

Contemporary Issues in Finance - Lecture 4



Lesson Title: Behavioral Finance
Instructor: Dr. Mary Githinji

Course Overview

Behavioral finance has matured into a vibrant field that challenges and enriches classical finance paradigms by introducing psychological, cognitive, and social factors into financial decision-making. This lecture presents an integrated overview of the state of behavioral finance, highlights key empirical findings and anomalies, discusses methodological issues, and points toward frontier directions. We also consider how behavioral biases manifest in corporate finance, financial inclusion, and market dynamics, and we conclude with open research questions.

Course Objectives

By the end of this session, Learners should be able to:

- Explain the core principles of behavioral finance
- Understand key psychological concepts.
- Analyze how behavioral factors contribute to market anomalies.
- Evaluate the role of emotions, social influences, and cognitive limitations.
- Apply behavioral insights to real-world contexts
- Explore emerging frontiers.
- Critically assess the limitations and ethical implications.



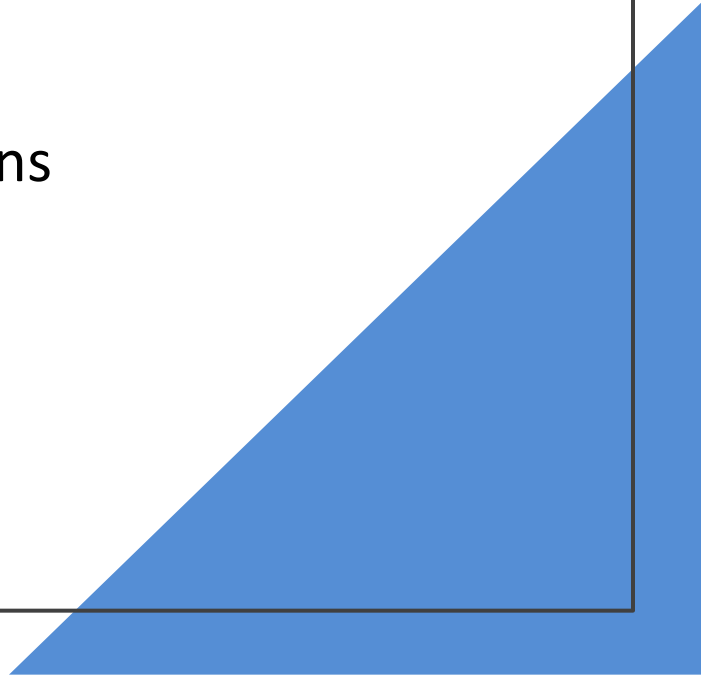
Learning outcomes

By the end of this lecture, learners will be able to:

1. Define and differentiate between traditional finance assumptions and behavioral finance principles.
2. Describe key behavioral theories such as Prospect Theory, Loss Aversion, and Heuristics.
3. Identify and categorize common behavioral biases affecting investors, managers, and markets.
4. Interpret market anomalies through behavioral explanations (e.g., momentum, herding, overreaction).
5. Apply behavioral insights to improve financial decision-making and policy formulation.
6. Analyze real-world financial events and crises from a behavioral perspective.
7. Evaluate emerging trends in Neurofinance, FinTech, and digital asset behavior using behavioral frameworks.
8. Critique the strengths and limitations of behavioral finance in explaining market behavior.

Lecture Outline

- Introduction and Motivation
- Behavioral Biases and Anomalies
- Behavioral Corporate Finance & Institutional Applications
- Methodological Challenges & Critiques
- Frontiers & Contemporary Issues



Introduction



Classical finance assumes rational investors, homogeneous expectations, efficient markets, and frictionless markets, where prices fully reflect information and investors optimize risk and return tradeoffs. However, real-world observations such as excess volatility, momentum, and return reversals often deviate from these predictions.



Behavioral finance incorporates psychological realism, studying how cognitive biases, emotions, heuristics, and social influences drive systematic departures from rational behavior, affecting asset pricing, trading, corporate decisions, and market stability. The field has grown across empirical, experimental, and theoretical approaches, with ongoing challenges in methodology, measurement, and new research directions. The lecture will cover behavioral biases, applications in corporate finance, methodological issues, and future research frontiers.

The Essence of Behavioral Finance



INTEGRATES PSYCHOLOGY
WITH FINANCE



CHALLENGES RATIONAL
INVESTOR ASSUMPTIONS



EMOTIONS AND HEURISTICS
INFLUENCE OUTCOMES

Historical Evolution - timeline

- 1950s–1970s: Psychology of decision-making
- 1979: Prospect Theory
- 1990s–2000s: Market anomalies
- Modern era: Neurofinance & AI

Foundations: Prospect Theory, Loss Aversion, and Heuristics



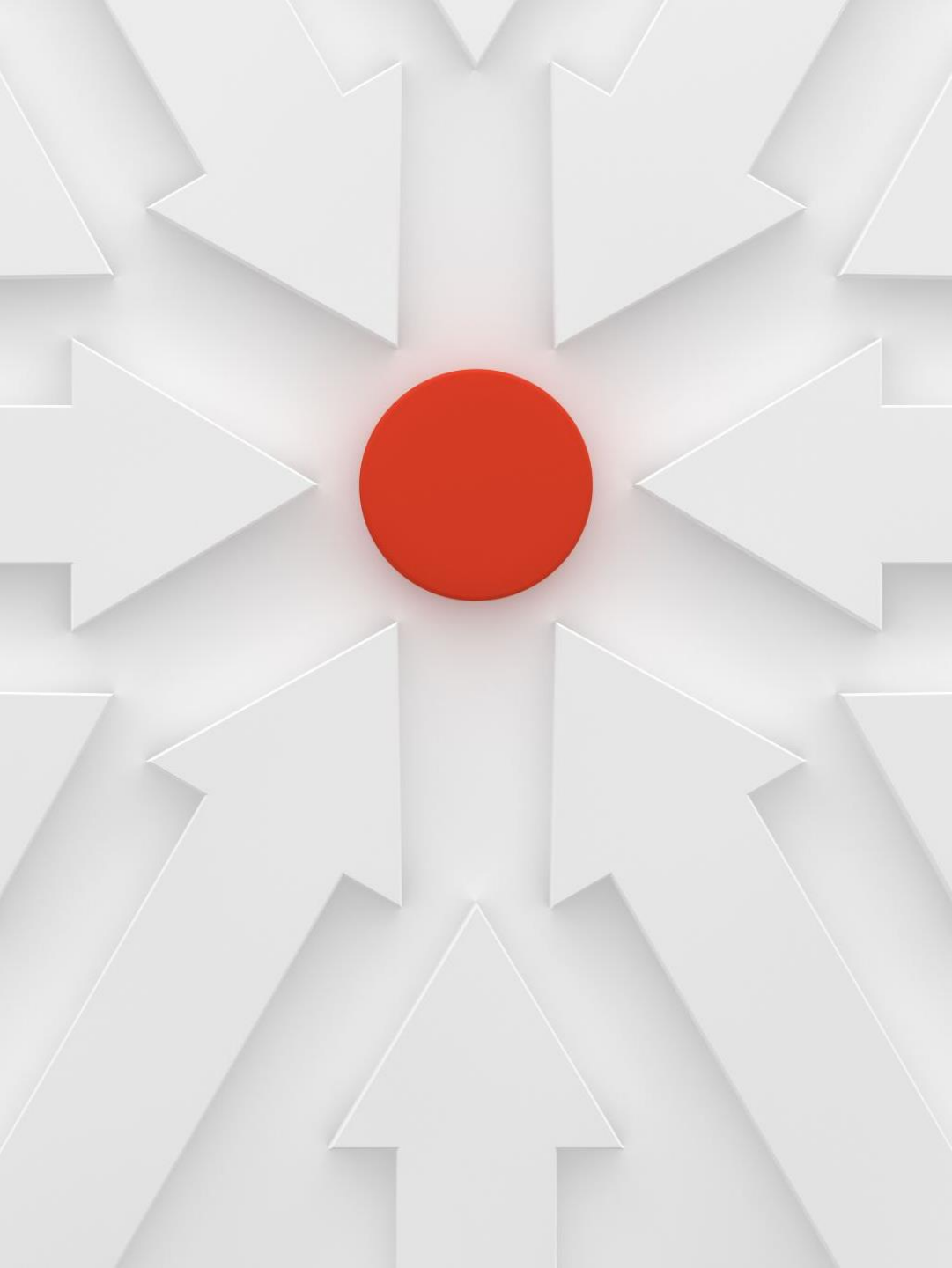
PROSPECT THEORY – OUTCOMES
JUDGED RELATIVE TO REFERENCE
POINT



LOSS AVERSION – LOSSES HURT
MORE THAN GAINS



HEURISTICS – MENTAL SHORTCUTS
SIMPLIFYING DECISIONS

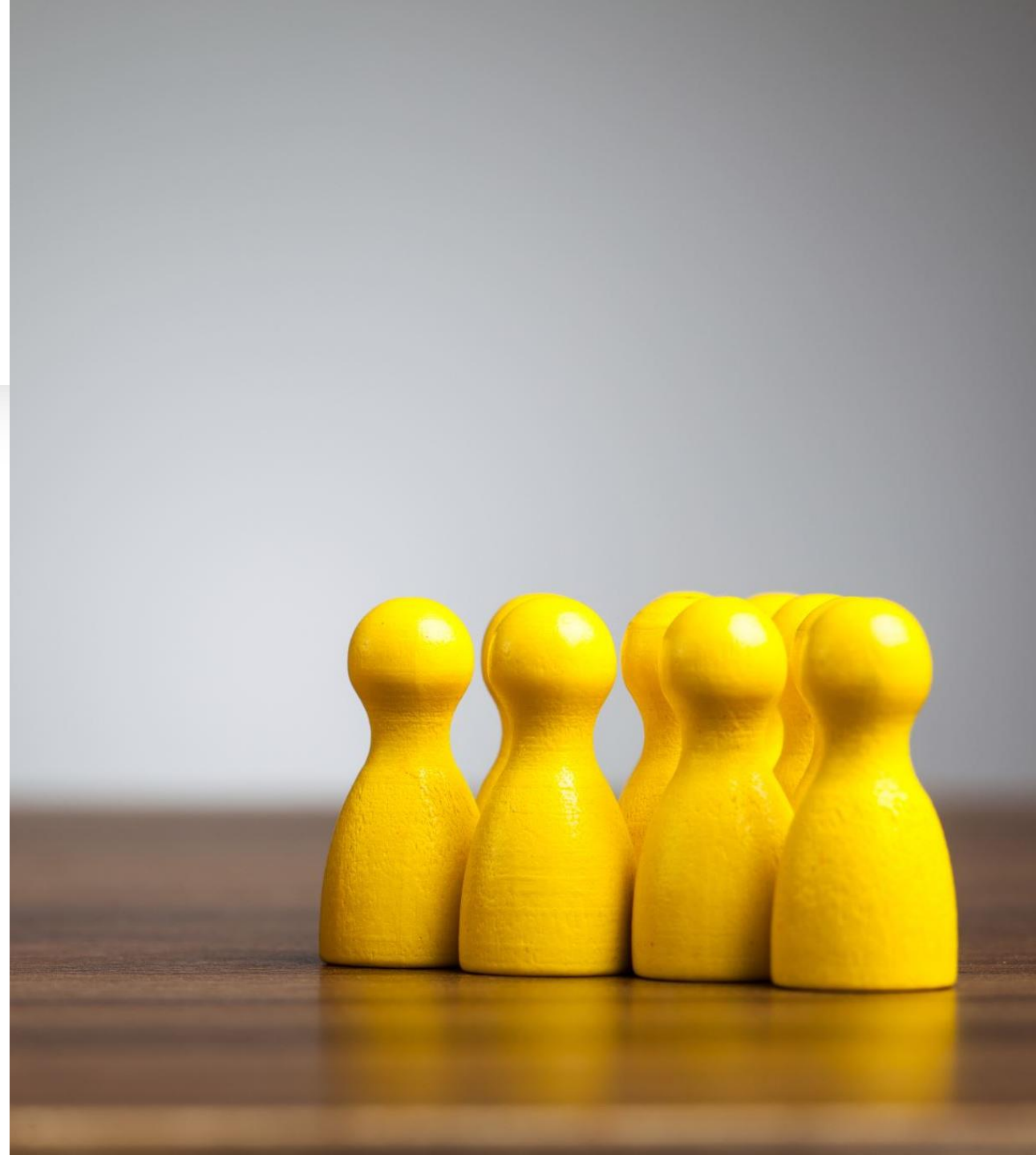


Prospect Theory

- Outcomes based on perceived gains/losses
- Concave for gains, convex for losses
- Explains risk-seeking and risk aversion asymmetry

Cumulative Prospect Theory

- Adds probability weighting
- People overweight small probabilities
- Better explains lottery-like behavior



Heuristics and Biases



Representativeness

Availability

Anchoring

Emotional and Affective Influences



EMOTIONS ALTER RISK
PERCEPTION



FEAR AND GREED DRIVE
CYCLES



OVERCONFIDENCE LEADS
TO EXCESSIVE TRADING

Behavioral Biases: Overview



Cognitive, Emotional,
and Social biases



Biases distort rational
decisions

Cognitive Biases

Overconfidence

Confirmation
Bias

Framing Effect

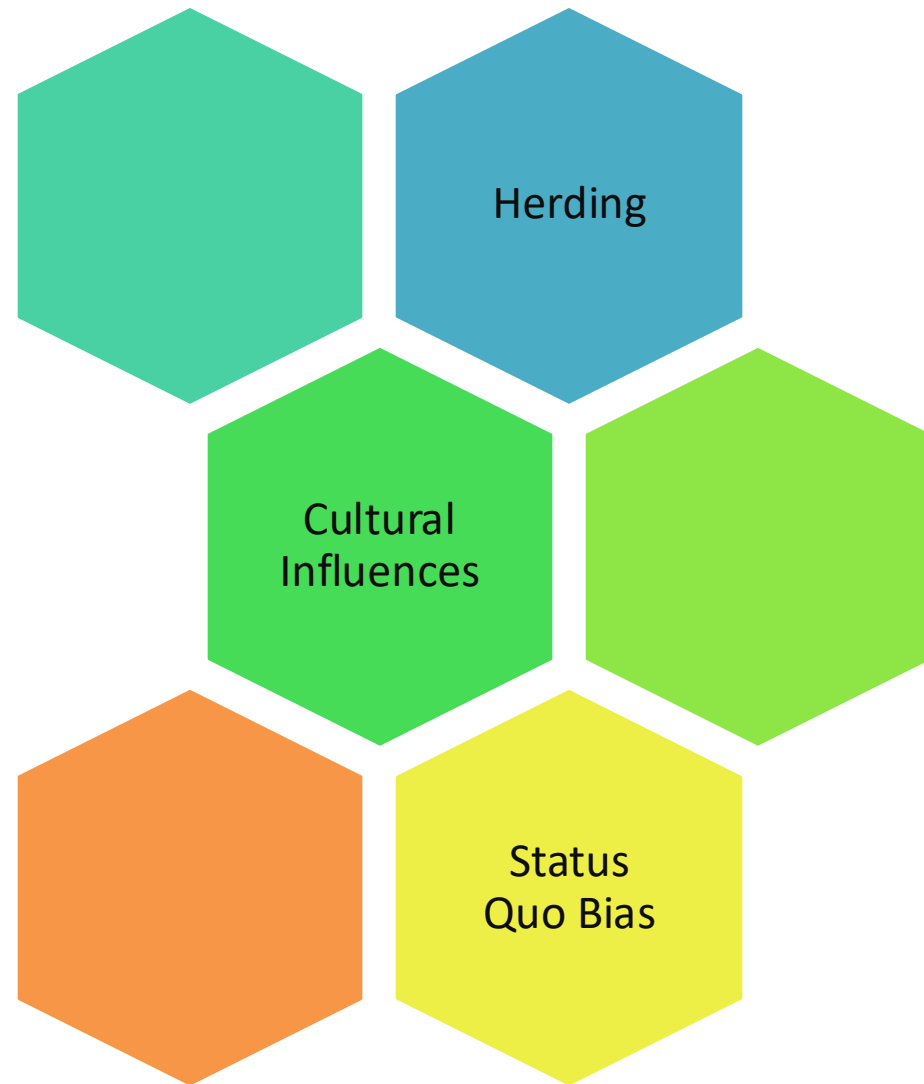
Emotional Biases

Loss Aversion

Regret Aversion

Endowment Effect

Social Biases



Market Anomalies: Introduction



ANOMALIES CHALLENGE
EMH



CALENDAR EFFECTS,
MOMENTUM, BUBBLES

Market Anomalies

Anomaly / Puzzle	Description	Behavioral Explanation
Excess volatility	Asset prices fluctuate more than fundamentals justify	Investor sentiment swings, noise trading, overreaction, feedback loops
Momentum / trend persistence	Past winners tend to continue winning (in short/mid term)	Underreaction, herding, slow diffusion of information
Return reversals / mean reversion	Over long horizons, past losers outperform winners	Correction of mispricing, overreaction
Post-earnings announcement drift	Stock returns drift after earnings surprises	Slow incorporation of information, anchoring
Disposition effect	Investors sell winners and ride losers	Regret aversion, realization utility
Equity premium puzzle / risk aversion gap	Observed equity premium is too high under standard utility assumptions	Behavioral preferences (loss aversion), limited participation
Predictability of flows / sentiment effects	Investment flows, sentiment surveys predict returns	Behavioral-driven flows move prices temporarily

Other anomalies



Calendar and Seasonal Effects;
January Effect, Weekend
Effect, Holiday Effect



Momentum and Contrarian
Effects



Bubbles and Crashes



Investor Behavior and
Portfolio Choices

Behavioral Corporate Finance



Behavioral thinking is not limited to individual investors. It has been extended into corporate finance, institutional decisions, and organizational behavior such as:

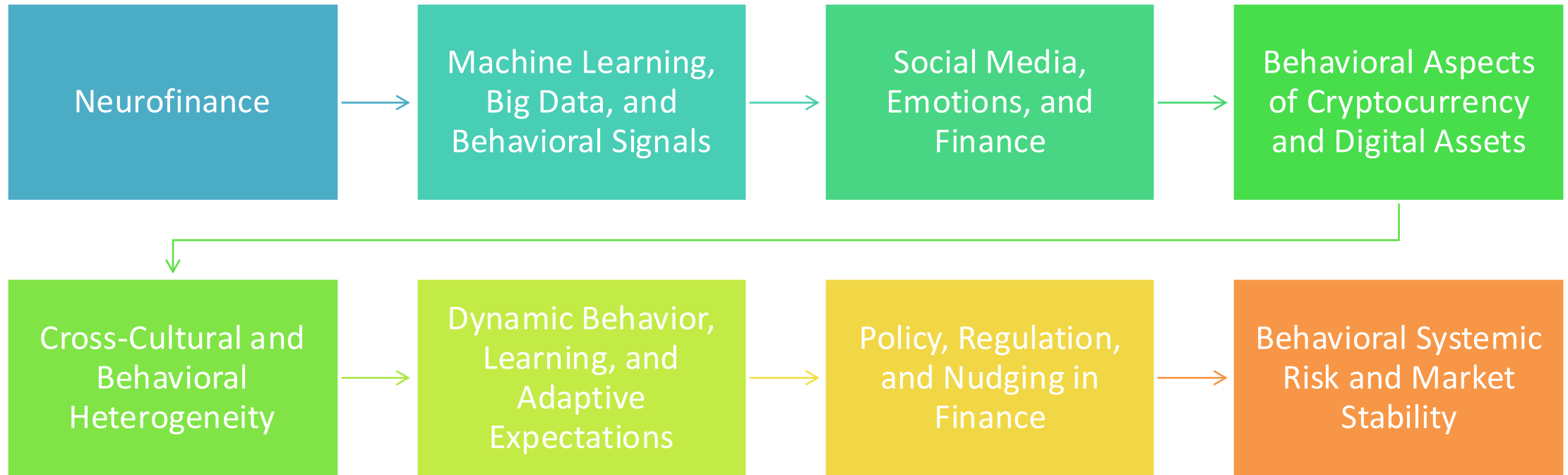
Managerial Biases, Overconfidence
Risk Management and Corporate Governance
Financial Markets & Intermediaries
Financial Inclusion

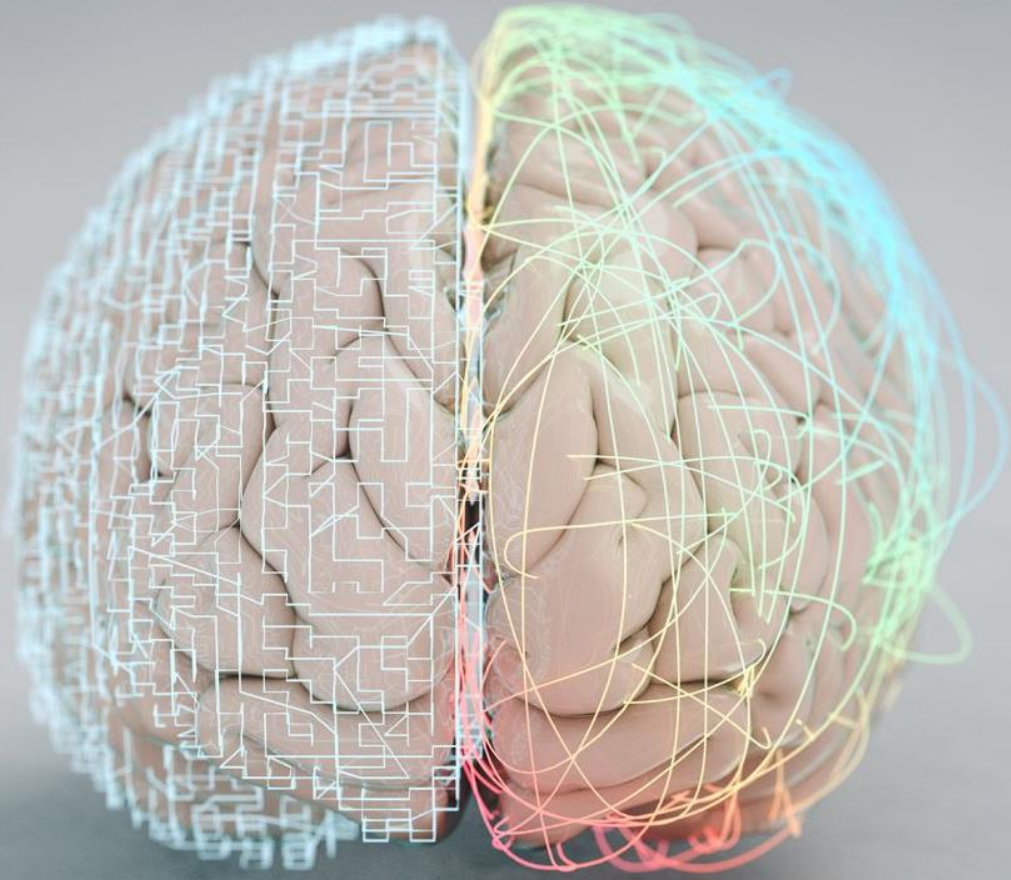
Methodological and Measurement Challenges

As behavioral finance has grown, several methodological issues and critiques have become more salient.

- Identification, Endogeneity, and Causality
- Replicability, Robustness, and P-Hacking
- Measuring Sentiment, Preference, and Biases
- Aggregation and Market-Level Effects
- Behavioral Models and Rational Benchmarks

Emerging Frontiers in Behavioral Finance





Neurofinance

- Studies brain activity for risk and reward
- Uses fMRI for emotion mapping
- Links decisions to neural activation

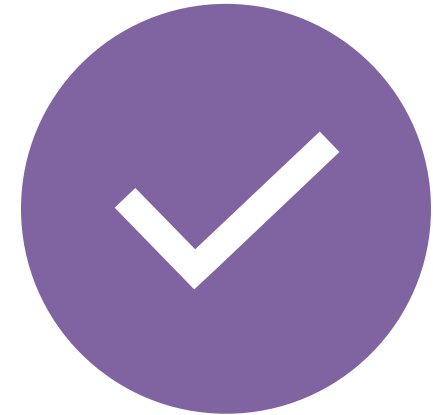
Behavioral FinTech and AI



AI MODELS INVESTOR
PSYCHOLOGY



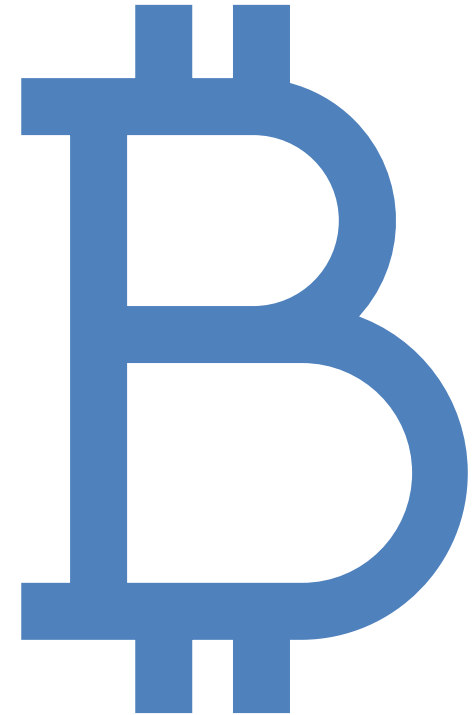
SENTIMENT ANALYSIS
FROM SOCIAL MEDIA



DYNAMIC PORTFOLIO
ADJUSTMENT

Cryptocurrency and Digital Assets

- Volatility from herding and speculation
- FOMO and overconfidence
- Social media amplifies biases



Critiques of Behavioral Finance

Limited predictive models

Overlap with traditional theories

Measurement challenges

Policy and Ethical Implications



INVESTOR PROTECTION AND
FINANCIAL EDUCATION



ETHICAL NUDGING



BEHAVIORALLY INFORMED
REGULATION

Summary and Reflection



Behavioral finance explains systematic irrationality



Shapes better financial decisions



Informs sustainable policy

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Thank you

