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EMOTIONAL FINANCE:

INVESTMENT AND THE UNCONSCIOUS

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About this briefing

This briefing introduces the concept of 'emotional finance', the idea that unconscious feelings help drive both individual investment decisions and market activity. It provides an overview of the underlying theory and explores how it can be applied to improve our financial understanding.

Context

Little attention has been paid by financial researchers to how people's unconscious thoughts help drive stock market behaviour and investment decisions. Traditional finance theory assumes that investment is a rational process and that investors can make unbiased forecasts about the future. In contrast, behavioural finance recognises that investors often behave in an irrational way and are biased in their judgments. It argues that if we understand our biases then we can overcome these. However, neither perspective fully accounts for the vital role unconscious needs and wish-fulfilling fantasies play in investor decision making and consequent market behaviour. Emotional finance, a new paradigm in finance developed by Professor Taffler, seeks to address this lacuna directly.

Implications

- Traditional and behavioural finance theories appear incomplete in being able to explain investor and market behaviour, including market bubbles and financial crises.
- The key role that unconscious processes play in investment decisions should be formally acknowledged if we want to understand and predict investor behaviour and market activity in a more holistic way.
- More empirical research is needed to explore and test predictions about individual and market behaviours proposed by emotional finance theory.

Emotional finance theory

Emotional finance theory draws on the psychoanalytic understanding of the human mind to describe how unconscious processes drive investment decisions. For example, psychoanalysis divides emotions into two categories, pleasurable and unpleasurable, which is reflected in the way that investment decisions create feelings of both excitement and anxiety over potential gains or losses. This conflict between opposing emotions is typically dealt with by the unconscious repression or denial of negative feelings. While rationally an investor 'knows' stocks can go both up and down, in psychic reality the direction is only up.

Emotional finance also draws on the psychoanalytic understanding of group dynamics viewing markets as large (virtual) groups with their own emotions, fantasies and collective behaviours. Groups also have a tendency to be carried way into *fight or flight*, which can help explain the growth and then imploding of asset pricing bubbles, as most recently with Bitcoin.

Emotional finance in practice

Emotional finance theory can be applied in a number of areas to improve our understanding of investment behaviour. For example:

- Emotional finance distinguishes the traditional understanding of risk (e.g., the distribution of likely returns on an investment) which is perceived as known and measurable, from the concept of *uncertainty* - the inability to predict future returns. Conventional models of risk also serve as a psychological defence against uncertainty and the 'real' risk of anxiety and helplessness that stems from this.

- The fact that the unpredictability of financial markets inevitably generates anxiety is not always acknowledged. Emotional finance shows how the ability to trust when not knowing the outcome is what enables an investor to enter into a relationship with an asset that can let him or her down. The need for trust and reassurance explains why fund managers place so much emphasis on meeting the managers of companies they plan to invest in, and similarly why investors in mutual funds look for managers and investment houses they can trust. The key role that stories play in promoting this is paramount.

- Emotional finance also predicts an unconscious need for stock prices to have already risen for investors to have the confidence and trust to invest in them, which could lead to individual stocks being mispriced.

- Speculation and unconscious excitement help drive investment behaviour. Emotional finance describes how investing in the stock market generates many of the same emotions experienced by gambling, defined in psychoanalytic terms as the illusion of power and control to defend against helplessness.

- The reasons that individuals often fail to invest and save adequately for retirement can be explained by emotional finance in terms of their unwillingness to acknowledge the implications of old age and ill health. Unconscious defences can prevent appropriate retirement planning decisions.

Further information

This briefing is based on:
Richard Taffler (2017): *Emotional finance: investment and the unconscious*, The European Journal of Finance,
DOI: 10.1080/1351847X.2017.1369445.

Conclusion

The central role that unconscious thought processes play in all human activity is worthy of greater attention in finance. The insights of emotional finance can be also be applied more generally to help explain asset pricing bubbles and financial crises, including the *dot.com bubble* in the late 1990s and the 2008 Global Financial Crisis, not just why and how investors invest. Traditional and behavioural finance theories have difficulty in doing so fully because they ignore the unconscious processes at work.

Emotional finance is only at the very beginning of its evolution as a research discipline but has the potential significantly to increase our knowledge and understanding of financial activity and market behaviours. While the underlying theory is already reasonably developed, the next stage is to explore the empirical application of emotional finance in more detail, using both quantitative and qualitative methodologies.

Contact the researcher

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