How Behavioral Finance Can Change the Theory and Practice of Investment Management Industry

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Abstract
Behavioral finance helps any potential investor inside or outside the industry to understand how investors make decisions, to design financial products that suit best to individual investors, to understand how institutional investors trade and to provide suitable regulation (for example, short selling). In other words to take advantage of other investors, to judge the cognitive biases and errors, and for the majority of investors to realize their mistakes before the investment of those price deviation varieties, and a reasonable price point, the unwinding profits. This article analyses the change that behavioral finance can bring inside the investment management industry.

Keywords: Behavioral finance, Investment management industry, Theory and Practice.

1. Introduction
The way in which academics and practitioners analyze investment performance has long shaped by the financial theory based on Modern Portfolio Theory (Markowitz, 1952) and Capital Asset Pricing Model (Sharpe, 1964). The theory is based on the notion that investors act rationally and consider all available information in the decision-making process, and hence investment markets are efficient, reflecting all available information in security prices.

Nowadays the psychology influences the behavior in the decision-making of individual and professional investors markets, and managers. This is the way that the behavioral finance is a relatively new field in economics, has become a hot topic for investment management industry. The Most of conferences were oriented toward investors have recently featured sessions on behavioral finance. However, because the behavioral finance is so new, most professionals responsible for large portfolios were not exposed to the principles of behavioral finance in their college curricula and these principles have significant practical implications for investment management industry. Looking ahead we will see that new branch of economics (behavioral finance) is very useful in helping people to understand the theory and practice of investment management industry. But in our case the question is still remaining, or the subject of our study was submitted:

<<How behavioral finance can change the serial and the practice of investment management industry?>>

Trough this paper we will try to answer and to explain the changing in the theory and practice of investment management industry caused by the behavioral finance. First of all we will try to give some thinking of different authors in this new field in economics, talk about the concept of the behavioral finance, and then explain the theory and practice of investment management industry, and then enter into the subject of paper.

2. Literature review
In this literature review, we will show like a story of the creation the behavioral over the years and over the different events in the stock market.
From the accounting literature, Basu (1997) funds evidence for the conservatism principle, which he interprets as earnings reacting ‘bad news’ more quickly than good news’. Bikhchandani, Hirshleifer and Welch (1998) argue that the theory of observation learning, and particularly of informational cascades, can help explain phenomena such as stock market crashes. Motivated by a variety of psychological evidence, Barberis, Shleifer and Vishny (1998) present a model of investor sentiment that displays underreaction of stock prices to news such as earnings announcements and overreaction of stock prices in the industry to a series of good or bad news. In his third review paper Fama (1998) defends the efficient market hypothesis that he famously defined in his first, and claims that apparent overreaction of stock prices in the industry to information got by the investment managers is about as common as underreaction. This argument is unconvincing, because under- and overreactions appear to occur under different circumstances and/or at different time intervals. Odean (1998) tested and found evidence for the disposition effect, the tendency of investors to sell winning investments too soon and hold losing investments for too long. Daniel, Hirshleifer and Subrahmanyam (1998) propose a theory of security markets based on investor overconfidence (about the precision of private information) and biased self-attribution (which causes changes in investor’s confidence as a function of their investment outcomes) which leads to market under- and overreactions. Camerer and Lovallo (1999) found experimentally that overconfidence and optimism lead to excessive business entry. Wermers (1999) studied herding by mutual fund investment managers and he found the highest levels in trades of small stocks and in trading by growth-oriented funds. Thaler (1999) summarizes the literature on mental accounting and concludes that mental accounting influences choice, that is, it matters. Gigerenzer, Todd and the ABC Research Group (1999) publish Simple Heuristics That Make Us Smart, a book about fast and frugal heuristics. Odean (1999) demonstrated that overall trading volume in equity markets is excessive, and one possible explanation is overconfidence. He also found evidence of the disposition effect which leads to profitable stock being sold too soon and losing stocks being held for too long. Hong and Stein (1999) model a market populated by two groups of boundedly-rational agents: newswatchers and momentum traders which leads to underreaction at short horizons and overreaction at long horizons. Nofsinger and Sias (1999) found that institutional investors positive-feedback trade more than individual investors and institutional herding impacts prices more than herding by individual investors. Veronesi (1999) presented a dynamic, rational expectations equilibrium model of asset prices in which, among other features, prices overreact to bad news in good times and underreact to good news in bad times. There is a commonly observed but unexpected negative correlation between perceived risk and perceived benefit. Finucane, et al. (2000) concluded that this was due to the affect heuristic people tend to derive both risk and benefit evaluations from a common source. Hong, Lim and Stein (2000) propose that firm-specific information, especially negative information, diffuses only gradually across the investing public, and this is responsible for momentum in stock returns. Shleifer (2000) publishes Inefficient Markets: An Introduction to Behavioral Finance, a quality book that considers behavioral finance vis-a-vis the EMH. In considering descriptive theories of choice under risk, Starmer (2000) reviews alternatives to expected utility theory. Shefrin (2000) wrote Beyond Greed and Fear, an excellent book on behavioral finance and the psychology of investing. In 2000, in his book Irrational Exuberance, Robert J. Shiller presented a persuasive case that the US stock market was significantly overvalued, citing structural factors, cultural factors and psychological factors (Shiller 2000). Kahneman and Tversky (2000) edit the book Choices, Values, and Frames, which presents a selection of the research that grew from their collaboration on prospect theory. Rabin (2000) provides a theorem showing that expected utility theory is an utterly implausible explanation for appreciable risk aversion over modest stakes. Lee and Swaminathan (2000) showed that past trading volume provides an important link between momentum and value strategies and these findings help to reconcile
intermediate-horizon underreaction and long-horizon overreaction effects. Rabin and Thaler (2001) consider risk aversion and pronounce the expected utility hypothesis dead. Psychological research has established that men are more prone to overconfidence than women (especially in male-dominated areas such as finance), whilst theoretical models predict that overconfident investors trade excessively. Barber and Odean (2001) found that men trade 45 per cent more than women and thereby reduce their returns more so than do women and conclude that this is due to overconfidence. Barberis, Huang and Santos (2001) incorporate prospect theory in a model of asset prices in an economy. Grinblatt and Keloharju (2001) identify the determinants of buying and selling activity and find evidence that past returns, reference price effects, tax-loss selling and the fact that investors are reluctant to realize losses are all determinants of trading. Barberis and Huang (2001) compare two forms of mental accounting by incorporating loss aversion and narrow framing into two asset-pricing frameworks: individual stock accounting and portfolio accounting. The former was the more successful. Gigerenzer and Selten (2001) edited Bounded Rationality: The Adaptive Toolbox, a collection of workshop papers which promote bounded rationality as the key to understanding how real people make decisions. The book uses the concept of an adaptive toolbox, a repertoire of fast and frugal rules for decision making under uncertainty. Huberman (2001) provide compelling evidence that people have a propensity to invest in the familiar, while often ignoring the principles of portfolio theory. Gilovich, Griffin and Kahneman (2002) edited Heuristics and Biases: The Psychology of Intuitive Judgment, a book that compiles the most influential research in the heuristics and biases tradition since the initial collection in 1982 (Kahneman, Slovic and Tversky 1982). In the Introduction (Gilovich and Griffin 2002) identify six general purpose heuristics (affect, availability, causality, fluency, similarity and surprise) and six special purpose heuristics (attribution substitution, outrage, prototype, recognition, choosing by liking and choosing by default), whilst two heuristics have been superseded (representativeness (replaced by attribution substitution (prototype heuristic and similarity heuristic)) and anchoring and adjustment (replaced by the affect heuristic)). Slovic, et al. (2002) describe and discuss the affect heuristic: the specific quality of `goodness' or badness. Daniel Kahneman won the 2002 Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel for his work on prospect theory, despite being a research psychologist and not an economist. If it were not for his untimely death, Amos Tversky, Kahneman's collaborator, would have almost certainly shared the prize. Holt and Laury (2002) conducted a simple lottery choice experiment and found differences in risk aversion between behavior under hypothetical and real incentives. Barberis and Thaler (2003) publish a survey of behavioral finance. More recent developments in decision making under risk have improved upon cumulative prospect theory, such as the transfer of attention exchange model (Birnbaum 2008). Harrison and Rutstrom (2009) proposed a reconciliation of expected utility theory and prospect theory by using a mixture model.

3. The concept of behavioral finance

Behavioral finance has recently become a subject of significant interest to investors. Because it is a relatively new and evolving field in economics and consequently not well defined, a legitimate question is: “What exactly is behavioral finance?” we try personally to describe behavioral finance as the following ways:

Behavioral finance is the integration of classical economics and finance with psychology and the decision-making sciences. It is also an attempt to explain what causes some of the anomalies that have been observed and reported in the finance literature. In addition Behavioral finance is the study of how investors systematically make errors in judgment, or “mental mistakes.”

All economic models make simplifying assumptions about both market conditions and the behavior of market investors. Sometimes the simplifying assumptions underlying the model are explicitly stated and
sometimes the assumptions are implicit; the latter is often the case regarding the behavioral assumptions underlying the model. In order to catch a meaning of behavioral finance, it is important to talk about the efficient market hypothesis that has the real importance for the investors and in the decisions making on the market. For example, let’s consider the efficient market hypothesis (EMH), an economic model of considerable importance to investors. The simplifying assumptions regarding market conditions that underlie the EMH frequently include, among others, assumptions such as: Transaction costs are zero, Markets are not segmented, Easy (even unlimited) entry into the security markets exists. The behavioral assumptions that underlie the EMH can be expressed as:
- Investors act, in an unbiased fashion, to maximize the value of their portfolios.
- Investors always act in their own self-interest.

The first behavioral assumption is frequently stated as investors are rational expectations wealth maximizers. This means that investors form unbiased expectations of the future and given these expectations, they buy and sell in the securities markets at prices which they believe will maximize the future value of their portfolios.

Behavioral finance questions whether the behavioral assumptions underlying the EMH are true. For example, consider the assumption that individuals always act in their economic self-interest. Suppose you are having dinner at an out-of-town restaurant and it is extremely unlikely that you will ever return to this restaurant. Most people do, but in this case leaving a tip decreases, rather than increases one’s wealth, and because you won’t be returning to this restaurant there are (presumably) no costs associated with not leaving a tip. In this case leaving a tip violates the rational expectations and self-interest assumptions. More germane to the EMH, consider social investing such as arbitrarily deciding not to invest in tobacco stocks or deciding to overweight environmentally clean industries, etc. Such behavior is not consistent with pure wealth maximization, if for no other reason than opportunities for forming better-diversified portfolios are foregone. Why investors might engage in non-wealth maximizing behavior, and what are the implications of such behavior for security pricing, are areas of inquiry in behavioral finance. Another aspect of behavioral finance concerns how investors form expectations regarding the future and how these expectations are transformed into security prices. Researchers in cognitive psychology and the decision sciences have documented that, under certain conditions, people systematically make errors in judgment or mental mistakes. These mental mistakes can cause investors to form biased expectations regarding the future that, in turn, can cause securities to be mispriced. By considering that investors may not always act in a wealth maximizing manner and that investors may have biased expectations, behavioral finance may be able to explain some of the anomalies to the EMH that have been reported in the finance literature. Anomalous returns such as those associated with value stocks, earnings surprises, short-term momentum and long-term price reversals are fertile ground for researchers in behavioral finance. According to the new field most of mismeasurements are caused by psychological biases, temporary supply and demand imbalances. For example, the tyranny of indexers can lead to demand shifts that are unrelated to the future cash flows of the firm. When Yahoo was added to the S&P 500 in December 1999, index fund managers had to buy the stock even though it had a limited public float. This extra demand drove up the price by over 50% in a week and over 100% in a month. Eighteen months later, the stock price was down by over 90% from where it was shortly after being added to the S&P. If it is easy to take positions (shorting overvalued stocks or buying undervalued stocks) and these mismeasurements are certain to be corrected over a short period, then arbitrageurs will take positions and eliminate these mispricing before they become large. But if it is difficult to take these positions, due to short sales constraints, for instance, or if there is no guarantee that the mispricing will be corrected within a reasonable timeframe, then arbitrage will fail to correct the mispricing. Indeed,
arbitrageurs may even choose to avoid the markets where the mispricing is most severe, because the risks are too great. This is especially true when one is dealing with a large market, such as the Japanese stock market in the late 1980s or the U.S. market for technology stocks in the late 1990s. Arbitrageurs that attempted to short Japanese stocks in mid-1987 and hedge by going long in U.S. stocks were right in the long run, but they lost huge amounts of money in October 1987 when the U.S. market crashed by more than the Japanese market (because of Japanese government intervention). If the arbitrageurs have limited funds, they would be forced to cover their positions just when the relative misevaluations were greatest, resulting in additional buying pressure for Japanese stocks just when they were most overvalued.

4. The theory and practice investment management industry

Give the definition of the theory and practice investment management is to define firstly the activities associated with investment management. There are:
1. How investment objectives are determined
2. The investment products to which an investor can allocate funds
3. The way investment products are valued so that an investor can assess whether or not a particular investment is fairly priced
4. The investment strategies that can be employed by an investor to realize a specified investment objective
5. The best way to construct a portfolio, given an investment strategy
6. The techniques for evaluating the performance of an investor.

And then to explain the investment management process, it involves the following five steps:

First step: Setting Investment Objectives

The first step in the investment management process, setting investment objectives, begins with a thorough analysis of the investment objectives of the entity whose funds are being managed. These entities can be classified as individual investors and institutional investors. Within each of these broad classifications is a wide range of investment objectives. The objectives of an individual investor may be to accumulate funds to purchase a home or other major acquisition, to have sufficient funds to be able to retire at a specified age, or to accumulate funds to pay for college tuition for children. An individual investor may engage the services of a financial advisor/consultant in establishing investment objectives. Institutional investors include pension funds, depository institutions (commercial banks, savings and loan associations, and credit unions), insurance companies (life companies, property and casualty companies, and health companies), regulated investment companies (mutual funds), endowments and foundations, treasury department of corporations, municipal governments, and government agencies.

Second step: Establishing an Investment Policy

The second step in the investment management process is establishing policy guidelines to satisfy the investment objectives. Setting policy begins with the asset allocation decision. That is, a decision must be made as to how the funds to be invested should be distributed among the major classes of assets (U.S. common stocks, Non-U.S. (or foreign), common stocks U.S. bonds, Non-U.S. (or foreign) bonds, Cash equivalents, Real estate).

Third step: Selecting a Portfolio Strategy
Selecting a portfolio strategy that is consistent with the investment objectives and investment policy guidelines of the client or institution is the third step in the investment management process. Portfolio strategies can be classified as either active or passive. An active portfolio strategy uses available information and forecasting techniques to seek a better performance than a portfolio that is simply diversified broadly. Essential to all active strategies are expectations about the factors that have been found to influence the performance of an asset class. For example, with active common stock strategies, this may include forecasts of future earnings, dividends, or price-earnings ratios. With bond portfolios that are actively managed, expectations may involve forecasts of future interest rates and sector spreads. Active portfolio strategies involving foreign securities may require forecasts of local interest rates and exchange rates.

A passive portfolio strategy involves minimal expectation input, and instead relies on diversification to match the performance of some market index. In effect, a passive strategy assumes that the marketplace will reflect all available information in the price paid for securities.

Between these extremes of active and passive strategies, several strategies have sprung up that have elements of both. For example, the core of a portfolio may be passively managed with the balance actively managed.

**Fourth step:** Selecting the Specific Assets

Once a portfolio strategy is selected, the next step is to select the specific assets to be included in the portfolio. It is in this phase of the investment management process that the investor attempts to construct an efficient portfolio. An efficient portfolio is one that provides the greatest expected return for a given level of risk, or equivalently, the lowest risk for a given expected return.

**Fifth step:** Measuring and Evaluating Performance

The measurement and evaluation of investment performance is the last step in the investment management process. Actually, it is misleading to say that it is the last step since the investment management process is an ongoing process. This step involves measuring the performance of the portfolio and then evaluating that performance relative to some benchmark.

5. The behavioral finance can change the theory and practice of investment management industry

In the Change in Investment Management industry, we analyzed the changes that became manifest during the credit crunch and what they mean in practice for investment management firms. Generally speaking, those managing hedge funds were more concerned about the behavioral finance impact that recent events will have on their businesses, their clients, and the environment they are working within. Behavioral finance theory holds that investors due to information processing capabilities, incomplete information, lack of time, and psychological bias constraints, will not be able immediately to respond to all public information. Investor’s often nonrelevant information to respond to their trading is not based on information but according to noise made. In this case, the market also cannot be effective. In addition, behavioral finance theory, starting right from the investor behavior has made many market anomalies to explain that the anomaly is a common phenomenon. This is evident from the illustration of how the industry is invalid.

The anomalies detected by the behavioral finance inside the investment management industry

People tend to have overestimated the psychological skills and knowledge of their tendency to the performance of investment decision-making over-confident of their own judgments and decisions. while ignoring the situation caused by changes in the objective possibility of making mistakes by hand.
over The organization completed England Securities Investor Behavior that the 65 million investors in England's stock market accounted for a large proportion of unemployed, who have reason to believe that a considerable portion of unemployed people is the lack of market competitiveness of the people, because nothing to do, do not consider their own ability to think of the stock market to make money, we can see that our investors are overconfident of severity. We can cite also anchoring of the error.

People in the value of an item to judge, usually requires certain information to determine the anchor as the reference standard. Similarly, investors predict stock price movements also need some information as a reference anchor often leads investors to new, positive message to inadequate response. Our investors often use a similar industry, sector, size, capital, operating results and other stock price to measure the stock price of their investment, but not for a long time anchor has maintained the accuracy and efficiency, that is, investors will judge the wrong anchor. But with the behavioral finance we can respect this reference standard by manage in the industry the stock prices movements.

there is also use the herd behavior that permit any managers look how the behavioral finance can change the theory and practice of investment management industry. The stock market's "herd behavior" refers to the investors, investment strategy due to the impact of other investors to adopt the same investment strategy and its critical impact on the behavior of other investors, investment decisions, and the result of his decision-making impact in the presence of a large number of US stock markets. The stock market follow suit, with the village, the investment fund’s portfolio the same class is typical of the herd behavior.

Noise trading and the value of non-rational investors to information that is unrelated to the value, or artificially create some investors false information, while other investors cannot identify the authenticity of the information is considered both noise, the corresponding transaction is called the noise generated by transactions in Asian's stock market close to 400% of the annual turnover of at least 300% can be attributed to noise trading.

One of the anomalies is the Representativeness, People underweight long-term averages. People tend to put too much weight on recent experience. This is sometimes known as the law of small numbers. As an example, when equity returns have been high for many years (such as 1982-2000 in the U.S. and Western Europe), many people begin to believe that high equity returns are normal. And the last that we can cite is Availability heuristic. This heuristic is used to evaluate the frequency or likelihood of an event on the basis of how quickly instances or associations come to mind. When examples or associations are easily brought to mind, this fact leads to an overestimation of the frequency or likelihood of this event. For Example, People are overestimating the divorce rate if they can quickly find examples of divorced friends.

Behavioral investment managers draw on the knowledge of human cognitive behavioral theories from psychology, sociology and anthropology. It was important to show the investor's problems in order to explain the various investor behaviors in investment management industry.

The change inside the investment management industry
the behavioral finance theory, securities investment management strategy under the guidance of Behavioral finance theory is to establish the significance of psychological factors of market participants in the investment decision-making behavior, and market pricing in the role and status, denial of the traditional financial theory simple assumption on the rational investors, more in line with the actual situation of financial markets. Behavior Finance guiding significance in practice is that investors can take irrational market behavior for the investment strategy to achieve the investment objective of profitability in the stock market such as the U.S. stock market, now that several asset management companies in the practice of behavioral finance theories, some of which are based on
Behavioral finance has made mutual funds 25% compound annual rate of return a good investment performance. On the one hand, to know and understand their own cognitive bias, to avoid making a wrong decision; on the other hand, to take advantage of other investors to judge the cognitive biases and errors, in the majority of investors to realize their mistakes before the investment of those price deviation varieties, and a reasonable price point, the unwinding profits. Because of human psychology and behavior is basically stable, so investment managers can take advantage of people's behavior deviation and long-term profitability. In particular, there are two kinds of application of ideas, that is behavioral finance theory, as an investment technology or as an investment idea, in fact a lot of investors are not only its technology as an investment as a mixed use investment philosophy. Concerning the public offering funds such as mutual funds directly billed as behavioral finance fund, they use a variety of cognitive bias of investors and the market price fluctuations manifested anomaly, in the behavioral finance theory, under the guidance of the use of mathematical tools and computer programs to the election stock and operations. For example the well-known American scientist Richard Thaler Behavioral Finance and Behavioral Finance Russell Fuller manages a mutual fund; its investment is the use of investor information processing errors caused by the non-validity of the market to obtain the return on investment, using bottom-up, combined with the concept of behavioral finance fundamental analysis to invest. For example, in the Asian futures market, there are a large number of inquiries the main trend to follow the trend of investment behavior, or open an account with a futures company of investors tend to hold in the same direction of the futures contracts. Herd behavior in the futures market because of the widespread presence of futures prices over-reaction would be inevitable, resulting in up too far or down too far. In this way, investment managers can take the opposite short-term trading investment strategy in order to obtain a normal reaction to over-reaction to the value of the process of return of profits. In addition, future's trading is a 'zero-sum game. If the removal of fees and other costs, futures trading is strictly speaking a negative-sum game, in such a market, the truth is often rests in the hands of a few. When most of the people think that the market price should be rising, prices tend to glimmer of hope. Therefore, as successful future stocks that should be bold enough to do a market in the minority, according to their own rational judgments and objective, to make the right investment decisions.

Since the beginning of the 20th century, 80 years, with the theory and practice of investment management industry contradict empirical studies continue to emerge, mainly reflected in changes in the investment strategy. Such as cost averaging strategy and time-diversification strategy. Cost averaging strategy refers to investors, depending on the price to buy shares in batches in order to prevent 'unexpected', the share of low-cost strategy, and time diversification is defined as the risk of the stock with the investment horizon to reduce the extension of the concept of As investors age, the growth will gradually reduce the proportion of shares strategy. These two strategies are considered to be of modern financial theory, the expected utility maximization obviously contrary to law. Some authors (Statman (1995), Fisher, Statman (1999)) in the hope that the use of behavioral finance theory, cognitive erroneous tendencies, dislike or regret view of the two strategies explained that strengthen self-control recommendations for improvement.

6. Conclusion
Behavioral finance is a modern financial theory that affects fundamental decisions and makes decisions of investment managers. In the framework, the original reason of Behavioral finance is to explain the market behavior and market participants to fully consider the role of psychological factors, for people to understand the financial markets provides a new perspective. Behavioral finance is the one able to effectively explain the abnormal behavior of the investment management industry. Behavioral
finance theory of the human mind based on the lot of research results to people's actual decision-making psychology as a starting point to discuss investment decisions of investors on the market prices. It focuses on the diversity of investor decision-making psychology, break through the investment management industry to focus only on the optimal decision-making model, the simplistic view that a rational investment decision-making model is to determine the market price changes in real investment decision-making model assumptions, so that people act on the management industry of financial market investors. This paper was conducted by how behavioral finance can change the theory and practice of investment management industry. We can say that this research was closed to the reality of the investment manager’s environment. Therefore, investment managers should be different in different investment strategy, only appeal to all levels of investments managers to participate in acts of financial problems, behavioral finance, and investment strategy can have very practical meaning in the world.

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