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The Journal of Entrepreneurial Finance

Volume 11
Issue 1 *Spring 2006*

Article 2

12-2006

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Rassoul Yazdipour
California State University, Fresno and Academy of Entrepreneurial Finance, Los Angeles, CA

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Recommended Citation

Yazdipour, Rassoul (2006) "Behavioral Finance and Entrepreneurial Finance: A Short Note," *Journal of Entrepreneurial Finance and Business Ventures*: Vol. 11: Iss. 1, pp. 1-2.
Available at: https://digitalcommons.pepperdine.edu/jef/vol11/iss1/2

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Behavioral Finance and Entrepreneurial Finance: A Short Note

Rassoul Yazdipour, Ph.D.,
California State University, Fresno and
Academy of Entrepreneurial Finance, Los Angeles

Traditional finance (and economic) theory squarely stands on the notion of "rational man" - a man who is much different from the "men" discussed in relative details in Jensen and Meckling's 1998 writing: "The Nature of Man". The rational construct assumes that individuals - both investors and managers - are "capable of understanding vastly complex puzzles and conduct endless instantaneous optimizations"[1] . Main results of such classical thinking are the concepts of market efficiency and arbitrage - with major practical implications for both areas of investment and corporate finance.

However, over the last few decades there have been major challenges to the rationality assumption that has stayed as the starting point for all modern finance theories. Such challenges, coming from the Behavioral Finance side, continue to advance the argument that the traditional finance theory's predictive power is no match to what investors observe and experience in the markets in reality[2]. After all, powerful models are expected to have accurate predictability powers and explain the real-life phenomena[3].

The growing body of Behavioral Finance literature continues to address the key issues very much dear to the traditionalists, such as the market efficiency arguments; however, the evolving field's underlying theories, borrowed mainly from the discipline of psychology, can

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[1] Montier, James; Behavioral Finance: Insights into Irrational Minds and Markets; 2007, John Wiley & Sons.
[2] For a good review and coverage of related issues, see Montier's Behavioral Finance, as well as Hersh Shefrin's Behavioral Corporate Finance; 2007; McGraw Hill.
[3] For a literature review, see "A Survey of Behavioral Finance" by Barberis and Thaler in the Handbook of the Economics of Finance; and available on SSRN http://papers.ssrn.com/sol3/DisplayAbstractSearch.cfm for download. Also, for complete discussion of all major Behavioral Finance issues, visit http://www.behaviouralfinance.net/ .

certainly help us better understand the unresolved issues that we face in our own area of entrepreneurial finance.

Specifically, we still do not have a good understanding of the decision making process on part of both entrepreneurs and investors - that portion of the entrepreneurial process that has become known among educators and professionals as the "black box". In other words, we certainly know much about the front-end of the entrepreneurial process: Opportunity recognition; and the back-end: Value creation. However, we know little about the middle portion of the process; that is: what else goes into the "black box"? A clear evidence for this is the fact that we still do not have convincing arguments and answers regarding behaviors that lead to venture failure and venture success. Or, which is really the major factor for venture capitalists when it comes to investing in startups: The product/service or the entrepreneur's "quality"? And if it is quality, as some would certainly say, what exactly are those traits? Furthermore, if so, can we generalize these to add to our predictive power? Such questions abound.

As Kaplan, et al put it, "Despite the long history of theory and empirical work (relative to the "Theory of the Firm"), there is little systematic evidence concerning what constitutes a firm at birth and how a firm evolves from birth to mature company"[4]. Of course, some researchers have already started to capitalize on the research interests created as the result of behavioralists' efforts; but that really should be the beginning.[5]

In closing, the purpose of this short note, which is partly based the opening talks we held at the 17th Annual Meeting of the Academy of Entrepreneurial Finance in Pasadena, is to especially draw the attention of the new researchers to what has been going on in the Behavioral Finance front; and how we can draw from and expand upon such works[6]. By doing so, we hope to find more convincing answers to the key questions that continue to define our fascinating academic niche.

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[4] "What are Firms? Evolution from Birth to Public Companies"; Steven Kaplan, et al; 2005; University of Chicago Working Paper; and available on SSRN for download.

[5] For an example, see "Emotion and Bounded Rationality in Entrepreneurial Decision Making: An Interdisciplinary Approach"; by Ichirou Horide; Reitaku International Journal of Economic Studies, Vol. 11, No. 1, March 2003; and available on SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=428980 for download. Furthermore, although Shefrin's 2001 "Behavioral Corporate Finance" Journal of Applied Corporate Finance, Vol. 14, No. 3, Fall 2001 does not directly discuss entrepreneurial decision making, but one easily see that the "errors" that he talks about can also be referred to as entrepreneurial behavior! This paper can also be downloaded from SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=288257

[6] Another very useful paper in this respect, especially for starters, is Victor Ricciardi's 2006 work, "A Risk Perception Primer: A Narrative Research Review of the Risk Perception Literature in Behavioral Accounting and Behavioral Finance", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=566802 .