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WHAT IS EMOTIONAL FINANCE?

Emotional finance is a new paradigm in the understanding of investment activity and prediction of asset prices and market behaviour. It differs both from traditional finance theory which is based on the idea investors are "rational", and behavioural finance which although recognising that investors are prone to bias nevertheless implicitly assumes they can still learn to be rational. Emotional finance recognises that people are inherently irrational and largely driven by their emotions, both those of which they are consciously aware and, more importantly, those which are unconscious. These latter are even more powerful because they are not directly accessible to the conscious mind.

Neuroscientists point out that at least 95% of our mental activity is unconscious and how, in practice, action precedes thought and conscious awareness. Emotional finance draws explicitly on the insights of the psychoanalytic understanding of the human mind to describe how unconscious processes drive investment decisions and market dynamics, and are an integral part of all financial decision making. By directly acknowledging the vital role investors' unconscious needs, fantasies and drives play in their investment judgments, emotional finance provides a very practical framework that can help explain and predict those aspects of investment decision making and market activity not open to rational models and conventional perspectives.

Research shows how market participants ultimately feel decisions rather than consciously make them despite what they appear to believe. Emotional finance directly recognises the important role illusion and the associated desire for wish-fulfilment play in this process. Investment decisions are, in effect, the outcome of a struggle between unconscious feelings of excitement, the pleasurable idea of potential future gain, and anxiety, the pain of potential future loss. Associated with this is the denial of the difficulty of outperforming, and its associated unconscious ramifications. In psychic reality the investor enters into an idealised emotional relationship with a stock, other asset, or even firm management, which can easily let him or her down. In fact, an important insight of emotional finance is how some types of investment, known technically as phantastic objects, represent exceptionally exciting and desirable transformational wish-fulfilling fantasies in unconscious terms. This can help explain such things as Bernie Madoff, dot.com stock valuations, the apparently magical nature of derivative products such as CDOs before 2008, the way some hedge fund managers are viewed almost like gods and even, more prosaically, the mispricing of individual stocks.

Emotional finance also recognises how markets constitute large virtual groups with behaviour reflecting the interaction of the often unconscious drives, needs, emotions and desires of their participants as they try and deal with the inherent uncertainty of the investment process and associated anxiety. Markets take on their own unconscious mental life and are prone to act out the same emotions as individual investors such as excitement, euphoria, panic, depression and mania. Importantly, by drawing on the insights of group psychodynamic theory emotional finance can help explain why markets behave as they do and different market states including asset pricing bubbles, such as the current rerun of dot.com mania and the Chinese stock market bubble, as well as many aspects of the Global Financial Crisis.

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An increasing body of empirical research evidence demonstrates the practical contribution emotional finance is able to make. For example, it can help us understand what really drives fund manager investment decisions which is very different to what is conventionally thought and told to their clients. Similarly, it helps explain why individual investors continue to invest so actively despite the resulting losses, and the unconscious fantasies that underpin this. Emotional finance insights are also key in helping to explain stock market anomalies where stocks appear to be systematically mispriced and, for example, why the market has great difficulty in dealing with bad news appropriately. Again, much investment activity has gambling-like characteristics with clear implications for market pricing, and by understanding the underlying psychological processes at work emotional finance is also able to contribute here. In summary, emotional finance gives us a handle on what is truly important to investors and their conviction to invest despite outcomes being so unpredictable.

The premise of emotional finance is that formal knowledge of the subtle and complex ways our unconscious mind works and associated unconscious group processes can help us understand better how asset valuations and investment judgements are made, and how markets work and why, at times, they break down. This new understanding can lead directly to better investment decisions and more effective financial decision making more generally, quite apart from its implications for, among others, economic policy makers and market regulators.

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