STUDY SESSION

1

Behavioral Finance

Behavioral 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

Reading 1	The Behavioral Biases of Individuals by Michael M. Pompian, CFA
Reading 2	Behavioral Finance and Investment Processes by Michael M. Pompian, CFA, Colin McLean, MBA, FIA, FSIP, and Alistair Byrne, PhD, CFA

LEARNING OUTCOMES

READING 1. THE BEHAVIORAL BIASES OF INDIVIDUALS

The candidate should be able to:

a compare and contrast 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;

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.

READING 2. 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.