

BOOK REVIEW

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UNVEILING THE ENIGMA OF BEHAVIORAL FINANCE

BEHAVIORAL FINANCE AND WEALTH MANAGEMENT: How to build optimal portfolios that account for investor Biases

Michael M. Pompian. Hoboken, USA: Wiley Finance Editions, 2011, 336p.

The work “Behavioral Finance and Wealth Management: How to build optimal portfolios that account for investor Biases” references behavioral finance and wealth management. The author explains that the success of this book involves changing the reader’s thought to what is ultimately an ideal investment portfolio. This work is also useful as a guide to not only understand investors’ irrational behaviors, but also create portfolios that serve them. It is divided into four parts, respectively addressing: an introduction to the practical application of Behavioral Finance, a definition and examples of investors’ behavioral trends, a presentation of case studies, and finally, a presentation of special topics in investing.

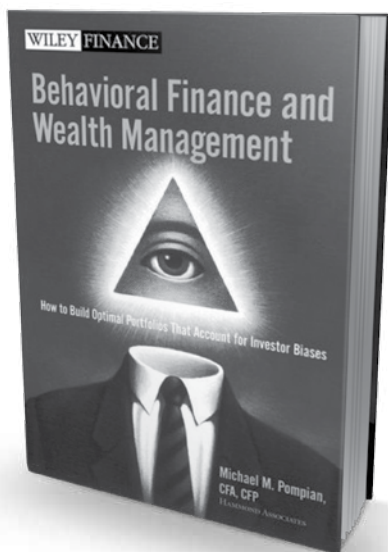
The first part of the book is composed of Chapters 1-3, and defines behavioral finance, its history, and the merging of investors’ behaviors in the process of assets distribution. The author defines behavioral finance as the typical application of psychology to finance and states that despite its popularity, a proper understanding on the subject is still lacking. As such, this first section consists of a literature review on the topic.

The author particularly focuses on recent developments in micro-behavioral finance that involve the application of theory in private customer situations. It should be noted that as thousands of studies pertain to behavioral finance, the author only uses studies from the last 250 years.

Studies of cognitive psychology have contributed much to the development of behavioral finance, as several studies demonstrate how the brain functions in financial decision-making. The author notes that the primary studies in this area include those of Barnewall (Psychological characteristics of the individual investor. In William Droms (Ed.), *Asset Allocation for the Individual Investor*. Charlottesville, USA: The Institute of Chartered Financial Analysts, 1987) and Bailard, Biehl, and Kaiser (*Personal Money Management* (5th ed.) Chicago, USA: Science Research Associates, 1986), which respectively address investors’ distinction in assets and liabilities.

The first section concludes by clarifying a basic structure that integrates behavioral finance and the portfolio’s structure.

The author achieves this objective through the practical application of behavioral finance, and explains that the best practices in assets distribution are considered as



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those that the customer can comfortably handle, rejecting the concept of “changing horses in the middle of the race.” The correct distribution, in other words, encourages the gaining of returns without giving the client anxiety. Finally, a step-by-step is presented for the appropriate determination of deviations from the rational portfolio, which adjusts the final structure of the portfolio.

The second section of the book is comprised of Chapters 4-23 and discusses investors’ behavioral trends; each trend is named and categorized as either emotional or cognitive. The author then demonstrates how each trend has been or may be used in practice. Namely, the study clarifies the importance of its practical application of trends to assist customers in their portfolio assets’ distribution. Trends are generally described and a technique explains its practical applications and implications for investors. Finally, the research on these trends is reviewed, and a test is presented to diagnose them. As each chapter studies a separate trend, the end of each chapter also provides the results of these tests, and recommendations as to how to handle the trend in question.

One example is noteworthy to better understand this concept: the trend of the status quo, which works with those who prefer that things that remain unchanged, or specifically, the tendency to prefer stability. In practice, investors with inheritance commonly avoid portfolio diversification. The author then reviews the research to explain that, as the status quo fosters investors’ conservative actions, it can be combined with a loss aversion trend because the investor’s risk of loss decreases in maintaining the status quo.

The test that diagnoses the status quo trend consists of such questions as: “Would you choose a 100% chance of winning \$10,000, or an 80% chance of winning \$13,000 with a 20% chance of not winning anything? Before the given scenario, do you sell your portfolio and buy another, or leave things as they are?” Two alternatives with different weights exist for each answer, which indicates the presence of the status quo trend for a determined investor. The author also warns readers as to how to minimize the effects of this trend, if one might notice the need to do so, at the expense of adapting to it.

However, the second section is observed as a review of trends commonly identified in investor behavior, supplemented by not only general and technical descriptions and a presentation of its practical application, but also a review of research regarding that trend, its implications for the investor, how to diagnose, and even a warning as to how to handle it.

The third section, composed of Chapter 22, functions as a combination of the first and second parts. The author creates a

union between what has been presented by using case studies that focus on the same fundamental questions:

1. How do customer trends affect asset distribution decisions?
2. Should the assessor attempt to moderate the impact of these trends and adapt to them?
3. What is the best practice for each investor’s distribution?

The three case studies are presented in the same format to answer these questions, as they aim to simulate the approach that each uses with clients.

The studies’ compositions in this case center on an introductory description of the case, an identification of its financial performance trends, and its likely effects when deciding assets distribution. Each composition includes a decision to attempt to moderate these effects or adapt to every trend, and ultimately recommends behavioral adjustments in the assets distribution, or specifically, a better practice distribution.

The book’s fourth part is comprised of Chapters 25-27, and references special topics in the practical application of behavioral finance.

The first topic refers to gender, personality type, and investor behavior, and the extent to which each of these points impacts the probability of identifying the investor’s vulnerability to the trends reported in literature. The author then reviews the first investor types, as aforementioned, and in the last chapter presents what the author calls the “next frontier” to explain investor behavior: neuroeconomics.

Neuroeconomics is a discipline that attempts to act as a bridge between the study of the brain and economic theory to understand the choices that are made regarding the fate of money. Specifically, this section reveals an intention to predict what will be on the agenda at the next theme’s study phase through a presentation of special topics.

Finally, it can be observed that one aim of this book is to change the reader’s thinking in the definition and creating of an ideal portfolio. The author idealizes this through literature that provides an understanding regarding the definition of this theme. For example, case studies are used that prove behavioral finance’s relevance in investment decisions, and provide subsidies to determine portfolios that meet clients’ needs by studying trends. The application of theory to practice in this work is evidenced through the author’s statements on case studies. Further, it is clear given these observations that the book is structured to lead the reader to dynamically understand the theme. This ranges from an understanding of the theory under study and its relevance in the first section, to the extent that a portfolio can potentially be constructed, by using studies from other parties.