

A Review of Behavioral Finance and Behavioral Econometrics: Theories and Applications

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Abstract

Purpose: Traditional financial theories based on the assumption of rationality cannot explain many paradoxes and anomalies in the financial markets. Behavioral Finance models are then developed to incorporate ideas from psychology and financial economics to explain market phenomena. Additionally, advanced Behavioral Econometric methods are proposed for testing theories in Behavioral Finance. This review paper introduces readers to theoretical frameworks and econometric modeling techniques for studying Behavioral Finance, with numerous applications in the literature.

Design/methodology/approach: This review provides comprehensive profiles of theoretical evolution, econometric methodology, and applied studies in Behavioral Finance, along with salient readings.

Findings: The results emphasize the ongoing development of theories in Behavioral Finance and Econometrics, from risk-seeking utility functions and stochastic dominance to advanced risk measures, econometric testing methods, and ultimately financial applications with testable implications. These advancements help readers understand the main research areas and emerging trends in this field.

Practical Implications: This review paper is valuable for academics and practitioners, as it advances Behavioral Finance and Behavioral Econometric theories, and also supports their application to portfolio construction, investment analysis, and risk management. This study contributes to decision sciences by helping financial analysts understand their clients' behavioral traits and make optimal decisions that improve their risk-return trade-off.

Originality/value: Many studies treated the evolution of Behavioral Finance theory, Behavioral Econometrics, and empirical investigations in isolation. This study not only summarizes existing work but also synthesizes these strands, ranging from theoretical model building to econometric testing and financial applications, into a unified framework.

Keywords: Behavioral Finance, Behavioral Econometrics, Applications

JEL classifications: C50, C58, G10, G11, G12, G40

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