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What is Behavioral Finance?

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Abstract

While conventional academic finance emphasizes theories such as Modern Portfolio Theory (MPT) and the Efficient Market Hypothesis (EMH), the emerging field of behavioral finance investigates the cognitive factors and emotional issues that impact the decision-making process of individuals, groups, and organizations. This paper presents an introduction to some general principles of behavioral finance including: overconfidence, cognitive dissonance, regret theory, and prospect theory. Also, this article provides strategies to assist individuals to resolve these mental errors and emotional pitfalls by recommending some important investment approaches for those who invest in stocks and mutual funds.

Note: This paper serves as a very good introductory reading for an undergraduate class in finance and economics.

Keywords: Behavioral Finance, Behavioural Finance, Behavioral Economics, Overconfidence, Financial Cognitive Dissonance, Regret Theory, Prospect Theory, Undergraduate, Graduate, Education, Students, Psychology, Overview, Introduction

JEL Classification: A12, G00, G14

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