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Editorial

Behavioral finance in Asia

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Abstract

This paper introduces the *Pacific-Basin Finance Journal*'s special issue on behavioral finance in Asia. We first briefly discuss behavioral finance in general, and then we explain why behavioral finance in Asia is an important topic worth studying. We describe the papers published in this special issue, and in doing so, we place the papers within the appropriate context of the growing literature on behavioral finance. We close by acknowledging the referees of this special issue and by offering brief concluding thoughts.

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1. Introduction

Why might the topic of behavioral finance in Asia be important and interesting? First, the study of behavioral finance is still a young field. The academic finance community has only recently accepted it as a feasible paradigm to explain how financial market participants make decisions and, in turn, how these decisions affect financial markets. Second, Asian financial markets are among the largest in the world, and there is some evidence – anecdotal, theoretical, and empirical – that Asians suffer from cognitive biases on a different level than people of other cultures. By studying behavioral finance in Asia, we can, therefore, add to our understanding of these two important topics.

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The study of behavioral finance allows cognitive psychology to play a potentially important role in finance. People are not always rational, and, thus, their financial decision making may be wholly or partially driven by behavioral biases. If people have beliefs or preferences that do not meet the traditional axioms of rational decision makers, then it is important that we identify the effects of these behavioral biases—especially if their cognitive errors impact prices and cannot be easily arbitraged away. Many finance scholars view the mid-1980s as the beginning of this area of research. DeBondt and Thaler (1985) showed that stock markets overreact to information, and Shefrin and Statman (1985) contended that investors are more likely to sell their winner stocks rather than their losers, even though selling losers (to realize tax losses) is optimal. If one believes these works to be the genesis of behavioral finance research, then the field is barely over two decades old.

The pervasiveness of behavioral finance research is even younger. The behavioral finance paradigm was not widely accepted at first. In fact, DeBondt and Thaler's (1985) paper was met with considerable skepticism (Thaler, 1999). More recently, many good theoretical models have explored the ramifications of less-than-rational agents. Initially, studies focused on asset pricing, but in recent years, models have incorporated the effect that less-than-rational managers may have on corporate finance decision making. Barberis and Thaler (2003) provide an excellent literature review of the many different types of behavioral biases that financial decision makers might hold and how these biases might affect decision making and, in turn, the financial markets.

Empirical papers on behavioral finance also had a slow start—primarily because arguments based on stock-level data suffer from the joint-test problem (market efficiency and asset pricing model) and were, thus, less convincing to an initially skeptical audience. Terrence Odean overcame this limitation by obtaining individual brokerage account data. In a series of papers (many with Brad Barber), he showed that individual investors suffered from several behavioral biases. Many other researchers and data sets have since empirically tested behavioral finance theories. Hirshleifer (2001) provides an excellent literature review of the empirical evidence in behavioral finance with regard to asset pricing. Somewhat surprisingly, however, few researchers have yet to use experiments to test behavioral finance theories, even though well-designed experiments allow researchers to control the environment.

Asia is an interesting place to study behavioral finance because of the different levels of capitalism and financial market experience of its participants. Countries such as China have been slowly changing over the last couple of decades to a capitalistic economy from a socialistic one. On the other hand, countries such as Japan have had large economic and financial markets for a much longer time. Thus, because variations in knowledge and experience likely play a role in explaining variations in economic decision making, Asia is fertile ground for the study of behavioral finance.

Also, there is a reason to believe that Asians in general suffer from cognitive biases more than do people of Western cultures. Anecdotally, individual investors in Asia are often viewed as mere gamblers. Theoretically, social scientists and psychologists have contended that culture can nurture tendencies toward behavioral biases at varying levels (e.g., Yates et al., 1989). According to Hofstede (1980), differences among cultures can be expressed on an individualism–collectivism continuum. Asian cultures tend to be based on a socially collective paradigm. It has been argued that collective-oriented societies can cause individuals to be overconfident, which is a behavioral bias. Because behavioral inclinations can be learned (Wolosin et al., 1973), cultural differences in life experiences and education may cause differences in behavior. Life experiences and education are certainly different among different cultures. To this end, some evidence exists that suggests that people raised in Asian cultures exhibit more behavioral biases than people from the United States (e.g., Yates et al., 1997).