Investing Psychology and Behavioral Finance

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

https://meet.google.com/paj-zhhj-myq
# Syllabus

<table>
<thead>
<tr>
<th>Week</th>
<th>Date</th>
<th>Subject/Topics</th>
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<tr>
<td>1</td>
<td>2022/09/13</td>
<td>Introduction to Artificial Intelligence in Finance and Quantitative Analysis</td>
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<td>2</td>
<td>2022/09/20</td>
<td>AI in FinTech: Metaverse, Web3, DeFi, NFT, Financial Services Innovation and Applications</td>
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<td>3</td>
<td>2022/09/27</td>
<td>Investing Psychology and Behavioral Finance</td>
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<td>6</td>
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<td>2022/11/22</td>
<td>Industry Practices of AI in Finance and Quantitative Analysis</td>
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<td>12</td>
<td>2022/11/29</td>
<td>Case Study on AI in Finance and Quantitative Analysis II</td>
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<td>2022/12/06</td>
<td>Deep Learning in Finance; Reinforcement Learning in Finance</td>
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<td>14</td>
<td>2022/12/13</td>
<td>Algorithmic Trading; Risk Management; Trading Bot and Event-Based Backtesting</td>
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<td>2022/12/20</td>
<td>Final Project Report I</td>
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<td>16</td>
<td>2022/12/27</td>
<td>Final Project Report II</td>
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<td>17</td>
<td>2023/01/03</td>
<td>Self-learning</td>
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<tr>
<td>18</td>
<td>2023/01/10</td>
<td>Self-learning</td>
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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
Fear & Greed Index

What emotion is driving the market now?

Source: https://money.cnn.com/data/fear-and-greed/
Consumer Psychology and Behavior
How consumers think, feel, and act

Fintech: Technology Innovation in Financial Services
Fintech Impact on Consumer Behavior

Behavioral Finance
Edwin Burton and Sunit N. Shah (2013)

Behavioral Finance:
Understanding the Social, Cognitive, and Economic Debates,
Wiley

Lucy Ackert and Richard Deaves (2009), Behavioral Finance: Psychology, Decision-Making, and Markets, South-Western College Pub

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

H. Kent Baker and Victor Ricciardi (2014)

Investor Behavior:
The Psychology of Financial Planning and Investing,

Wiley

Marketing

“Meeting needs profitably”

Value

the sum of the tangible and intangible benefits and costs

Value

Total customer benefit

Customer perceived value

Total customer cost

Customer Perceived Value

- Product benefit
- Services benefit
- Personnel benefit
- Image benefit

Total customer benefit

- Monetary cost
- Time cost
- Energy cost
- Psychological cost

Total customer cost

Customer perceived value

Model of Consumer Behavior

Marketing Stimuli
- Products & Services
- Price
- Distribution
- Communications

Other Stimuli
- Economic
- Technological
- Political
- Cultural

Psychology
- Motivation
- Perception
- Learning
- Memory

Buying Decision Process
- Problem Recognition
- Information Search
- Evaluation of Alternatives
- Purchase decision
- Post-purchase behavior

Purchase Decision
- Product choice
- Brand choice
- Dealer choice
- Purchase amount
- Purchase timing
- Payment method

Building Customer Value, Satisfaction, and Loyalty

Customer Perceived Value, Customer Satisfaction, and Loyalty

Theory of Reasoned Action (TRA)

TRA (1975)

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

TRA (1989)

Beliefs and Evaluations ($\Sigma b_i e_i$) → Attitude Toward Behavior (A) → Behavioral Intention (BI) → Actual Behavior

Normative Beliefs and Motivation to comply ($\Sigma n b_i m c_i$) → Subjective Norm (SN) → Behavioral Intention (BI)

Beliefs about consequences of behavior X → Attitude toward behavior X → Intention to perform behavior X → Behavior X

Subjective norm concerning behavior X → Intention to perform behavior X → Behavior X

Influence

Feedback

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

Theory of Planned Behavior (TPB)

TPB (1985)

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

FIG. 1. Theory of planned behavior

Icek Aizen (Ajzen)

Professor of Psychology
University of Massachusetts

http://www.people.umass.edu/aizen/index.html
Technology Acceptance Model (TAM)

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

Behavioral Finance Themes

• Heuristic-Driven Bias
• Framing Dependence
• Inefficient Markets

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


Efficient Market Hypothesis (EMH)

Expected Utility Theory (EUT)

Prospect theory: An analysis of decision under risk

PROSPECT THEORY: AN ANALYSIS OF DECISION UNDER RISK

BY DANIEL KAHNEMAN AND AMOS TVERSKY

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.

Decision Making under Risk

Which of the following would you prefer?

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

• B:
  • 450 for sure.

Problem 1: Choose between

A: 2,500 with probability .33,

2,400 with probability .66,

0 with probability .01;

B: 2,400 with certainty.

Problem 1: Choose between

A: 2,500 with probability .33, B: 2,400 with certainty.

2,400 with probability .66,
0 with probability .01;

\[ N = 72 \quad [18] \quad [82]* \]

Problem 2: Choose between

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

Decision

Problem 2: Choose between

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

N = 72 [83]* [17]
Expected Utility

\[ u(2,400) > 0.33u(2,500) + 0.66u(2,400) \text{ or } 0.34u(2,400) > 0.33u(2,500) \]

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." 
Problem 3:

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

Problem 3:

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

\[ N = 95 \quad \text{[20]} \quad \text{[80]}^* \]

Problem 4:

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

Decision

**Problem 4:**

\[ C: \ (4,000,.20), \quad \text{or} \quad D: \ (3,000,.25). \]

\[ N = 95 \quad [65]^* \quad [35] \]

Problem 5:

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

\[ N = 72 \quad [22] \]

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

\[ N = 72 \quad [78]^* \]

Problem 6:

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

\[ N = 72 \quad [67]^* \]

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

\[ [33] \]
PROBLEM 7:

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

\[ N = 66 \quad [14] \quad [86]^* \]

PROBLEM 8:

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

\[ N = 66 \quad [73]^* \quad [27] \]

Preferences Between Positive and Negative Prospects

<table>
<thead>
<tr>
<th>Positive prospects</th>
<th>Negative prospects</th>
</tr>
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<tbody>
<tr>
<td>Problem 3: (4,000, .80) &lt; (3,000).</td>
<td>Problem 3': (−4,000, .80) &gt; (−3,000).</td>
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<tr>
<td>N = 95</td>
<td>N = 95</td>
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<tr>
<td>[20]</td>
<td>[92]*</td>
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<tr>
<td>[80]*</td>
<td>[8]</td>
</tr>
<tr>
<td>Problem 4: (4,000, .20) &gt; (3,000, .25).</td>
<td>Problem 4': (−4,000, .20) &lt; (−3,000, .25).</td>
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<tr>
<td>N = 95</td>
<td>N = 95</td>
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<td>[65]*</td>
<td>[42]</td>
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<tr>
<td>[35]</td>
<td>[58]</td>
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<tr>
<td>Problem 7: (3,000, .90) &gt; (6,000, .45).</td>
<td>Problem 7': (−3,000, .90) &lt; (−6,000, .45).</td>
</tr>
<tr>
<td>N = 66</td>
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<td>[86]*</td>
<td>[8]</td>
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<tr>
<td>[14]</td>
<td>[92]*</td>
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<tr>
<td>Problem 8: (3,000, .002) &lt; (6,000, .001).</td>
<td>Problem 8': (−3,000, .002) &gt; (−6,000, .001).</td>
</tr>
<tr>
<td>N = 66</td>
<td>N = 66</td>
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<tr>
<td>[27]</td>
<td>[70]*</td>
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<tr>
<td>[73]*</td>
<td>[30]</td>
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Certainty, Probability, and Possibility

Prospect theory
Value Function

Prospect theory
Weighting Function

Problem 4 as a decision tree (standard formulation)

Problem 10 as a decision tree (sequential formulation)

Source: Kahneman, Daniel, and Amos Tversky. "Prospect theory: An analysis of decision under risk." 
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).

\[ N = 70 \quad [16] \quad [84]^* \]

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).

\[ N = 68 \quad [69^*] \quad [31] \]

Problem 13:

\[(6,000, .25), \quad \text{or} \quad (4,000, .25; 2,000, .25).\]

\[N = 68 \quad [18] \quad \quad [82]*\]

Problem 13′:

\[(-6,000, .25), \quad \text{or} \quad (-4,000, .25; -2,000, .25).\]

\[N = 64 \quad [70]* \quad \quad [30]\]
Decision

Problem 14:

\[(5,000, .001), \quad \text{or} \quad (5).\]

\[N = 72 \quad [72]^* \quad [28]\]

Problem 14’:

\[(-5,000, .001), \quad \text{or} \quad (-5).\]

\[N = 72 \quad [17] \quad [83]^*\]

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.

Prospect theory

• People generally discard components that are shared by all prospects under consideration.

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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.

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.

Behavioral Heuristics and Biases in Decision Making
Behavioral Finance Anomalies

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

Prospect Theory

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

Behavioral Finance Anomalies

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

Perception Biases

• Saliency
• Framing
• Anchoring
• Sunk Cost Bias

Inertial Effects

• Endowment Effect
• Status Quo Effect
• Disposition Effect

Causality and Statistics

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

Illusions

• Illusion of Talent
• Illusion of Skill
• Illusion of Superiority
• Illusion of Validity

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
Arbitrage

$100 → Gain $20 → $120

Buy Low in Market A

Sell High in Market B
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

The Facts

Your Beliefs

Overvalued

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

\[ P(A \cap B) < P(A) \text{ or } P(B) \]

Source: Robert A. Strong (2004), Practical Investment Management, South-Western
Katona’s Economic Psychology Model

Economic Conditions (E) → Personal Characteristics (P) → Economic Behavior (B)

Python in Google Colab (Python101)

https://colab.research.google.com/drive/1FEG6DnGvwUbeo4zJ1zTunjMqf2RkCrT

https://tinyurl.com/aintpupython101
Summary

• Investing Psychology
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  • 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
References