**Behavioral Finance Principles**

Behavioral finance is the study of how psychological phenomena impact financial behavior. It is the study of how investors tend to make systematic errors based on human psychology.

Some Examples:

1. Investors tend to overly rely on steryotypes, placing too much weight on conditional probabilities and not enough weight on unconditional probabilities
2. Investors tend to believe that trends will continue
3. Investors tend to be either overly optimistic or overly pessimistic
4. Investors tend to be overconfident – which can lead to an underestimate of risk
5. Investors base their decisions on a point of reference rather than an absolute value. They are less willing to take risks when they are above that point of reference and more willing to take risks when they are below that point of reference
6. Humans (which includes investors) will often make decisions based on the way a question is framed rather than the merits of the question.
7. Investors tend to prefer investments with guaranteed gains
8. Investors tend to reject investments with guaranteed losses
9. Investors tend to look at separate investments individually rather than as part of a portfolio

Implications:

1. Investors will tend to sell winners too soon
2. Investors will tend to hold on to losers too long
3. Investors will invest in riskier stocks if they are “down” for the year
4. Investors will invest in safer stocks if they are “up” for the year
5. The market will be more volatile than the economy
6. Investors will short stocks too often
7. Investors will under-diversify
8. Investors will hold very risky and very safe investments in the same portfolio
9. Investors will tend to follow the herd