Behavioural Finance

A Different Perspective - Individual and Institutional

Traditional Finance is based upon NeoClassical Economics where risk aversion , utility maximisation and rationality are the key words to describe the investors . Also markets are assumed to be efficient and it is assumed that prices incorporate and reflect all available and relevant information.

Behavioural finance applies Psychology to finance and attempts to understand and explain observed investor and market behaviour .

Behavioural finance Micro (BFMI) questions rationality and decision making process of individuals

Behavioural Finance Macro (BFMA) questions efficiency of markets and considers market anomalies that distinguish markets from the efficient markets of traditional finance

Key Differences can be summarised as

	Traditional Finance	**Behavioural Finance**
Assumtions	Perfect Rationality	Non Normative assumptions Bounded Rationality
Based Upon	Utility Theory ; Risk Aversion Theory	Prospect Theory (Loss aversion rather than risk aversion)
Individuals	Rational , Risk Averse , self interested utility maximisers , Unbiased Construct and Hold Optimal Portfolios	Observed Investor Behaviour ; Bounded rationality ; Behavioural Biases ; informational , computational and intellectual limitations Satisfice rather than optimise
Portfolios	Optimal and mean variant efficient	Constructed in layers to satisfy goals
Markets	Are Efficient ; Prices incorporate all available information	Not efficient but rather anomalous

(other terms to understand are neuro economics and adaptive finance)

It is advisable to construct investment solutions using an integrated approach that uses traditional finance to build a rational solution and then make adjustments using Behavioural insights