Behavioral Finance and the Role of Psychology

This lecture might be seen like a psychological lecture, not an economy lecture first, so it sounds like weird and hard to me first time but gradually it seems to make sense to converge financial behavior and psychology. First, professor Shiller said people aren’t rationally always as all of theories of economics says, rather people sometimes behave stupidly. So, understanding of psychology is important to analyzing financial situation. And this trying was start at Adam Smith, because first he not just economist but he was philosophy and he emphasized of ‘morality’ aspects in human’s decision and economics was driven from that idea. So, understanding psychology in economics is very important and has a history.

Shiller introduces seven psychological theory that prospect theory, regret theory, overconfidence, cognitive dissonance, anchoring, representativeness heuristic and social contagion. First, we make a decision by evaluating loss and gain, and in this perspective, evaluate gain and loss is very important. And this prospect theory assumes that people are more sensitive to damage than to gain, that gains and losses are assessed on a reference point basis, and that both gains and losses have a utility-sensitive relationship. And they evaluate this utility by loss and gain using value function and weighting function. And then, he introduce regret theory, it means that, as a theory in the field of theoretical economics, is suggested that information on the best course of action can affect future decisions when making decisions under uncertainty. It is a theory that proves mathematically the process and logic that this psychological regret affects economic utility.

Meanwhile he also highlight peoples tendency like ‘overconfidence’ that every people believes that their estimation may be in 90% confidence interval at some kind of decision. Because one of this reason is that people seem to have a sense that they understand the world more than they really do. But, it is an illusion. Specially, we must be alert at stock market and professor Shiller introduce some examples about CEO. We do not be faked by fake genius CEO. And also, there are others theory like Cognitive Dissonance, . Anchoring, Representativeness heuristic, and Social contagion. I want to introduce these all theories but there is a limit in report, I’ll just briefly introduce these theory.

Given that behavioral finance is an economics armed with theories of psychology, it’s prospects are very good and research is expected to be very active. Intrinsically, the limit of economics is the assumption that “it will be”, which will be provided a theoretical framework by psychology and if there is something wrong in assumption, psychology will be a powerful tool to correct them. I hope that more and more students will be exposed to these fields when they become organized in the future.