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Independent Study & Mentorship (ISM)

16 September 2026

Annotated Article

Annotated Bibliography Assessment #3: Behavioral Finance

Barber, Brad M., and Terrance Odean. “The Behavior of Individual Investors.” Handbook of the Economics of Finance, vol. 2, Elsevier, 2013, pp. 1533-1570.

Brad M. Barber and Terrance Odean explore the actual behavior of individual investors and explain why investors sometimes act in ways that differ from the predictions made by traditional financial theories. This source is relevant to behavioral finance because traditional financial theories tend to assume that investors make rational decisions by processing all available information, managing risk and return appropriately, diversifying their portfolios, and trying to maximize their wealth. Instead, Barber and Odean explore evidence that actual investors do not always act in these ways. Their focus is on individual investors and they also investigate behaviors such as overtrading, overconfidence, the disposition effect, attention bias, familiarity, reinforcement learning, and failure to diversify.

Barber and Odean are credible sources for behavioral finance because both have done extensive

research on the behavior of individual investors and are researchers at established institutions. At the time their article was published, Barber was affiliated with the Graduate School of Management at the University of California, Davis and Odean was affiliated with the Haas School of Business at the University of California, Berkeley. In addition to their article, Barber and Odean have published multiple studies that investigate investor trading performance and behavioral biases. Their article was published by Elsevier in the Handbook of the Economics of Finance, which makes it a credible academic source.

One of the most important concepts discussed in this source is overconfidence. Barber and Odean explain that some investors may believe that they are more knowledgeable or skilled in investing than they actually are. This overconfidence may lead investors to trade more because they believe they can successfully find profitable investments. However, according to the evidence Barber and Odean examine, more frequent trading does not necessarily lead to better performance. For instance, an examination of performance in U.S. discount brokerage accounts found that the average individual investor underperformed a market index and investors who traded more frequently underperformed even more. Barber and Odean link this behavior to studies that show investors who believe they are more knowledgeable about investing also tend to trade more frequently.

Another important concept discussed is the disposition effect, or investors selling investments that have increased in value while holding onto investments that have decreased in value. Barber and Odean explain that the disposition effect has been observed in multiple countries and among both individual and some institutional investors. Instead of making decisions based only on the expected future performance of an investment, an investor may be influenced by whether the current investment is a gain or a loss. This links financial decision making to emotions such as pride and regret and demonstrates the importance of psychological factors in investment behavior.

Another concept discussed in this source is attention bias. Because individual investors cannot assess all possible investments, their attention may be drawn to investments that are in the news or that experience unusually large price movements. Consequently, investors may be disproportionately likely to invest in attention-grabbing investments. This is particularly relevant to my research as today's investors are exposed to a significantly greater amount of financial information through social media, financial online communities, and mobile investing platforms. Barber and Odean also discuss familiarity. Investors may prefer to invest in companies in their local area or companies connected to their work or other investments they are familiar with. While familiarity can provide a sense of safety with an investment, focusing on familiar investments can also reduce diversification and increase risk.

Overall this source is beneficial to my research because it ties together many of the major concepts I have come across while researching in the area of behavioral finance. In my annotated bibliography, I have researched sources discussing excessive trading, overconfidence, loss aversion, mental accounting, the disposition effect, familiarity bias and investor attention. This article ties together many of these concepts by demonstrating that individual investor behavior cannot be explained by a single behavioral bias. Instead, financial decisions can be the result of multiple psychological and environmental factors influencing investor behavior.

One drawback with this source is that it was published in 2013 and much of the evidence analyzed in the article uses investment data from even earlier years. Therefore, the article does not fully explore the current environment in which investors make decisions. Commission-free mobile trading, social media, cryptocurrencies, financial influencers on the Internet and prediction markets have significantly changed how fast financial information can be accessed and how fast financial decisions can be made. This limitation presents an area of opportunity for my future research. I am interested in investigating whether access to current financial information actually enables investors to make more informed decisions or whether exposure to financial information, trends and other investors intensifies behavioral biases such as overconfidence, herd behavior and attention

bias. This source not only provides a good foundation for understanding individual investor behavior but also presents questions that I can continue to explore during my ISM research.