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BOOK REVIEW

William Forbes: Behavioural Finance

Wiley, 2009

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Behavioral finance was an integral part of financial theory even before Kahnemann and Smith were awarded the 2002 Economics Prize in honor of Alfred Nobel for their work in this field. The topic is a difficult one, but William Forbes's *Behavioural Finance* textbook will facilitate the study of this very diverse and complex field. Professor Forbes, who teaches at Loughborough University (UK), merges both recent and fundamental scholarly models in assessing the applicability of this theory to practice. The scope of the book is comprehensive, ranging from utility theory and psychology to human financial decision making and empirical puzzles of standard financial theory. In discussing behavioral finance, the author often chooses a renowned scholarly model, discusses it, sometimes presents a numerical example, and then shows which facets of human financial behavior the model captures. Each chapter features learning goals and questions for students as well as an extensive reference list. Additional teaching material is available on the publisher's website.

The book itself is comprised of an introduction and four parts. The first part, "Foundations," introduces basic intertemporal utility theory and Bayesian learning. Utility theory as a framework for rational agents is presented rather cursorily and students may be well advised to supplement Forbes's treatment with another textbook, especially since the subject is discussed several times in the text. Moreover, new features of utility theory are introduced throughout the book. In the chapter on Bayesian learning, the author presents Bayes Law and relates it to empirical findings on how information is processed in practice. This first part of the book also includes a chapter on financial bubbles, which essentially provides anecdotal evidence on the existence of bubbles, without much focus on the theory behind them.

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In the second part of the book the author deals with asset pricing. Noise trader models and prospect theory serve as the workhorses of this section and each receives a separate chapter. Noise trader models include informed and uninformed agents and these agents may differ in how they process information. This model is the subject of much scholarly work, which is cited in subsequent chapters. A similar model is that of Odean, which the author uses to discuss overconfidence of investors. Prospect theory is at the very core of behavioral finance and Forbes discusses several variations on the theory, including those of its founders, Kahnemann and Tversky, as well as the work of Barberis and Huang. The subsequent chapters in this part deal with applied problems, namely, overreaction, momentum, and herding. Professor Forbes describes each phenomenon with a detailed research model and provides insights into what behavior the models are able to reproduce. The final chapter of Part 2 covers how behavioral finance deals with the equity premium puzzle.

Part 3 elaborates on the corporate finance aspects of behavioral finance. This section of the book relies less on scholarly models than the other sections and more on stylized facts generated from, e.g., prospect theory. It starts with arguments for the existence of companies and a general discussion of corporate governance and the principal–agent problem. One chapter explains how market participants process information. Behavioral finance approaches to explaining dividend policies are discussed separately. The last chapter is especially notable for covering self-control versus self-confidence from the perspective of an entrepreneur, an aspect of behavioral finance rarely found in textbooks.

In the fourth and final part of book on "The Professions," the author returns to principal–agent problems, this time looking at them from an accounting and regulation perspective. This part of the book includes many instructional cases, some drawn from the recent credit crisis.

Compared to what I expect from a textbook, I found each chapter's introduction and comments written a little too colloquially for my taste. This may be appealing to some readers but I found that the style distracted me from the principles the author is trying to explain. Additionally, the sometimes very long case studies should be read with a grain of salt since alternative interpretations receive little attention. However, nearly every statement is backed with citations, if not from scholarly research then from other sources of literature. The author covers all prominent examples of how behavioral finance deviates from standard rational theory in detail, but the models are explained, perhaps by necessity, in a rather sketchy manner. Hence I advise that teachers using this textbook supplement it with additional information on the scope of the models. The book excels when it discusses how scholarly models are applied to capture observed human behavior. In summary, William Forbes's *Behavioural Finance* is an accessible textbook with a focus on stylized facts encompassed within selected reference models of behavioral finance research.