

A Conceptual Study on Behavioural Finance

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ABSTRACT

Behavioral finance is the amalgamation of finance and psychology. It is an emerging trend in recent times which supports modern theory of finance. As per the classical theory of finance the behavior of investor is rational but according to modern theory the behavior of investor is not always rational or logical in nature. It focuses on how investor analyses or interprets the information while making an investment decision. This study is done to analyze key behavioral factors which affects the decision making and helps in identifying investment patterns of the investors.

1. Introduction

“Investing isn’t about beating others at their game. It’s about controlling yourself at your own game.” – Jason Zweig

The study of investor’s behavior and how it influences the dimensions in the market is of prime importance in today’s volatile global scenario. Daniel Kahneman and Vernon LSmith did a revolutionary study in the area of Behavioural finance and shared the prestigious Nobel Prize in the year 2002.

Behavioural finance is the area in finance which studies the behaviour of investors in the financial market based on the psychological factors and how it changes the dimensions of market place while undergoing the process of buying and selling of securities.

According to Swell “ *Behavioural finance is the study of the influence of the psychology on the behaviour of financial practitioners and the subsequent effects on the markets*”

As per the recent study human emotion plays a bigger role in triggering a market event. It is seen that speculation in the stock market can often result in oversubscription or undersubscription of an issue. Shuffling of top management in a company leads to fall or rise of share prices of that firm. Even changes in the economic policy /fiscal policy of the country can make the market bullish or bearish in nature. All these are a result of behavioural factors like overconfidence ,anxiety,greed etc. But they are responsible for changing the present and future trends in stock market. The study is mainly done to understand the cause and factors behind behavioural anomalies .

2. Review of Literature

Tai-Yuen Hon (2012) studied the behaviour of small investors during and after global economic crisis. He identified five factors that capture the behaviour of small investors in derivatives markets in Hong Kong. The factors are personal background, reference group, return performance, risk tolerance, and cognitive style.

Abhijeet Chandra and Ravinder Kumar(2012) in a study attempting to investigate the factors influencing individual investor behaviour in Indian Stock Market found that there are five underlying psychological axes that appear to be driving the Indian individual investor behaviour. These five pertinent axes on the basis of the underlying variables are named as prudence and pre-cautious attitude, conservatism, under confidence, informational asymmetry, and financial addiction.

Seth L. Elan(2010) stated that Active Trading, More Attention to the Past Returns, Familiarity Bias, Momentum Investing, Under diversification, etc are some of the common mistakes made by the investors and Financial illiteracy and the lack of trust in financial markets play important roles in curbing participation in retirement plans.

Monti and Legrenzi (2009) investigated the relationships between investment decision making and Hindsight bias. They say that economic studies consider the agent’s foresight perspective only, without taking into account the Hindsight bias possible effects in the decision-making process. They collected data from 25 Master and PhD students attending courses in Finance and Economics at Bocconi University and from 35 financial managers from a leading Italian bank by circulating two sets of questionnaires. The study found strong evidence for the consequences that Hindsight bias can have on the investor’s portfolio decisions: the portfolio allocation perception and therefore, the risk exposure.

Sairafi, Selleby and Stahl (2008) in their study ‘Behavioral Finance- a Student Perspective’ examined the characteristics of investment interested business students and their decision-making process and choices from the perspective of behavioral finance. The research holds an abductive approach and is based on qualitative data. Data collection was done through an Internet-based questionnaire. In the study, herd behavior was found to be the most evident behavioral factor. This paper found that the behavior of respondents in the chosen population was best described as “student behavior”; a somehow irrational behavior explained by the learning process in which business students exist.

Waweru, Munyoki and Uliana (2008) surveyed the institutional investors at the Nairobi Stock Exchange. The work investigated the role of behavioral finance and investor psychology in investment decision making. The study established that behavioral factors such as Representativeness, Overconfidence, Anchoring, and Gamblers' Fallacy, Availability, Loss Aversion, Mental Accounting and Regret Aversion affected the decisions of institutional investors operating at the Nairobi Stock Exchange.

3. Behavioural Finance Theories-

3.1 Prospect Theory: This theory was initially framed by Kahneman and Tversky (1979). According to this theory there are two phases in choice process: phase of framing followed by phase of editing. It states that investors are risk averse during gains and risk taker under losses. The choice of investors is also effected by framing effect. Framing is a cognitive bias which occurs when people makes decision depending on the way same set of information is presented to decision makers. The key concepts in prospect theory are as follows:

- **Loss Aversion:** The investor becomes risk-seeker when faced with the situation of facing losses, but are risk-averse in the process of gains. This phenomenon is called loss aversion.
- **Regret Aversion:** this phenomenon is basically arising out of fear /regret or pain in investors mind of investing in poorly performing securities. It compels an investor to hold weak securities or shares and also avoids the sale of those securities as it might again lead to losses in the market.
- **Mental Accounting:** As described by Richard Thaler(1999) *mental accounting are the "set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities."* It is the set of logical operations used by investors to organize, evaluate, and keep track of their financial activities. This result in a tendency wherein investors distribute their money into different accounts based on a variety of reasons.
- **Self Control:** Investors should try to minimise the losses and protect their investment. As explained by Thaler and shefrin investors come under temptation and they try to avoid those temptations by looking for tools which helps them to overcome self control. By mentally separating their financial assets into capital and expenditure pools, investors can control their urge to over consume.

3.2 Heuristics Bias

As told by Daniel Kahneman (Parikh, 2011) "*Heuristics are simple efficient rules of the thumb which have been proposed to explain how people make decisions, come to judgments and solve problems, typically when facing complex problems or incomplete information. These rules work well under most circumstances, but in certain cases lead to systematic cognitive biases*".

It is process by which investor solve a complex problem using trial and error ,these solution in some cases might not

give correct solution which give rise to rule of thumb. Some of the biases under heuristics are as follows:

- **Representativeness:** Investors believe that their recent success in any investment will continue in future as well. This tendency of the investors which is derived from their past judgment and experience is known as stereotypes. Hence Representativeness bias is a judgment which is based on stereotypes. Debon(1998) has also founded that investors decisions are biased in the direction of recent success /failure in their earning forecast.
- **Overconfidence:** It means investors relying excessively on their reasoning ,judgement and stock selection. It can cause people to overestimate their knowledge and skill and lead to excessive trading in the market.
- **Anchoring:** According to anchoring bias investors while making a decision can rely too much or anchor on initial information. They stick to the piece of information or facts which were provided initially or historical data rather than relying on new piece of information which might change trends in the market.
- **Gamblers Fallacy:** It is a misconception in the minds of the investors that market trends will reverse in the near future.
- **Availability Bias:** In this type of bias investors rely too much on the recent available information which might lead to poor results in the market.

4. Applications of Behavioral finance

1. **Improves Advisor Client Relationship:** Behavioral theories can boost and refine advisor client relationship by giving an insight on various biases which exist in the minds of the investors. By bringing behavioral theories investment firms can differentiator them with the competitors.
2. **Asset Management:** Asset managers face tough competition with emerging robotic advisors which are based on concept of artificial intelligence. In such situation asset managers can take advantage of behavioral concepts and understand decision making process of human minds.
3. **Individual Investors:** Individual investors can understand the behavioral factors which effects their decision making while investing in the market.
4. **Financial Institution:** These theories might prove fruitful to financial institution who have large customer base in the country. By understanding the psychology behind investing they can position themselves firmly and bring innovative financial products.
5. **Public Companies:** The public relation officers in the public sector companies cannot ignore the behavioural biases of their shareholders as it impact the share prices of the company.

5. Conclusion

Behavioral factors play a vital role both for investors as well as financial intermediaries. It's not necessary that all the investors might suffer from biases as stated above but understanding of theoretical factors can bring an affirmative

change in the mind of the customer as well financial agencies operating in the markets. These concepts are also relevant in academic and research areas as they contribute in

understanding the blend of finance and psychology and helps in finding out the correlation between various factors in this field.

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