

Behavioral Finance and Investor Types: Managing Behavior to Make Better Investment Decisions

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Human psychology is complicated because individuals build their habits and attitudes in a variety of ways in eating, working, interpersonal relationships and so on. Similarly, decisions on money and investment are intertwined in the tangled web of the human mind. These decisions are based on two fundamental psychological concepts: emotion and cognition. The former is mainly concerned with how individuals feel, while the latter is concerned with how individuals think. By contemplating these phenomena, this book, which is divided into four parts, provides some insights into one's basic investor habits and explains how to reduce the potentially unfavorable effects associated with biased investment decisions. Part I of the book gives a general review of behavioral finance, introduces behavioral biases and explains why accomplishing financial objectives is challenging. Part II provides a thorough analysis of personality theory, background data on the behavioral investor type (BIT) framework, and information on the BIT diagnostic test. Part III gives an explanation of each of the BITs. Part IV covers practical advice on asset allocation, financial planning, capital markets and investment suggestions for each BIT.

Part 1: Introduction to behavioral finance

Most individuals are aware of the benefits of saving money, but their need for tangible possessions and their propensity to spend money on services sometimes trump these otherwise reasonable inclinations. In the initial chapter, the author develops an understanding of the difficulties associated with behavior control and places emphasis on the significance of why behavior must be meticulously regulated. They examined certain self-defeating behaviors that are both non-financial (such as an unhealthy diet, no exercise and the habit of smoking) and financial (such as poor investment performance due to the habit of chasing returns, overconfidence and too much conservatism in investment). In Chapter 2, the author presents an outline of behavioral finance and compares it to traditional finance. Behavioral finance is the integration of psychology, sociology and finance that gained prominence as a consequence of the 2008–2009 financial market crash and the March 2000 burst of the tech stock bubble. Its primary goal is to comprehend how individuals make decisions, both individually and collectively. The author outlined the two main streams of behavioral finance: the first is behavioral finance micro, which examines the biases of individual investors that set them apart from the rational ones envisioned by traditional economic theory, and the second is behavioral finance macro, which recognizes and explains anomalies from the efficient market hypothesis (EMH) that behavioral models may be able to explain.



Traditional finance, on the contrary, assumes that individuals always make perfectly rational economic decisions. In the 1970s, the traditional finance theory of market efficiency became the paradigm of market behavior. The EMH, which arose from Fama's doctoral thesis, established that investments will be adequately valued and represent all relevant information in a securities market. So, seeking out mispriced stocks will not yield abnormal returns. Furthermore, because stock prices follow a random walk pattern, future stock prices cannot be predicted. The efficient market theory is classified as weak, semi-strong or strong. However, researchers have discovered many persistent anomalies that refute the EMH. Anomalies in the stock market provide an excellent opportunity to augment the return on investments. These anomalies are traits of specific types of stocks, such as valuation and size, which frequently deliver higher returns than investors would anticipate, given their risk. Fundamental, technical and calendar anomalies are the three basic forms of market anomalies. However, in reality, stock markets are neither completely efficient nor perfectly anomalous.

The author expanded on behavioral biases in Chapter 3. A bias is an unreasonable and unjustified distortion of judgment in favor of or against a person or object. Behavioral biases can cause decisions to stray from rational decision-making because of cognitive errors and emotional biases. Cognitive errors are induced by faulty reasoning, yet they are frequently correctable with better knowledge, guidance and education. They are classified into two types: The first type is "belief perseverance" biases, which refer to the propensity to hold onto one's views, whether they have been held for a while or just recently, in an illogical or irrational manner. Conservatism, representativeness, confirmation, hindsight, illusion of control and cognitive dissonance are a few examples of belief perseverance biases. The second type concerns people's irrational information processing when making financial decisions. Anchoring and adjustment, framing, mental accounting, self-attribution, availability, recency and outcome are a few examples of information processing biases. On the contrary, emotional biases are more difficult to rectify because they are based on instinct or intuition, particularly when they include subjective and perhaps unreasoned judgments. Loss aversion, self-control, overconfidence, endowment, status quo, affinity and regret aversion are the seven emotional biases. Instead of seeking to change an emotional bias, it may be more effective to concentrate on the cognitive aspects of biases.

Part II: Personality theory

In the second part of the book, personality theory, personality testing history and the BIT framework are covered in Chapters 4–6. Personality is made up of the specific patterns of thoughts, behaviors and feelings that define a person. It develops within the individual and persists throughout one's life. There are four primary types of personality theories: trait theories, behavioral theories, humanist theories and psychodynamic theories. To begin with trait theories, two main psychologists, Raymond Cattell and Eysenck, elaborated them. According to Raymond Cattell, a personality trait is "that which reveals what a person would do when placed in a certain scenario." He believes that the environment has a substantial impact on human behavior. He devised the econetic model, a framework for incorporating environmental and person-based aspects into human behavior theories. On the contrary, Eysenck defines traits as "theoretical constructs that are based on observable intercorrelations among a variety of distinct habitual responses." He identified three personality dimensions: extraversion-introversion, neuroticism and psychoticism. Unlike Cattell, Eysenck believed that genetic factors influenced personality more than environmental factors. Second, behavioral theorists like B.F. Skinner and Albert Bandura emphasize observable and measurable behaviors, rejecting theories that take into account

internal ideas and feelings. According to behavioral theories, personality is the outcome of interactions between the individual and their environment. Skinner stated that humans have freedom only because they have the ability to control their own circumstances. He highlights that, instead of counteracting external effects, the human environment in which they live impacts their behavior. As opposed to this, Bandura proposed a social cognitive theory that contends that triadic reciprocal determinism – which asserts that environmental, behavioral and personal components all function as interacting determinants that influence each other bidirectional – affects behavioral decisions.

Third, humanist theories highlight the importance of individual experience and free will in the development of personality. Humanist philosophers Carl Rogers and Abraham Maslow felt that the ideal way to comprehend human nature was to “initiate by studying people who are healthy, active, creative, and, on the surface, cheery and optimistic.” They felt that the goal of human existence was to completely achieve one’s innate potential, whether modest, spectacular or somewhere in between. Fourth, Sigmund Freud, Carl Jung and Erik Erikson bolstered psychodynamic theories. Freud developed a psychoanalytic theory in which he detailed a tripartite structure of the human psyche, arguing that human personalities are formed via the interplay of the id, ego and superego. Another of Freud’s outstanding works is on the concept of psychosexual development. He was a firm believer that by the age of six, an individual’s personality is fully developed. On the other hand, Jung proposed analytic psychology, which held that life is made up of opposites like day and night, happiness and misery, birth and death, introversion and extroversion, conscious and unconscious, love and hate, thinking and feeling, haughtiness and inferiority, cynicism and belief and so on. Personality, according to Jung, is split into three parts: the conscious, the personal unconscious and the collective unconscious.

Chapter 5 covers information on personality testing and its types and describes how personality tests have evolved through time. Personality tests are classified into two types: an objective test and a projective test. The objective test is considered highly structured due to the subject’s limited freedom in terms of potential responses to the test’s questions. It is graded in a straightforward manner. Each response is given a numerical value based on some aspect of personality (extraversion, for example). The big five factor model and the Myers–Briggs type indicator are two examples of objective tests that assess personality along many different dimensions. These tests are more reliable than projective tests because they are rated objectively and nonarbitrarily. People who take projective tests are given arbitrary, open-ended test items. These tests not only have arbitrary test items but are also unstructured. Chapter 6 fills in the gaps between prevalent theories of personality and presents the concept of “financial personality types,” or BITs. These BITs are preserver, follower, independent and accumulator. Although the BIT creation framework contains components of several theories on personality, it is the type theories, such as the Myers–Briggs types and the Kiersey types, and trait theories that reveal the dominant trait of each BIT. Furthermore, the author created two approaches for implementing behavioral finance in practice: the “bottom-up approach” and the “behavioral alpha process: a top-down approach.” In the former case, the advisors have to detect and correct behavioral biases; they must first test for all behavioral biases in the client before using bias information to construct a customized investment plan. The latter case is a top-down, simpler, more efficient approach to bias detection that can make bias identification considerably easier.

Part III: Explanation of the behavioral investor types

In this part, the author digs into the attributes of each BIT. Preserver BIT is addressed first in Chapter 8, then follower BIT, independent BIT and accumulator BIT are covered after

that in Chapters 9, 10, and 11, respectively. A “preserver” BIT is a type of investor that prioritizes financial security and asset preservation over taking risks to generate wealth. Preservers prefer lower volatility in their portfolios, which can result in superior long-term compounded returns. To safeguard their gains, they may sell their winning investments too soon. Furthermore, their excessive focus on mental accounting might result in inefficient portfolio development. They are primarily affected by emotional biases like endowment, status quo and loss aversion biases, which are tricky to control or change, especially during market turbulence. They may also display cognitive biases like anchoring and mental accounting. A follower is a passive investor who frequently lacks interest in and has little aptitude for investment. Followers often do not have their own investment ideas. Instead, they choose to make their investments based on the advice of their friends, co-workers or whatever the popular investing trend is at the time. They are focused on accumulating wealth and believe that taking risks is beneficial, yet they frequently overlook the negative aspects of doing so. When an investment choice succeeds, individuals may deceive themselves into believing they are knowledgeable or skilled in the field, which might encourage them to take unnecessary risks. In addition, they need to catch up on the latest investment fad and invest at the wrong time, when values are at their greatest. Cognitive biases such as framing, recency, hindsight and cognitive dissonance influenced them more than emotional biases.

An independent BIT is an active investor who is strong-willed, profoundly analytical and critical. Independents tolerate medium- to high-risk situations when making investments. They make decisions based on reasoning and their own gut instincts. They are always ready to take risks and act decisively. However, when their investments fail, they are reluctant to accept that they were incorrect or made a mistake. Independents frequently conduct their own research and postpone an investment unless they have validated their decision with research or another type of substantiation. They are primarily impacted by cognitive biases like availability, confirmation, conservatism, self-attribution and representative. The accumulator BIT refers to investors who are interested in and confident about accumulating wealth. Accumulators often have a track record of business success and have the self-confidence to succeed as investors, too. As a result, they frequently want to adapt their portfolio holdings and allocations in response to market conditions. They are risk-takers who are certain that whatever path they pick is the right one. Unfortunately, certain accumulators are prone to emotional biases that might restrict their investing performance, such as overconfidence, illusion of control, affinity, self-control and outcome.

Part IV: Plan and act

Part IV of the book, divided into four chapters, discusses the subject’s practicality and offers prospects for real-world application. This part has been divided into four chapters. In Chapter 12, the author covers the basics of capital markets and asset classes. Building a competent investment portfolio necessitates an awareness of capital market fundamentals, asset classes in which to invest and the risks associated with each investment instrument (Fabozzi, 2008). An asset class is a group of securities having identical traits and characteristics. The three primary criteria used to characterize an asset class are anticipated return, expected standard deviation and expected correlation with other asset classes. Modern portfolio theory advocates extensive diversification into asset classes with imperfect correlations, regardless of the degree of risk that an investor is expected to take. This allows investors to optimize return at a certain level of expected risk. Asset classes are classified into three broad categories: capital assets, economic input assets and value storage assets. Capital assets are claims on a company’s future cash flows, with their value defined

by the expected net present value of those cash flows. Investments in capital assets may be divided into three groups: equities, bonds and real assets. Economic input assets are generally commodities that are used or converted as part of the manufacturing process before becoming valuable products. Metals like copper are examples of economic input assets. Value storage assets do not produce cash flows or serve as economic inputs; rather, the value of these assets is only realized when they are sold. Examples of value storage assets are gold and artwork.

In Chapter 13, the key concepts pertaining to asset allocation are reviewed. Asset allocation refers to the process of selecting the number, types and percentages of assets that will be included in a portfolio. When constructing an investment portfolio, this is the most crucial choice an investor must make. Because asset allocation is a quantitative process, it takes into account expected return, efficient frontier analysis, percentages and other factors. It is divided into two categories: strategic asset allocation (SAA) and tactical asset allocation (TAA). By incorporating SAA into the investment policy statement, the investment mix is meant to satisfy the objectives and constraints of an investor. On the contrary, TAA is the method for making short-term changes to the asset class percentages selected in the SAA. Chapter 14 covered the process of financial planning. Financial planning is the process of setting and achieving one's financial objectives in life. Life objectives differ from one individual to the next and from one wealth level to the next. The majority of people's main financial objectives are to purchase a home, save for their children's education and prepare for retirement. Others have charity and wealth transfer motives in mind. Generally, the financial planning process has three major components: identifying one's assets and liabilities, setting life objectives and the plan itself. Individuals can more readily analyze short- and long-term consequences on financial objectives by seeing each financial decision holistically. Many individuals use financial advisors to help them in their quest to achieve their objectives. A financial planner is a professional who advises clients on a variety of financial planning-related issues.

The last chapter discusses about behaviorally modified asset allocations (BMAA) for each BIT, also known as practical allocation. To examine the BMAA for each of the BITs, financial advisors should take the time to evaluate the behavioral signs produced by them. To begin with preservers, they require big-picture advice, and advisors should avoid getting bogged down in details like standard deviations and Sharpe ratios; otherwise, they will lose the client's interest. Preservers must first discuss their emotional issues with their advisors before allocating assets to their portfolios. They will most likely become an advisor's best clients because they respect the advisor's professionalism, competence and neutrality in assisting them in making sound financial decisions. For followers, advisors must exercise caution when dealing with them because they are inclined to consider every investment option that seems logical to them, irrespective of whether the advice is in their best long-term interests. To prevent followers from overestimating their risk tolerance, advisors must help them examine their own behavioral proclivities. Usually, the best course of action for followers is to educate themselves on the advantages of portfolio diversification and adhere to a long-term strategy. The third are independents, which, because of their contrarian thinking, are challenging clients to advise but are typically grounded enough to listen to excellent advice when it is provided. An excellent strategy for independents is to incorporate educational conversations about the benefits of portfolio diversification and stick to a long-term strategy. In this manner, the advisor does not only draw attention to recent failures but rather teaches on a regular basis and can incorporate concepts that he or she believes are suitable for the client. Finally, the most aggressive BITs are the accumulators. They are the most challenging clients to advise, especially those who have suffered losses. Advisors to

accumulators must illustrate how financial decisions affect family members' lives, lifestyles and family legacy. If advisors can demonstrate to their clients that they have the capacity to assist them in making solid long-term decisions, their accumulator clients become better clients who are easier to advise.

In a nutshell, one may comprehend how an investor is surrounded by several behavioral biases, regardless of his level of financial understanding, after reading the entire book. Which bias a person exhibits depends on their personality and the type of investment behavior they exhibit. A competent financial advisor should also be aware of his client's psychological state before recommending any investments. Understanding and implementing behavioral finance solutions can assist irrational clients in meeting their financial objectives (Nofsinger, 2017). Regardless, the book offers a comprehensive foundation for behavioral finance. Although behavioral finance is a blend of finance, psychology and sociology (Ricciardi and Simon, 2000), the book overlooks the influence of other factors on irrational investors, such as social, economic and sustainability considerations, at a broader level. Furthermore, the demographic profile of an investor, which has a significant influence on any investment decision, is absent. In addition, several approaches are examined for making investment decisions from various viewpoints, such as expected utility theory, prospect theory, heuristic theory and herding theory (Luong and Thu Ha, 2011). However, the foundation for these theories is absent from this book. Despite such critiques, we recommend this book to readers of *Quantity and Quality* who aspire to comprehend behavioral finance approaches and the impact of these approaches on investors and advisors.

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