Behavioral Finance and its Applications

Julia Dupire[1]

[1] New York University

Classical economics prescribes how agents should behave, while behavioral economics describes how agents do behave. Seemingly rational behaviors actually follow their own rationality and numerous cognitive biases, such as endowment effect, disposition effect, herding, and sunk cost have been reported and analyzed. We examine the consequences in the world of investing. We review the elements that differentiate prospect theory from utility theory, namely change of wealth as opposed to absolute wealth, loss aversion as opposed to risk aversion and distortion of small probabilities. Then we present our 4-step Learning Curve Model for information perception, and show how it alters our decision-making patterns and we apply this theory to crypto currency trading.