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TOPIC #10: **Positive + Normative Behavioral Finance**

PROMPT: **Provide an overview, and some examples, of differences between positive and normative behavioral finance.**

The inquiry into how individuals (or firms) actually *do* behave is termed the study of descriptive or positive behavioral finance. How individuals (or firms) *should* behave is dubbed the study normative behavioral finance. One assertion confronted at the outset of comparing positive and normative models, is whether it is fair to assert how individuals *should* act rationally if the normative expectations inherently ignore the typical biases and violations regularly observed. Said another way, if anomalies never allow a model to truly exist, is it better to keep the model and simply highlight the margin of error?

Kahneman and Tversky's (1979) seminal article effectively tackled the convergence of dominant normative models of rational choice, like the expected utility theory (EUT), with the need for a model that better understood the psychological implications which thwarted typical probability analysis (p. 263). Further, the emergence of neurological understanding and the rider/elephant concepts, has brought great clarity to the 2002 Nobel prize winning concept of a dual-self economic behavior model, attributed to Kahneman. The segue was now open to the concept, prevalence of bounded rationality. That is to say, on one hand, yes people can be rational, but there are more constraints than we know.

Three biggest examples of constraints are more salient notions have more influence, the amount of internal processing power or attention that is available influences one's capacity, and generally people want to perform the least amount of effort for the most amount of output. These three basic tenets, often a person is willing to compromise rationality to achieve satisficing behavior or acceptable well-being, achieved by a psychological shift from "maximum optimal outcome" to "satisfactory outcomes".

Preference patterns that vary from rational expectation include the Endowment effect (people often demand considerably MORE to give up an object than they would be willing to pay to acquire it) and Status Quo Effect (preference for one's current state). Both are anomalies related to loss aversion. When inheriting monies or stocks or choosing between reliability of companies, or Car insurance offerings of unlimited rights to sue, people are more likely to the positions in which they are already invested (Kahneman, Knetsch, & Thaler, 1991, p. 199). Status quo preferences increase when the number of alternatives increase, as people tend not to take the time to patiently discern between options for more optimization. More central aspects of loss aversion are the disproportionate weights assigned to gains and losses in certain situations. Small or moderate loss of money is typically *twice* the weight of a proportionate gain, a 1:2 ratio which normalizes as one gets further out on the curve—meaning less anomalies at higher reward/lower risk levels. In conclusion to the debate between positive and normative models, one thing can be sure: a normative theory that ignores loss aversion can be less stable.

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