Quantitative Finance

ISSN: (Print) (Online) Journal homepage: https://www.tandfonline.com/loi/rquf20

Behavioral Finance and Your Portfolio: A Navigation Guide for Building Wealth

by M. M. Pompian, New Jersey, John Wiley & Sons, Inc. (2021). Paperback. ISBN 9781119801610

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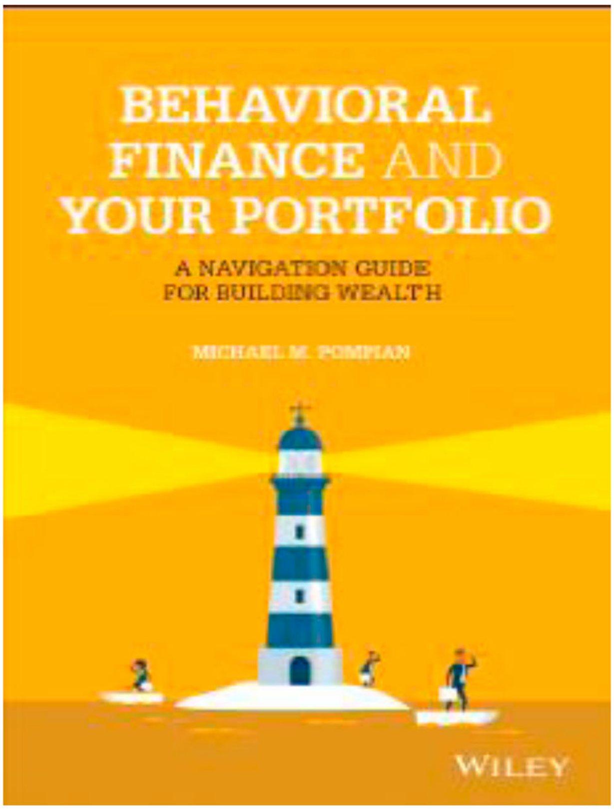
Quantitative Finance, 2022
Vol. 22, No. 7, 1229–1230, https://doi.org/10.1080/14697688.2022.2077231

Routledge
Taylor & Francis Group

Book review



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‘Behavioral Finance and Your Portfolio: A Navigation Guide for Building Wealth’ is the latest book by Michael M. Pompian, an author, founder, and Chief Investment Officer of Sunpointe Investments, partner at Mercer Investment Consulting, a wealth management advisory. Previously Michael M. Pompian has written four books on behavioral finance: Giving Advice to Clients and Firms of Very Rich Families (Wiley, 2009), Behavioral Finance and Wealth Management (Wiley, 2006), Behavioral Finance and Wealth Management (2nd Edition Wiley, 2012) and Types of Behavioral Investors (Wiley, 2015). His most recent book ‘Behavioral Finance and Your Portfolio’ is written from an investor’s point of view and builds optimal portfolios by taking a so-called `biased investor behavior’ into account. Behavioral finance is considered a complementary theory to standard finance theory.

In the past 25 years, research interest in behavioral finance has been steadily increasing, and scores of newly appearing articles have been indexed in publications. The book `Behavioral Finance and Your Portfolio: A Navigation Guide for Building Wealth’ presents the topic of potentially irrational investing behavior and of possible efforts to build better portfolios for individual investors who aim to take irrational behavior (systematically) into account. As opposed to other monographs, this book focuses on individual investors, who aim to critically inspect (even introspectively) irrational behaviors and address behavioral biases in investment decisions.

The author provides an overview, practical application, implications, diagnostics of bias, and advice for investors with clear terminology and description of the concepts. This book spreads over 320 pages consisting of six parts and thirty-two chapters. The first part provides an introduction to the practical application of behavioral finance. These chapters include an overview of behavioral finance at the individual investor level and the behavioral biases used when incorporating investor behavior into the asset allocation process. We believe that understanding the first part is crucial to understand explain the next chapters.

In part two of this book, the focus lies on the persistence of beliefs is a cognitive bias. The six chapters of part two cover various types of bias including ‘belief perseverance bias’, ‘cognitive dissonance bias’, ‘conservatism bias’, ‘confirmation bias’, ‘representative bias’, the so-called ‘illusion of control bias’, and ‘hindsight bias’ and details descriptions and examples of these. In part three, seven chapters focus on cognitive biased information processing. There are various kinds of effects on cognitive information processing induced by these biases. This section describes ‘mental accounting bias’, ‘anchoring bias’, ‘framing bias’, ‘availability bias’, ‘self-attribution bias’, ‘outcome bias’, and ‘recency bias’. Part four of the book is dedicated to the concept of emotional bias. There are seven chapters in this section explaining emotional bias, including ‘loss aversion bias’, ‘overconfidence bias’, ‘self-control bias’, ‘status quo bias’, ‘endowment bias’, ‘regret aversion bias’, and ‘affinity bias’, all derived from typical behavioral patterns. In summary, parts two, three, and four include a comprehensive overview with diagnostics of bias, practical examples (such as examples of behavior that can lead to errors in investments), and advice and implications for investors.

Part five of this book describes the four Behavioral Investor Types, or BITS, and combines them in the form of a case study that shows how investors can use behavioral finance in real-world portfolio management. Finally, section six concludes with a discussion of concrete implications on portfolio implementation: It discusses behavioral finance aspects of the so-called `active/passive debate’, and showcases examples of behaviorally conscious portfolio construction, and examples behavioral finance-aware and market corrections.

After reading this book, the reader may feel motivated to change their financial behavior in investing. It can change the readers’ perspective and thinking due to increased awareness to biasses. This in turn may open up possibilities for building better portfolios. In summary, this book does not only list the diagnostic questions to identify and describes the cases of vulnerability to bias, but it also gives several exemplifying case studies on building a portfolio with this new awareness. For example, to illustrate the cognitive bias and emotional bias that occurs in investors (parts two, three and four), the author gives plenty of real-world examples. It should be pointed out that the context of observation of bias is not limited to a particular country. However, what’s most interesting about this book is that not only does it raise awareness for and increase our understanding of behavioral biases, it also serves as a guide for finding ways to adapt investment programs to take these biases into account. We are thrilled that these insights are also suitable for investors in emerging countries.

Investors can find out about how to adapt their strategies and portfolios to these biases so that they can comply with their investment goals, and can increase the economic returns of their investments. All topics in this book will resonate well with readers who have an interest in the field of behavioral finance, but also with readers who have an interest in the practical aspects of the observations. In addition to gaining a new perspective, decision-makers and academics, postgraduate students will benefit from a comprehensive review of the literature available in this book on available behavioral finance research. Should it be used as a textbook it would benefit from a small extension by a summary of concepts and examples in each chapter. However, the target audience is not limited to readers with previous knowledge and comprehension is not subject to specific preparations. This book is a guide to understanding behavioral finance yourself, to building `the best portfolio and is useful for all (potential) investors who want to apply behavioral finance to their asset allocation process and create better portfolios for achievieving financial goals.

Acknowledgements

The authors would like to express their deepest gratitude to Lembaga Pengelolaan Dana Pendidikan (LPDP/Indonesia Endowment Fund for Education) under the Ministry of Finance of the Republic of Indonesia as the sponsor for first author doctoral’s studies, and the support of this publication.

Funding

This work was supported by Lembaga Pengelola Dana Pendidikan [grant number 20201221305677].

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