

When Disciplines Collide: The Case of Teaching Behavioral Finance

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ABSTRACT

Behavioral finance is a growing area of finance. In this paper, we look at the evolution of the field of behavioral finance and the integration of behavioral finance and organizational behavior/management topics. Conversations between finance and management faculty could facilitate the growth in the behavioral finance field. Silos between business schools disciplines are pointed to as the likely culprit in the lack of discussion and even lack of awareness of the interest each discipline has in these psychology-based concepts.

INTRODUCTION

Kurt Vonnegut wrote “If it weren't for the people, the @#\$%& people ... the world would be an engineer's paradise.” Using behavioral finance, we can paraphrase Vonnegut and say “If it weren't for the people, the @#\$%& people ... the world would be an investor's paradise.” In the past few years, finance has become aware of tenets that management professors have been teaching for years--people's perceptions and biases impact their decision making. Rational decision making is, in many cases a myth, or at least a standard to which few people can truly meet. Although the field of finance is steeped in the assumption of rationality, when people are involved, nothing is clear-cut.

The field of behavioral finance has been growing and becoming a more mainstream part of finance. During the last few years, the topic of behavioral finance has begun appearing in finance textbooks and is starting to be taught as part of the finance curriculum. Surprisingly, or not surprisingly, the field of behavioral finance has been heavily influenced by the fields of psychology and economics and not the business discipline most closely related to behavioral issues and decision making, management. The field of behavioral finance appears to be a prime area for interdisciplinary research and cooperation between finance and management. However, little interdisciplinary efforts appear to be occurring in the field of behavioral finance. The lack of cooperative efforts may be due to the “silos” that may develop in business schools. This paper will discuss what happens when different business disciplines collide, or intersect, using the case of teaching behavioral finance and will explore the issues associated with integrating traditional finance and organizational behavior.

OVERVIEW OF BEHAVIORAL FINANCE

Traditional finance has a long history. Classical economists such as Ricardo, Malthus, and Smith developed the free market theory in the late 18th century. In finance, the assumption of economic rationality is critical to the “efficient market” hypothesis, which states that financial market prices reflect all available information -- making it impossible to achieve excess rates of return. Efficient market theory is a cornerstone of modern financial theory and the conceptualizations of the risk-return tradeoff driving market valuations. In addition to the rationality assumption, financial theories such as the efficient market theory assume that decisions will be based on all relevant information.

The hypothesis of economic rationality and efficient market has been challenged in many studies such as Reinganum’s 1981 study of earnings yield, Keim’s 1983 study of size anomalies and the study of inefficiencies and overreaction in the market place by DeBondt and Thaler (1985). While these and other studies have identified potential market anomalies, explanations for why these anomalies may exist have often been aimed at misspecification of the CAPM or other model deficiencies rather than a full exploration of the behavioral assumptions underlying financial theories.

Shefrin (2000, p. xi) defines behavioral finance as “the study of how psychology affects finance.” He traces the beginning of the development of behavioral finance as a field to a 1984 session of American Finance Association on behavioral finance. He also mentioned Kahneman, Slovic, and Tversky’s 1982 work as instrumental in bringing psychology to the discipline of finance. According to Shefrin (2000), the three frames of behavioral finance include (1) use of heuristics or rules of thumb, (2) frame dependence, and (3) inefficient markets based on errors and decision frames.

In the 2011 book, *Thinking, Fast and Slow*, Nobel Laureate Daniel Kahneman integrates psychology and behavioral economics research into a model of judgment and decision making. Kahneman suggests that human decision making is governed by two interacting systems. System 1 is rapid, automatic, and intuitive. System 1 makes most moment-to-moment decisions. System 2 is slower and more analytic, requiring significant effort and concentration. System 2 is invoked only when complex analysis is required. The interacting systems may have significant implications for financial decision making and furthers questions the assumptions of rationality and the proper use of all relevant information that underlies many financial theories.

Through the works of researchers such as Shefrin and Kahneman, there is growing recognition that traditional theories in finance that describe market behavior and are dependent on assumptions of rationality need to be reexamined. Behavioral finance topics are slowly starting to be presented in a limited manner in both investment and corporate finance textbooks. The growth of the behavioral finance field requires that finance faculty become more aware of the behavioral aspects of financial decision making when teaching and conducting research.

INTEGRATING BEHAVIORAL FINANCE AND ORGANIZATIONAL BEHAVIOR

In business schools, the discipline that is most closely related to psychology is management, specifically the field of organizational behavior. Organizational behavior is very closely related to the area of industrial-organizational psychology. Although there were early examples of management (e.g., the construction of the Pyramids), management as a field developed in the late 1800s and early 1900s. Organizational behavior is often traced to the

Hawthorne studies of the late 1920s and early 1930s. The topic of decision making is a part of management and organizational behavior, but investment decision making has not been a specific area of focus.

To a management professor, the behavioral finance literature is very familiar but used in a different context. As noted before, Shefrin (2000) stated the three frames of behavioral finance are (1) use of heuristics or rules of thumb, (2) frame dependence, and (3) inefficient markets based on errors and decision frames. In Principles of Management and Organizational Behavior classes, the discussion of the use of heuristics and framing is commonplace when discussing managerial decision making.

Classical decision making assumes people are rational and make optimal decisions. Most of us are familiar with the steps in the classical decision making model of first defining the problem, then developing alternatives, evaluating the alternatives and finally, selecting the *best* alternative. March and Simon (1958) questioned whether optimum decisions are made and developed the concept of bounded rationality. Bounded rationality suggests that people make decisions in conditions of limits or bounds on their rationality. Rationality is limited by lack of time, lack of information, and ultimately, by the limits in cognitive ability. In other words, even if there were no limits on time and information was complete, people have limitations on their ability to interpret, process, and act on information. In a later edition of his book, *Administrative Behavior*, Simon (1997) noted that computers have greatly expanded rationality by making information more readily available and more easily compiled and analyzed. Although computers have helped in gaining more information on which to based decisions, there are still limits or bounds to people's rationality. Bounded rationality results in *satisficing* rather than *optimizing* decisions. In other words, although the goal is to make the best decision possible, under conditions of bounded rationality, the decisions are acceptable, if not optimum, given the lack of time, resources, information, and cognitive ability.

Another reason why the classical decision making model is flawed is that the information available to decision makers is often ambiguous. It is up to decision makers to interpret the information. For the issues related to interpreting information, we turn to another psychology-based management topic--perception. An often quoted saying is "There is no reality, there is only our perception of reality." Perception is the process of selecting, organizing, and interpreting data from the environment. When faced with ambiguous information, the perceptual process is very important in the final interpretation of that information and how it is used in the decision making process. The perceptual process is influenced by several factors including characteristics of the perceiver, characteristics of the target and characteristics of the situation (George & Jones, 2012). Characteristics of the perceiver include the perceiver's schemas, motivational state, and mood. Schemas are the perceiver's knowledge base formed by past experiences. Schemas are perceptual shortcuts and can be functional or dysfunctional. Stereotypes are forms of schemas.

Characteristics of the target of the perception are also important and include the ambiguity, social status, and impression management. Ambiguous information fits into this category. Characteristics of the situation provide additional influence to the perceptual process. Saliency fits into this category and is mentioned by Shefrin (2000) as being important in behavioral finance. In his discussion of biased reaction to earnings announcements, Shefrin indicated that saliency was key. "If the earlier history is especially salient, the information about recent change will be underweighted. If the recent information about change becomes more salient, it will be overweighted (Shefrin, 2000: 103)."

Work in information processing tells us that disconfirming evidence is often ignored resulting in a confirmation bias. Confirmation bias is the seeking or interpreting of evidence in ways that are partial to existing beliefs, expectations, or a hypothesis in hand (Nickerson, 1998). Confirmation bias may happen in the selection process where selective perception may occur and only confirming evidence is recognized as salient and selected. Confirmation bias may also occur in the interpretation phase of the perceptual process. Shefrin (2000) recognized confirmation bias when discussing the presence of sentiment in investment decisions. Shefrin (2000:62) noted, “Investors search only for confirming evidence; and they ignore disconfirming evidence.”

Shefrin (2000) also discusses self-attribution bias. Attribution theory is a topic covered in Organizational Behavior and increasingly it is being included in Principles of Management textbooks. Attribution theory describes the causation of behavior, both our own behavior and other people’s behavior. Essentially, one makes either an internal attribution, the cause of the behavior is due to something about the individual, or an external attribution, the cause of the behavior is due to an influence outside the individual. Self-attribution bias is a basic attributional bias. Self-attribution bias is the tendency to take credit for one’s successes (i.e., make an internal attribution) and to attribute failure to outside influences (i.e., make an external attribution).

Shefrin (2000) discussed self-attribution bias when discussing using a financial advisor. When an investor uses a financial advisor and the investment turns out well, the investor will still claim credit for the good investment. If the investment turns out poorly, the investor will blame the advisor. As Shefrin (2000:130) noted, “The investor attributes favorable outcomes to skill, and unfavorable outcomes to either somebody else, or just plain bad luck.” Attributing favorable outcomes to skill is making an internal attribution and attributing unfavorable outcomes to somebody else or bad luck is making an external attribution.

Shefrin (2000) also noted that investors often recollect having better performance or judgment than the actual performance highlighting the Goetzman and Peles’ (1997) study in which mutual fund owners remembered their fund performing better than it did. Shefrin credited that reaction to cognitive dissonance. Cognitive dissonance is a theory by Festinger (1957), which essentially says people are uncomfortable with new information that conflicts with preexisting beliefs or by having two conflicting beliefs and people try to reconcile that dissonance by justifying or rationalizing away the discrepancy. The Aesop fable of the fox not being able to reach grapes and then rationalizing that he didn’t want them anyway because they were probably sour (hence the phrase sour grapes) is an example of cognitive dissonance.

Behavioral finance has adapted many psychological concepts that are routinely discussed in possibly both a Principles of Management or Organizational Behavior course. Although we know students do not have perfect recall of subject matter covered in previous courses, finance professors should recognize that many of these concepts have been covered in management courses and seek to build upon the knowledge the students received in these courses as they introduce behavioral finance topics. Conversations with their management colleagues could tell them what topics are covered in management courses. Ah, therein lies the rub—conversations between business faculty colleagues from different disciplines would need to take place. Can these entrenched silos be broken down to encourage discussions between business faculty? First, finance faculty will need to recognize that they do not have to go across campus to the psychology department to discuss these concepts used in behavioral finance. They can simply go down the hall or to another floor in their business building and talk with their management colleagues. These conversations would enlighten their management colleagues who probably have no idea that finance is exploring the behavioral realm.

CONCLUSION

Finance faculty are finding themselves discussing behavioral topics that might be outside their traditional area of expertise. Organizational behavior faculty, for the most part, have no idea their finance counterparts are delving into the behavioral world. With each of these business disciplines having long histories, we can point to the “silos” that develop in business schools as one reason that the decision making material taught in management/organizational behavior classes did not migrate into the finance area until the 1980s and 1990s. And we can point out that the behavioral finance pioneers took this information from the field of psychology—not the business field that is closely related to psychology. Countless opportunities abound for cross-disciplinary work in this area, but the silos developed by business schools will have to be overcome for each side to be able to learn from one another. Shefrin (2000) noted that he saw a flashing yellow light with regard to studies in finance and economics that develop their own behaviorally motivated explanations for financial decision making that are not grounded in psychology. As Shefrin (2000:102) stated, “...when economists have developed their own psychology, the results has been both bad psychology and bad economics.”

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