

# STUDY SESSION

# 4

## Behavioral Finance

**B**ehavioral finance is introduced in the first study session on portfolio management because all market participants, regardless of expertise or experience, may be subject to behavioral biases. Behavioral finance provides insight into how emotional biases and cognitive errors may influence individuals' perceptions and investment decisions. As a consequence, knowledge of behavioral biases may help in understanding client goals, in constructing investment portfolios, and in identifying inconsistencies in investment decision making. Behavioral finance also provides insights into issues such as market anomalies. The readings propose that integration of behavioral and traditional finance may lead to a better outcome than either approach used in isolation.

### READING ASSIGNMENTS

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| <b>Reading 7</b> | The Behavioral Finance Perspective<br>by Michael M. Pompian, CFA   |
| <b>Reading 8</b> | The Behavioral Biases of Individuals<br>by Michael M. Pompian, CFA   |
| <b>Reading 9</b> | Behavioral Finance and Investment Processes<br>by Michael M. Pompian, CFA, Colin McLean, FSIP, and<br>Alistair Byrne, PhD, CFA |

**Note:** The readings in this study session use widely recognized terminology. Nevertheless, readers should be aware that writers on behavioral finance vary in their choice of terminology.

**LEARNING OUTCOMES****READING 7. THE BEHAVIORAL FINANCE PERSPECTIVE**

The candidate should be able to:

- a** contrast traditional and behavioral finance perspectives on investor decision making;
- b** contrast expected utility and prospect theories of investment decision making;
- c** discuss the effect that cognitive limitations and bounded rationality may have on investment decision making;
- d** compare traditional and behavioral finance perspectives on portfolio construction and the behavior of capital markets.

**READING 8. THE BEHAVIORAL BIASES OF INDIVIDUALS**

The candidate should be able to:

- a** distinguish between cognitive errors and emotional biases;
- b** discuss commonly recognized behavioral biases and their implications for financial decision making;
- c** identify and evaluate an individual's behavioral biases;
- d** evaluate how behavioral biases affect investment policy and asset allocation decisions and recommend approaches to mitigate their effects.

**READING 9. BEHAVIORAL FINANCE AND INVESTMENT PROCESSES**

The candidate should be able to:

- a** explain the uses and limitations of classifying investors into personality types;
- b** discuss how behavioral factors affect adviser–client interactions;
- c** discuss how behavioral factors influence portfolio construction;
- d** explain how behavioral finance can be applied to the process of portfolio construction;
- e** discuss how behavioral factors affect analyst forecasts and recommend remedial actions for analyst biases;
- f** discuss how behavioral factors affect investment committee decision making and recommend techniques for mitigating their effects;
- g** describe how behavioral biases of investors can lead to market characteristics that may not be explained by traditional finance.