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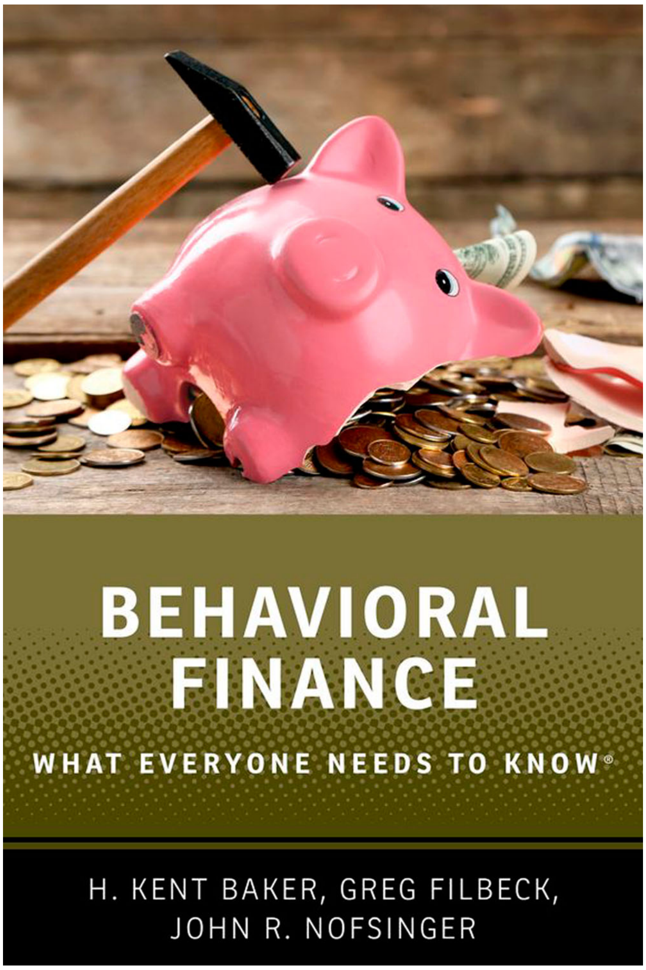
Book review



Behavioral Finance: What Everyone Needs to Know, by H. Kent Baker, Greg Filbeck, and John R. Nofsinger, Oxford University Press (2019). Paperback. ISBN 9780190868734

'*Behavioral Finance: What Everyone Needs to Know'* is the latest book by three university professors, H. Kent Baker, Greg Filbeck, and John R. Nofsinger. Well-known in both the academic and professional worlds, these renowned authors have published extensively in finance. The psychological aspects of investment decision-making by individual investors, professional money managers, and corporate executives have long been one of their areas of interest.

The study of the effect of psychological factors and human emotions on financial decision-making, which is at the heart of behavioral finance, has gained widespread recognition over the past decades. By now, behavioral finance is widely considered a companion that completes, and even influences, traditional finance.

'Behavioral Finance: What Everyone Needs to Know' presents an up-to-date overview of behavioral finance. The book focuses on helping investors to understand their decision-making process. As is customary in Oxford University Press's 'What Everyone Needs to Know' series, the book is organized in straightforward questions and answers format. So there is no need to read it cover-to-cover to benefit immediately.

Readers can tackle the questions and answers in the order they choose.

The authors follow a similar articulation for every question and answer. Each answer identifies and defines clearly the terminology and concepts. Then, the authors carefully illustrate all the key terms and definitions with examples. Hence, readers do not require prior education or experience in investment management to read the book. Throughout the book, the authors also discuss remedies and corrective actions to lessen, mitigate, counter, and combat behavioral biases. However, investors should understand that these corrective actions are general advice. They need to give further thought to apply them to their everyday investment practice. This situation reflects a key challenge in behavioral finance overall. While biases and psychological pitfalls are well-researched, concrete remedial actions are still work-in-progress.

The book comprises six sections. The opening section on 'Foundations and Psychological Concepts' lays the groundwork. It not only surveys the origin and development of behavioral finance but also discusses different frameworks and criticism from traditional finance. I strongly recommend reading this section first. The following three sections identify, describe, and discuss cognitive biases, emotional biases and social-cultural influences, and finally, investor behavior. In a later edition, the addition of visual summaries for the main concepts and examples could make the book more appealing and fun.

Section five examines both the influence of frame dependence on investment decision-making and the concept of nudging. To illustrate frame dependence, the authors draw from real-life examples such as payday loans, the sub-prime crisis, lotteries, and pension plans. The authors also discuss how governments can engineer effective nudge policies to increase the engagement of the desired behavior. They show that nudge programs can be cost-effective and useful tools to improve socially desired behaviors.

The final section investigates the importance and influence of cognitive ability on decision-making and risk tolerance. The authors discuss the three types of cognitive functions: fluid intelligence (IQ), cognitive reflection (thinking fast vs. thinking slow), and the theory of mind (mind-reading). They also address two topical issues: the impact of cognitive aging (slowing down with age) on an aging population's financial decision-making, and the effect of sleep deprivation on cognitive ability.

Overall, I enjoyed reading this book. It is well-written and particularly easy to read. The authors provide many real-world examples to illustrate the cognitive biases that investors exhibit. Readers may be astonished when they realize how many biases they should tick in the long list discussed in the book. The book is targeted at a general audience and organized as a Q&A. As a result, definitions and discussions of various concepts are repeated frequently to ensure that the answers are self-contained. Some readers may find this mildly offputting, especially if they intend to read the book cover-to-cover. Others may prefer this format, especially if they intend to pick a random Q&A to read on their daily commute.

Quantitative-minded readers should not be disappointed with the absence of mathematical formulas. Instead, reading how investors actually make decisions should intrigue them and inspire them to investigate how behavioral biases can systematically derail the rational models developed in standard finance.

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