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Behavioral Finance

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ABSTRACT

The behavioral finance is the study of human decision making is related to the field of finance. The paper specifies about the specialization about the behavioral finance. The characteristics of the behavioral finance consist of emotions ,market impact etc.. behavioral finance is applied in the business sectors and the educational institutions. And finally the paper describes about the limitations of behavioral finance.

1. Behavioral Finance

Behavioral finance, with its roots in the psychological study of human decision-making, is a relatively new and evolving subject in the field of finance. In brief, behavioral finance is the study of investors' psychology while making investment decisions. Being a relatively new subject, not much prodigious research literature is available in this subjects.

2. Meaning of Behavioral Finance

Behavioral finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on market. According to behavioral finance, investors' market behavior derives from psychological principles of decision-making to explain why people buy or sell stock. Behavioral finance focuses upon how investor interprets and acts on information to take various investment decisions.

3. Characteristics of Behavioral Finance

Four Key Themes: These themes are integrated into review and application of investments,

Corporations, markets, regulations, and educations-research.

1. Heuristics
2. Framing
3. Emotions
4. Market Impact

1. Heuristics

Heuristics are referred as rule of thumb, which applies in decision making to reduce the cognitive resources to solve a problem. These are mental shortcuts that simplify the complex methods to make a judgment. Investor as a decision maker confronts a set of choices within certainty and limited ability to quantify results. This leads identification and understanding of all heuristics that affect financial decision making. Some of heuristics are representativeness, anchoring &adjustments, familiarity, overconfidence, regret aversion, conservatism, mental accounting, availability, ambiguity aversion and effect. Heuristics help to make decision.

2. Framing

The perceptions of choices that people have are strongly influenced by how these choices are framed. It means choices depend on how question is framed, even though the objective facts remain constant. Psychologists refer this behaviour as a frame dependence. As Glaser, Langer, Reynders and Weber show that investors forecast of the stock market depends on whether they are given and asked to forecast future prices or future return. So it is how framing has adversely affected people's choices.

3. Emotions

Emotions and associated human unconscious needs, fantasies, and fears drive much decision of human beings. How these needs, fantasies, and fears influence financial decision? Behavioral finance recognize the role Keynes's "animal spirit" plays in explaining investor choices, and thus shaping financial markets . Underlying premises is that our feeling determine psychic reality affect investment judgment.

4. Market Impact

Do the Cognitive errors and biases of individuals and groups of people affect market and market prices? Indeed, main attraction of behavioral finance field was that market prices did not appear to be fair. How market anomalies fed an interest in the possibility that they could be explained by psychology? Standard finance argues that investors' mistakes would not affect market prices because when prices deviate from fundamental value, rational investor would exploit the mispricing for their own profit. But who are those who keep the market efficient? Even institutional investor exhibits the inefficiency. And other limit to this is arbitrage This prevents rational investor from correcting price deviations from fundamental value. This leaves open the possibility that correlated cognitive errors of investor could affect market prices.

4. Concepts of behavioral finance

Behavioral finance encompasses many concepts, but four are key:

- Mental accounting,
- Herd behavior,
- Anchoring, and
- High self-rating.

Mental accounting refers to the propensity for people to allocate money for specific purposes.

Herd behavior states that people tend to mimic the financial behaviors of the majority, or herd.

Anchoring refers to attaching a spending level to a certain reference, such as spending more money on what is perceived to be a better item of clothing.

Lastly, highself-rating refers to a person's tendency to rank him/herself better than others or higher than an average person. For example, an investor may think that he is an investment guru when his investment performs optimally but will dismiss his contributions to an investment performing poorly.

5. Biases Studied in Behavioral Finance

A prominent psychological bias is the herd instinct, which leads people to follow popular trends without any deep thought of their own. Herding is notorious in the stock market as the cause behind dramatic rallies and sell-offs. The herd instinct is correlated closely with the empathy gap, which is an inability to make rational decisions under emotional strains, such as anxiety, anger, or excitement.

The self-attribution bias, a habit of attributing favorable outcomes to expertise and unfavorable outcomes to bad luck or an exogenous event, is also closely studied within behavioral finance. George Soros, a highly successful investor, is known to account for this tendency by keeping a journal log of his reasoning behind every investment decision. Many other tendencies are studied within behavioral finance, including loss aversion, confirmation bias, availability bias, disposition effect, and familiarity bias.

6. Application of Behavioral Finance

Behavioral finance actually equips finance professionals with a set of new lenses, which allows them to understand and overcome many proven psychological traps that are present involving human cognition and emotions. This includes corporate boardsand managers, individual and institutional investors, portfolio managers, analysts, advisors, and even policy makers. Behavioral traps exist and occur across all decision spectrums because of the psychological phenomena of heuristics and biases. These phenomena and factors are systematic in nature and can move markets for prolonged periods. It applies to:

1. Investors
2. Corporations
3. Markets
4. Regulators
5. Educations

7. Limitations of behavioral finance

1. Failure to acknowledge the findings of the allied social sciences one of the cardinal laws in scholarship is to acknowledge the work of others and avoid reinventing the wheel.
2. A narrow, limited critique of economic theory Cataloging the many ways humans fail to think rationally about money, investments and risk is a good start. But in most ways, behavioral finance leaves intact the problematic assumptions of traditional finance, pulling its punches, so to speak.

Among the most noteworthy examples:

a) Behavioral finance remains stuck at the individual level of analysis As in traditional finance and economics, the object of inquiry in behavioral finance is the individual—despite rafts of evidence going back decades that individuals don't make decisions about money, risk or investing in a vacuum, but as a result of social influences. Of course, this evidence comes from those allied social sciences that are being so studiously ignored. For example, economic psychologist George Katona showed 35 years ago that most people choose investments based on word of mouth recommendations from their friends and neighbors. This influence of social forces in economic decision-making has been demonstrated with equal or greater impact.

b) Behavioral finance limits itself to pointing out failures of cognition and calculation. As important as those factors are in distorting financial decision-making. This includes emotions, and social phenomena like status competition, both of which play a significant role in the findings of economic sociology, psychology and anthropology. The cognitive/calculative failures may interact with the socio-emotional phenomena, but we won't know as long as behavioral finance pretends the latter don't exist. That's a loss for all of us interested in markets, money and investing.

c) Behavioral finance doesn't explain how individual acts and decisions produce aggregate outcomes As a consequence of keeping the analytical focus on individuals avoiding the social and interactive aspects of economic activity behavioral finance doesn't have the theoretical means to address mechanisms through which individual acts and decisions aggregate. That means it can't explain institutions and other manifestations of collective behavior which form the context for all the individual behavior it examines

8. Conclusion

I conclude that behavioral finance is used in all the sectors as it is easy to handle. The above paper briefly describes the characteristics , applications and limitations. Behavioral finance actually equips finance professionals with a set of new lenses, which allows them to understand and overcome many proven psychological traps that are present involving human cognition and emotions.

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