Contents

Preface xv

Acknowledgments xxiii

PART ONE

Introduction to Behavioral Finance 1

CHAPTER 1

What Is Behavioral Finance? 3

Behavioral Finance: The Big Picture 4

Standard Finance versus Behavioral Finance 12

The Role of Behavioral Finance with Private Clients 19

How Practical Application of Behavioral Finance Can Create a Successful Advisory Relationship 19

Notes 21

CHAPTER 2

The History of Behavioral Finance Micro 23

Historical Perspective on the Link between Psychology and Economics 23

Modern Behavioral Finance 27

Psychographic Models Used in Behavioral Finance 36

Notes 40

CHAPTER 3

Introduction to Behavioral Biases 43

Introduction 43

Behavioral Biases Defined 44

Why Understanding and Identifying Behavioral Biases Is Important 45

Categorization of Behavioral Biases 46

Differences between Cognitive and Emotional Biases 46

Difference among Cognitive Biases 47
CONTENTS

Emotional Biases 48
A Final Word on Biases 49
Summary of Part One 50

PART TWO
Belief Perseverance Biases Defined and Illustrated 51

CHAPTER 4
Cognitive Dissonance Bias 53
Bias Description 53
Practical Application 55
Research Review 57
Diagnostic Testing 59
Advice 60
Conclusion 62
Notes 62

CHAPTER 5
Conservatism Bias 63
Bias Description 63
Practical Application 64
Research Review 67
Diagnostic Testing 69
Advice 70
Notes 71

CHAPTER 6
Confirmation Bias 73
Bias Description 73
Practical Application 75
Research Review 77
Diagnostic Testing 81
Advice 83
Notes 84

CHAPTER 7
Representativeness Bias 85
Bias Description 85
Practical Application 87
Research Review 89
Contents

Diagnostic Testing 93
Advice 94
Notes 97

CHAPTER 8
Illusion of Control Bias 99
Bias Description 99
Practical Application 100
Research Review 103
Diagnostic Testing 104
Advice 105
Final Thought 106
Notes 106

CHAPTER 9
Hindsight Bias 107
Bias Description 107
Practical Application 108
Research Review 109
Diagnostic Testing 112
Advice 113
Notes 114

PART THREE
Information Processing Biases Defined and Illustrated 117
Overview of the Structure of Chapters 10 through 16 117

CHAPTER 10
Mental Accounting Bias 119
Bias Description 119
Practical Application 121
Research Review 123
Diagnostic Testing 128
Advice 130
The Behavioral Finance Approach to Asset Allocation based on Mental Accounting 133
Notes 134

CHAPTER 11
Anchoring and Adjustment Bias 135
Bias Description 135
Practical Application 136
## CONTENTS

- Research Review 138
- Diagnostic Testing 139
- Advice 140
- Bonus Discussion: Investment Strategies that Leverage Anchoring and Adjustment Bias 141
- Notes 142

### CHAPTER 12

**Framing Bias** 143
- Bias Description 143
- Practical Application 145
- Research Review 148
- Diagnostic Testing 150
- Advice 152
- Notes 153

### CHAPTER 13

**Availability Bias** 155
- Bias Description 155
- Practical Application 157
- Research Review 160
- Diagnostic Test 162
- Advice 163
- Notes 164

### CHAPTER 14

**Self-Attribution Bias** 165
- Bias Description 165
- Practical Application 166
- Research Review 167
- Diagnostic Testing 169
- Advice 170
- Notes 171

### CHAPTER 15

**Outcome Bias** 173
- Bias Description 173
- Diagnostic 176
- Notes 178
Contents

CHAPTER 16
Recency Bias 179
  Bias Description 179
  Practical Application 181
  Research Review 184
  Diagnostic Testing 185
  Advice 187
  Notes 188

PART FOUR
Emotional Biases Defined and Illustrated 189

CHAPTER 17
Loss Aversion Bias 191
  Bias Description 191
  Practical Application 193
  Research Review 194
  Diagnostic Testing 195
  Advice 196
  Notes 197

CHAPTER 18
Overconfidence Bias 199
  Bias Description 199
  Practical Application 200
  Research Review 201
  Diagnostic Testing 203
  Advice 206
  A Final Word on Overconfidence 208
  Notes 208

CHAPTER 19
Self-Control Bias 211
  Bias Description 211
  Practical Application 214
  Research Review 216
  Diagnostic Testing 219
  Advice 220
  Notes 222
CONTENTS

CHAPTER 20
Status Quo Bias 223
  Bias Description 223
  Practical Application 224
  Research Review 225
  Diagnostic Testing 226
  Advice 228
  Notes 229

CHAPTER 21
Endowment Bias 231
  Bias Description 231
  Practical Application 232
  Research Review 235
  Diagnostic Testing 237
  Advice 239
  Notes 240

CHAPTER 22
Regret Aversion Bias 243
  Bias Description 243
  Practical Application 244
  Research Review 246
  Diagnostic Testing 247
  Advice 249
  Notes 251

CHAPTER 23
Affinity Bias 253
  Bias Description 253
  Research Review 256
  Diagnostic Testing 258
  Advice 259
  Notes 260

PART FIVE
Application of Behavioral Finance to Asset Allocation and Case Studies 261

CHAPTER 24
Application of Behavioral Finance to Asset Allocation 263
  Practical Application of Behavioral Finance 264
  Best Practical Allocation 266
Contents

Guidelines for Determining Best Practical Asset Allocation 267
Quantitative Guidelines for Incorporating Behavioral Finance
  in Asset Allocation 269
Investment Policy and Asset Allocation 271
Notes 271

CHAPTER 25
Case Studies 273
  Case Study A: Mr. Nicholas 276
  Case Study B: Mrs. Alexander 281
  Summary of Case Studies 286

PART SIX
Behavioral Investor Types 287

CHAPTER 26
Behavioral Investor Type Diagnostic Process 289
  Background of the Development of Behavioral Investor Types 290
  Psychographic Models of Investor Behavior 291
  Early Psychographic Models 293
  The Behavioral Alpha Process: A Top-Down Approach 295
  The BIT Identification Process 296
  Summary 299
  Notes 300

CHAPTER 27
Behavioral Investor Types 301
  Introduction 301
  Preserver 302
  Follower 305
  Independent 308
  Accumulator 312
  Summary 315

Index 317