

12.1: Introduction

Much of what is known about finance and investments has come from the study of economics. Classic economics assumes that people are rational when they make economic or financial decisions. "Rational" means that people respond to incentives because their goal is always to maximize benefit and minimize costs. Not everyone shares the same idea of benefit and cost, but in a market with millions of participants, there tends to be some general consensus.

This belief in rationality leads to the idea of **market efficiency**. In an efficient market, prices reflect "fundamental value" as appraised by rational decision makers who have access to information and are free to choose to buy or sell as their rational decisions dictate. The belief in efficiency assumes that when prices do not reflect real value, people will notice and will act on the anomaly with the result that the market "corrects" that price.

People are not always rational, however, and markets are not always efficient. **Behavioral finance** is the study of why individuals do not always make the decisions they are expected to make and why markets do not reliably behave as they are expected to behave. As market participants, individuals are affected by others' behavior, which collectively affects market behavior, which in turn affects all the participants in the market.

As an individual, you participate in the capital markets and are vulnerable to the individual and market behaviors that influence the outcomes of your decisions. The more you understand and anticipate those behaviors, the better your financial decision making may be.

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