

# Chapter 1

## Behavioral Finance vs. Traditional Finance

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### **ABSTRACT**

*This chapter explored the development of behavioral finance theories from the traditional finance theories in detail. Traditional financial theory has assumed that investors are perfectly well-informed in making financial decisions for many years. However, the reality shows that these assumptions are not valid, especially over the last two decades. It is observed that investors exhibit irrational behaviors by acting with emotions even if they are well-informed. Because of the awareness of the importance human psychology in investment decisions, behavioral researchers have advanced their research in this direction. Thus, behavioral finance theories have been developed with this in mind.*

### **INTRODUCTION**

This chapter investigated the development of behavioral finance theories starting the traditional theories framework. Traditional financial theories have supposed that individuals are well-informed in making financial decisions, cautious and consistent for many years. It argues that investors are not surprised that they are presented with information because it accepted that all information is known, and they do not behave by their emotions. According to the traditional finance theory, the aim of the investors is maximum utility, and always acts without prejudice and rational manner for this purpose. Today, this aspect of finance has changed dramatically. Nevertheless, the real financial markets do not match to these assumptions. Especially over the past two-three decades this aspect of traditional finance has changed dramatically.

The interest of the behavioral finance field has been increasing during the last two-three decades due to the empirical evidence that individuals rarely behave by the assumptions of traditional finance theories and formation the perception that the theory of finance should take into account the observed individual behavior. Investigations in behavioral finance area have indicated that human psychology is very vital role in making financial decisions. Therefore, behavioral researchers generally conduct research from psychology to better understanding of financial decision-making process.

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The crises, panics, downfall, enthusiasm and bubbles that happen in the financial markets are the most important indicators that humans are not always rational. This area, which examines psychology, sociology, anthropology and finance together, is called behavioral finance. According to this behavioral finance theory, investors often show irrational behavior, unlike the traditional definition, and often pre-judge investment decisions. “Why do investors make irrational decisions?” is the main field of study of behavioral finance. Cognitive errors and prejudices that investors often make are identified in studies conducted.

Today, strong psychology as well as financial literacy and market experience are among the basic requirements for being a leading investor. Learning the basic concepts of behavioral finance will enable the investor to become aware of the prejudices and cognitive errors of his / her feelings and thoughts.

In this chapter these two finance fields have been focused with general principles and reflect the requirements of a comprehensive view on the subject. It has been also aimed to analyze how finance theory evolved over time from Efficient Market Hypothesis to Behavioral Finance and put forward the results for investors, corporate finance decision makers, market regulators and policy makers by examining pros and cons of EMH which had gained both theoretical and empirical success since its first appearance in 1960's till the beginning of 1980's. As a result, the aim of the chapter is to provide a better understanding of the different perspectives of traditional and behavioral finance disciplines as a whole.

## **TRADITIONAL FINANCE THEORY AND DECISION MODELS**

This part of the chapter examines what traditional theories and their models are and includes all details about these.

The beginning of the classical economics is in the middle of the 18th century. Mill (1844), presented the notion of “rational economic man”, whose aim to maximize his utility by taking into account the constraints he faced. According to the aim of maximizing utility, the traditional finance theories have four foundation blocks:

1. Perfectly rational investors;
2. Efficient markets;
3. Constructing portfolios depending on the rules of traditional Mean-Variance model,
4. Risk-return trade off. Expected returns on investments are explained by differences in risk.

Modern portfolio theory dates back to 1950s. In 1952, Markowitz (1952) determined initial form of mean-variance portfolio theory. Sharpe (1964) adopted this theory as a definition of investor behavior and presented the Capital Asset Pricing Theory (CAPM). According to the CAPM, differences in expected returns are only determined by differences in risk. Fama (1965) also described efficient markets concept.

A summary table is provided for the theories to be explained in this part below. In Table 1 the traditional finance theories have been summarized that will be compared with behavioral finance. Summarizing theories such as traditional theory of investor preference, the expected utility theory, Markowitz Mean-Variance portfolio theory, Capital Asset Pricing Model (CAPM), arbitrage asset pricing theories (APT), and Fama-French three factor model,

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