DePaul University, Chicago, Illinois
DRIEHAUS CENTER FOR BEHAVIORAL FINANCE

PSYCHOLOGY OF FINANCIAL DECISION-MAKING

A common portrayal of financial decision-making is one that interprets all action as rational choice. However, pure rationality strains credulity as a description of how decisions are actually made. This course studies the various behavioral strategies that people rely upon to make financial decisions.

The course starts with a review of psychological research on intuitive judgment, belief formation, learning, memory, utility theory, risk attitudes, and intertemporal choice. We introduce concepts such as framing, heuristics, self-control, and conformity. These ideas are illustrated with practical applications to household financial management, economic forecasting, trust between financial advisors and their clients, and decision-making in groups.

Topics and assignments

WEEK 1: FOUNDATIONS

Herbert Simon, "Alternative visions of rationality," *Reason in Human Affairs*, 1983

Paul Slovic,ˇ Psychological study of human judgment: Implications for investment decision-making." *Journal of Finance*, 1972

*(recommended) Robin Hogarth, "Human judgment: An overview," in Robin Hogarth, *Judgment and Choice: The Psychology of Decision*, Wiley, 1987

WEEK 2: JUDGMENT

Amos Tversky and Daniel Kahneman, "Judgment under uncertainty: Heuristics and biases," *Science*, 1974

Barbara McNeil et al., "On the elicitation of preferences for alternative therapies," *New England Journal of Medicine*, 1982

Robyn M. Dawes, David Faust, and Paul E. Meehl, "Clinical versus actuarial judgment," *Science*, 1989

Robert Dipboye, "Self-fulfilling prophecies in the selection-recruitment interview," *Academy of Management Review*, 1982

WEEK 3: CHOICE

Daniel Kahneman and Amos Tversky, "Choices, values, and frames," *American Psychologist*, 1984.

Daniel Kahneman and Mark Riepe, "Aspects of investor psychology," *Journal of Portfolio Management*, 1998

*(recommended) Amos Tversky and Daniel Kahneman, "Rational choice and the framing of decisions," *Journal of Business*, 1986.

WEEK 4: MENTAL FRAMES, MEMORY AND LEARNING

Daniel Kahneman, Jack Knetsch, and Richard Thaler, "The endowment effect, loss aversion, and status-quo bias," *Journal of Economic Perspectives*, 1991

Barry Staw, "The escalation of commitment: An update and appraisal," in Z. Shapira, *Organizational Decision-Making*, 1997

Baruch Fischhoff and Ruth Beyth, "I knew it would happen: Remembered probabilities of once-future things," *Organizational Behavior and Human Performance*, 1975

*(recommended) Daniel Schacter, *The Seven Sins of Memory: How the Mind Forgets and Remembers*, Houghton Mifflin, 2001

*(recommended) Richard Thaler, "Mental accounting matters," *Journal of Behavioral Decision Making*, 1999

WEEK 5: CONFIDENCE AND EMOTIONS

Neil Weinstein, "Unrealistic optimism about future life events," *Journal of Personality and Social Psychology*, 1980

Dale Griffin and Amos Tversky, "The weighing of evidences and the determinants of confidence," *Cognitive Psychology*, 1992

*(recommended) Jon Elster, "Emotions and economic theory," *Journal of Economic Literature*, 1998

*(recommended) Paul Slovic et al., "Rational actors or rational fools: Implications of the affect heuristic for behavioral economics," Working paper, University of Oregon, July 2002

WEEK 6: CHOICE OVER TIME

George Loewenstein and Richard Thaler, "Intertemporal choice," *Journal of Economic Perspectives*, 1989

Richard Thaler, "Saving, fungibility, and mental accounts," *Journal of Economic Perspectives*, 1990

Shlomo Benartzi and Richard Thaler, "Naïve diversification strategies in retirement savings plans," *American Economic Review*, 2001

*(recommended) Meir Statman, "A behavioral framework for dollar-cost averaging," *Journal of Portfolio Management*, 1995

WEEK 7: PERSONAL FINANCE

Werner De Bondt, "A portrait of the individual investor," *European Economic Review*, 1998

Jan Pahl, "His money, her money: Recent research on financial organization in marriage," *Journal of Economic Psychology*, 1995

*(recommended) Lawrence Ausubel, "The failure of competition in the credit card market," *American Economic Review*, 1991

*(recommended) Thomas Stanley, *The Millionaire Mind*, Andrews McMeel Publishing, 2000

WEEK 8: FORECASTING

Mary Bange, "Do the portfolios of small investors reflect positive feedback training?" *Journal of Financial and Quantitative Analysis*, 2000

Arnold Cooper, Carolyn Woo and William Dunkelberg, "Entrepreneurs' perceived chances for success," *Journal of Business Venturing*, 1988

*(recommended) Daniel Kahneman and Danial Lavallo, "Timid choices and bold forecasts: A cognitive perspective on risk taking," *Management Science*, 1993

WEEK 9: TRUST

Avinash Dixit and Barry Nalebuff, "Making strategies credible," in R. Zeckhauser, *Strategy and Choice*, 1991

P. Tetlock, "Accountability: A social check on the fundamental attribution error," *Social Psychology Quarterly*, 1985

Lynn Stout, "The investor confidence game," Working paper, UCLA School of Law, April 2002

*(recommended) David Maister et al., *The Trusted Advisor*, Simon & Schuster, 2000

WEEK 10: DECISION-MAKING IN GROUPS, BARGAINING AND SOCIAL INFLUENCES

Linda Babcock and George Loewenstein, "Explaining bargaining impasse: The role of self-serving biases," *Journal of Economic Perspectives*, 1997

Ernst Fehr and Simon Gaechter, "Reciprocity and economics: The economic implications of Homo Reciprocans," *European Economic Review*, 1998

*(recommended) Jon Elster, "Envy in social life," in R. Zeckhauser, *Strategy and Choice*, 1991

Additional reading and sources

Jonathan Baron, *Thinking and Deciding*, Cambridge University Press, 1988

Max Bazerman, *Judgment in Managerial Decision Making*, Wiley, 1986

Tom Gilovich, Dale Griffin, and Daniel Kahneman, *Heuristics and Biases: The Psychology of Intuitive Judgment*, Cambridge University Press, 2002

James March, *A Primer on Decision-Making*, Free Press, 1994

Scott Plous, *The Psychology of Judgment and Decision-Making*, McGraw-Hill, 1993

J. Edward Russo and P.J.H. Schoemaker, *Decision Traps*, Simon & Schuster, 1989

Hersh Shefrin, *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, Harvard Business School Press, 1999

Charles Smith, *Understanding the Mind of the Market: Success and Survival on Wall Street*, Rowman and Littlefield, 1999

Karl-Erik Warneryd, *Stock-Market Psychology: How People Value and Trade Stocks,* Edward Elgar, 2001