of the decisions which are made by the investors. It can also be established that the manner in which information is presented to a person also has a very bib impact on the reaction or the action that a person is likely to take as can be seen in the case of frame dependence. In this situation, a person will make different decisions when a similar problem is presented to him/her but framed with either a loss or a gain. It can also be established that market efficiency is also a very important aspect of investment which also depends on psychology. The perception of the investors will determine the efficiency of the market since if many investors shy off from a given place due to fear then the market for items in such place cannot be as efficient as it could have been in places where there is investor confidence is upheld. The aspect of psychology has been ignored for a very long period of time. I would therefore highly recommend this book to investors or anyone planning to invest in different sectors of economy so that he/she can realize the importance of psychology in the field of investment.

References

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

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