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## Preface

In quiet times, most people do not pay too much attention to financial markets. Just a few years back, however, such quiet times came to an abrupt end with the onset of the financial crisis of the years 2007–2009. Before that crisis, everybody took it for granted that we can borrow money from a bank or get to save on interest payments on deposits, but all these fundamental beliefs were shaken in the wake of the financial crisis and – not much later – during the Euro crisis. Although times are now much quieter again, these crises left some lasting impact on how we trust the functioning of financial markets.

When the man on the street loses his faith in systems which he believed to function as steadily as the rotation of the earth, how much more have the beliefs of financial economists been shattered? But the good news is that, in recent years, the theory of financial economics has incorporated many aspects that now help to understand many of the bizarre market phenomena that we could observe during the financial crisis. In the early days of financial economics, the fundamental assumption was that markets are always efficient and market participants perfectly rational. These assumptions allowed to build an impressive theoretical model that was indeed useful to understand quite a few characteristics of financial markets. Nevertheless, a major financial crisis was not necessary to realize that the assumptions of perfectly efficient markets with perfectly rational investors did not hold – often not even “on average.” The observation of systematic deviations gave birth to a new theory, or rather a set of new theories, *behavioral finance theories*.

While classical finance remains the cornerstone of financial theory – and be it only as a benchmark that helps us to judge how much real markets deviate from efficiency and rationality – behavioral finance enriches the view on the real market and helps to explain many of the more detailed phenomena that might be small on sunny days, but decisive in rough weather.

Often, behavioral finance is introduced as something independent of financial economics. It is assumed that behavioral finance is something students may learn after they have mastered and understood all of the classical financial economics.

In this book, we would like to follow a different approach. As market behavior can only be fully understood when behavioral effects are linked to classic models, this book integrates both views from the very beginning. There is no separate chapter on behavioral finance in this book. Instead, all classic topics (such as decisions on

markets, the capital asset pricing model, market equilibria, etc.) are immediately connected with behavioral views. Thus, we will never stay in a purely theoretical world, but look at the “real” one. This is supported with many case studies on market phenomena, both during the financial crisis and before.

How this book works and how it can be used for teaching or self-study is explained in detail in the introduction (Chap. 1). Please notice that there is an accompanying book with exercises and solutions. With this, students can check their understanding of the material and prepare for exams.

For now, we would like to take the opportunity to thank all those people who helped us write this book. First of all, we would like to thank many of our colleagues for their valuable input, in particular Anke Gerber, Bjørn Sandvik, Mei Wang, and Peter Wöhrmann.

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That this book is not only an idea but a real printed book with hundreds of pages and thousands of formulas is entirely due to the fact that we had two tremendously efficient L<sup>A</sup>T<sub>E</sub>X professionals working for us. A big “thank you” goes therefore to Thomas Rast and Eveline Hardmeier. We are grateful to Simone Fuchs and Johannes Baltruschat for their great support in finalizing the second edition.

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Finally, we thank our families for their even larger patience with their book-writing husbands and fathers.

We hope that you, dear reader, will have a good time with this book and that we can transmit some of our fascination for financial economics and its interplay with behavioral finance to you.

Have fun!

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