



Behavioral Finance Explained for the Markets



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Behavioral finance is a field that combines psychology with traditional finance to understand how human emotions, cognitive errors, and biases influence financial decisions and market outcomes.

Unlike traditional finance, which assumes that individuals are rational and markets are efficient, behavioral finance recognizes that investors often act irrationally, leading to deviations from expected financial outcomes.

In this post, we go through behavioral finance and how you can use it to your advantage with your trades.

What is Behavioural Finance

Behavioral finance explores how psychological factors impact investors and financial markets. It seeks to explain why investors frequently struggle with self-control, act against their best interests, and make decisions driven by personal biases rather than objective facts.

A contemporary example of this can be seen in the 2021 events involving Reddit, GameStop, Robinhood, and Melvin Capital, which highlighted how irrational, biased, and emotional behaviors can influence market movements.

Behavioural Finance Concepts

Behavioral finance can be examined from multiple perspectives.

While [stock market](#) returns are often cited as a prime example of how psychological behaviors influence market outcomes, there are many other angles to consider.

The goal of classifying behavioral finance is to understand better why individuals make confident financial decisions and how those decisions impact the markets.

In this field, it is assumed that financial participants are not perfectly rational or self-controlled but are instead influenced by psychological factors and exhibit a mix of normal and self-regulating behaviors.

“It’s an understatement to say that financial health affects mental and physical health and vice versa. It’s a cyclical relationship,” said Dr. Carolyn McClanahan, founder and director of Financial Planning at Life Planning Partners Inc. “When people are stressed about finances, they release chemicals called catecholamines, such as epinephrine, that can put the entire body on high alert. This not only affects mental health and cognitive function but also physical health, leading to exhaustion, sleep problems, and the development of harmful coping behaviors.”

A crucial aspect of behavioral finance is the role of biases. These biases can arise for various reasons and are typically categorized into five key concepts.

Understanding and classifying these different types of biases is essential for analyzing industry or sector outcomes and results in a focused manner.



Behavioural Finance Theory

Behavioral finance is a contemporary field that seeks to merge behavioral and cognitive psychology insights with traditional economics and finance, aiming to explain why individuals often make irrational financial decisions.

Unlike the Efficient Market Hypothesis (EMH), which suggests that competition among investors drives prices to their "correct" values, behavioral finance posits

that financial markets are informationally inefficient. The EMH acknowledges that not all investors are rational but assumes that markets make unbiased predictions.

In contrast, behavioral finance argues that markets can fail to reflect economic fundamentals due to irrational behavior, systematic patterns, and limits to arbitrage.

Applications of behavioral finance can be seen in phenomena such as inflation and the underpricing of IPOs. The theory holds that when investors fail to process all available information correctly, their irrational behavior can lead to persistent price deviations from a company's actual value.

For instance, when a large group of investors exhibits similar irrational behaviors—like overconfidence, overreaction, or representativeness—these [patterns can be powerful](#) enough to distort a company's share price away from its economic fundamentals.

Two notable phenomena observed in the markets are long-term reversals and short-term momentum.

Long-term reversal refers to the tendency of high-performing stocks in recent years to become low performers in the following years, which behavioral finance theorists attribute to investor overreaction.

Conversely, momentum occurs when stocks that have delivered positive returns over the past few months continue to do so for several more months.

However, behavioral finance still struggles to explain why investors overreact in some situations, such as IPOs, and underreact in others, like earnings announcements.

Given the assumption that a company's share price will eventually revert to its intrinsic value, managers should use discounted cash flow (DCF) valuation when making strategic decisions.

Behavioural Finance Examples

Cognitive biases emerge when economic and financial heuristics lead to faulty judgments and beliefs. Some of the most common cognitive biases include:

- **Self-attribution bias:** Attributing successful investment outcomes to personal skill while blaming unfavorable results on bad luck.
- **Confirmation bias:** Focusing on information that supports existing beliefs about finance or investments while disregarding information that contradicts them.
- **Representative bias:** Assuming a stronger correlation between two things or events than exists.
- **Framing bias:** Reacting to a financial opportunity based on how it is presented rather than its intrinsic merits.
- **Anchoring bias:** Allowing the first price or number encountered to influence your opinion or decision disproportionately.

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- **Loss aversion:** Placing more emphasis on avoiding losses than recognizing potential gains, leading to missed investment opportunities.

These biases and the heuristics that contribute to them significantly impact investor behavior, market psychology, cognitive errors, and emotional decision-making.

Hot to Use Behavioural Finance in Your Trading

Recognizing these common biases is the first step in minimizing their impact. The next step is to develop habits that help counteract them.

Here are some strategies:

- **Automate your savings:** Set up automatic transfers to your savings with each paycheck, ensuring you spend less than you earn without thinking about it.
- **Create a written investment plan:** Document and refer to your investment strategy when considering changes. This helps maintain consistency and reduces impulsive decisions.
- **Implement a waiting period:** Before making any changes to your investment plan, impose a delay of two weeks or a month. During this time, document the reasons for the change and update your plan accordingly.

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- **Have a strategy for market downturns:** When market corrections make you anxious, resist the urge to check your accounts frequently. Avoid logging in until you hear positive recovery news, or use techniques like J.L. Collins' [stock market](#) meditation to stay calm.
 - **Set a research deadline:** Thoroughly research your investments, but set a time limit to decide. Accept that risk is always present, and your goal is to minimize it, not eliminate it.
 - **Seek an advisor or a knowledgeable partner:** Discuss your decisions with an investing advisor or a trusted friend who can provide an objective perspective. They can help you identify biases like hindsight bias and confirmation bias.
 - **Diversify your information sources:** Expose yourself to various viewpoints that challenge your investing philosophy. This will help you question your assumptions and broaden your understanding.
 - **Be realistic about your skills:** Acknowledge that you're an average investor. Just because you're an expert in one field doesn't mean you have the same expertise in investing. Humility can prevent overconfidence.
 - **Keep an investing journal:** Regularly review your past decisions to see if you genuinely "saw it coming." This reflection can help you learn from your experiences and avoid repeating mistakes.