ISSN: 0974-5823 Vol. 6 No. 3 December, 2021

International Journal of Mechanical Engineering

BOOK REVIEW Michael M. Pompian: “Behavioral Finance and Your Portfolio: A Navigation Guide for Building Wealth, New Jersey, John Wiley & Sons, Inc. (2021), ISBN 978-1-119-80161-0”

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This is the bottommost book written by Michael M. Pompian who is an author, founder, Chief Investment Officer of Sunpointe Investments, partner at Mercer Investment Consulting and a wealth management advisory.

He writes this book from the perspective of an investor and builds the optimal portfolio keeping in mind the so called 'biased investor behavior'. Behavioral finance is considered a parallel theory to standard finance theory.

The author provides an outlook, understanding of concepts by case studies, diagnosis of bias and suggestions to investors with clear terminology and descriptions of different approaches which are crucial for making investments. The book is spread over 320 Pages consisting of six parts and thirty two chapters.

The focal point of this book is on the potentially irrational investment behavior and possible efforts to build better portfolios for individual investors who want to (systematically) take irrational behavior into account.

Unlike other monographs, this book focuses on individual investors, who aim to critically examine irrational behavior and behavioral biases in investment decisions.

The first part of this book provides an introduction to the practical application of behavioral finance. These chapters comprise an overview of behavioral finance at the individual investor level and the behavioral biases used when incorporating investor behavior into the asset allocation process. To review, remember that when considering behavioral biases in asset allocation, financial advisors must first determine whether to adapt to moderate or irrational client preferences. It basically involves weighing the rewards of maintaining a calculated, profit-maximizing allocation against the outcome of potentially humiliating the client, whose bias may position them to favor a different portfolio structure altogether. The principles set forth in this section provide guidelines for solving the puzzle "When to moderate, when to optimize?"

The part two of this book explains about the endurance of beliefs is a cognitive bias. This part covers different types of bias including belief persistence bias, cognitive dissonance bias, conservatism bias, confirmation bias, representational bias, the so-called ‘illusion of control bias’, hindsight bias in detail with examples. The bottom line in overcoming the negative behavioral effects of cognitive dissonance is that clients must immediately acknowledge that a faulty cognition has occurred.

Part three focuses on cognitively biased information processing. The cognitive information processing induced by these biases has a variety of effects.

This section describes about the

a) Mental accounting bias: It elaborates the tendency of people to code, classify, and estimate economic results by grouping their assets into any number of irreconcilable mental accounts.

b) Anchoring bias: This reduces the subject's ability to incorporate updated information. This behavior can have significant implications for the investment sector and should be widely consulted.

c) Framing bias: It notes the tendency of decision makers to respond differently in different situations depending on the context in which a choice is presented.

d) Availability bias: The availability bias is a rule of thumb, or mental short-cut, that allows people to estimate the profitability of an outcome based on how prevalent or familiar the results are in their lives.

e) Self-attribution bias: It refers to the tendency of individuals to attribute their successes to innate aspects, such as foresight talent, while more often blaming failures on external influences, such as misfortune.

f) Outcome bias: It is a cognitive and information processing bias, where investors make decisions based on the outcome, not the process that led to the outcome.

g) Repetition bias: This is particularly intriguing because they provide a window on decision making outside the laboratory. In real life, judgments do not occur in discrete and isolated trials with long inter-trial intervals, but within context and are therefore potentially biased by past decisions made in the immediate past.

The fourth part of the book clarifies the concept of sentimental inclination. This section has seven chapters explaining various types of biases which are derived from specific behavior patterns.

The fifth part of this book describes the four behavioral investor types and combines them as a case study that shows how investors can use behavioral finance in real-world portfolio management.

Section six of this book concludes with a discussion of the tangible effects on portfolio implementation: it discusses the behavioral finance aspects of the so-called "active/passive debate", and used examples of behaviorally conscious portfolio construction.

In short, this book not only lists diagnostic questions to identify and describe cases of susceptibility to bias, but it also gives several examples of case studies on building a portfolio with this newfound awareness.

In case, for understanding the cognitive bias and emotional bias that exist in investors (Parts Two, Three and Four), the author presents plenty of real-world examples. It should be kept in mind that the ambience of the observation of bias is not limited to a certain country.

However, the most interesting thing about this book is that it not only raises awareness and increases our understanding of behavioral biases, but also helps us find ways to optimize investment programs with these biases in mind.

Investors can learn how to adapt their strategies and portfolios to these biases so that they can adhere to their investment goals and increase the economic returns of their investments.

All topics in this book will resonate well with readers who have an interest in the field of behavioral finance, but also with readers who have an interest in the practical aspects of the observations.

In addition to gaining a fresh perspective, decision makers and academics, postgraduate students will benefit from a comprehensive review of the available literature in this book on behavioral finance research. This book can be used as a textbook as it summarizes each part in a well versed manner.

The book itself is useful for understanding behavioral finance, for building the Best Portfolio and for all (potential) investors who want to apply behavioral finance in their asset allocation process and build a better portfolio to achieve financial goals.