

A Study on Behavioural Finance

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ABSTRACT

Behavioral finance refers to the study of how thought process can affect and influence the decision making of investors. It explains occurrence of bad decision-making and still people think that they made the right choice. It gained prominence when traditional finance theories failed to explain many economic events like stock market bubbles. There are hundreds of behavioral biases that affect the decision making of investors. But by studying these biases one can overcome them. Thus, by learning the theory of behavioral finance investors can make better decisions and thereby improve their profit.

Keywords: Behavioral finance, behavioral biases, decision making, investment patterns.

INTRODUCTION

Behavioural finance is a fragment of Behavioural economics. It is the study of how psychology affects the behavior of investors or consumers, financial markets and financial analyst. It is based on the assumption that the investors cannot be always rational but sometimes they are influenced by their own biases. Traditionally, economics and finance have focused on models that assume rationality. It attempts to find out reasoning patterns of investors decision making. It tries to identify why market participants make irrational choices. Because such errors create market inefficiency.

Behavioural finance uses experiment and research that demonstrates how humans make irrational choices and many times their decision making is flawed. It tries to measure the misguided moves & miscalculations that people make with their money. Behavioural finance help the investors to understand how the financial decisions like the investments, payments, risk, and personal debt, are highly influenced by the factors like human emotions, biases, and rational limitations of processing of mind as well as responding to information. Behavioural finance provides mechanisms for identifying and managing unwelcome behaviors. Hence, after studying Behavioural finance anyone can overcome their biases and make better, logical and safe investment decisions.

OBJECTIVES

- To understand the evolution of Behavioural finance.
- To identify the biases of investors.
- To find out how to overcome the biases faced by the investors

LITERATURE REVIEW

Bachar Fakhry says that humans interpret the given information in a different way. The financial crises is about the information which is increasingly irregular and news has a larger impact than that of the fundamentals. Behavioural finance theory and market hypothesis explain different parts of asset pricing. In order to understand asset pricing there is still a requirement to use both fundamental theories. But he concluded that the efficient market hypothesis is theoretically superior theory of asset pricing.

Dr Reema Sharma gives a theoretical model which can be used to predict the investment decision of investors. Investors choose different investment alternatives based on various factors such as income, age, gender, occupation. But financial literacy and risk tolerance plays a major role in investment decision. Her research is also helpful for the investors in understanding financial literacy in dealing with risky investment.

Yadav Devi Prasad Behera, Sudhansu Sekhar Nanda and Tushar Ranjan Sahoo find out that failure in the past and domestic economic crisis because of international economic break down has scared investors away from investing in capital market. For "Atmanirbhar Bharat" giving confidence to domestic investors is very important. Strategy makers should use different dimension of cognition to become knowledgeable about the sources of information that investors can use and make better investments.

Neven Erfan, Sanjeevni Gangwani, Samira Ben Belgacem, suggested guidelines to help women investors to make better decision while investing. Disposition effect is essential to understand how the various factors impact the investors. If the portfolio is diversified, there is less inclination towards disposition effect. Results highlighted that female investors realize fewer capital losses with higher disposition effects and are more loss

averse than men. Disposition effect in women investor can be improved by maximizing the utility (current and expected) of their lifetime consumption.

Mohd. Shamim Ansari, Mohd. Adil have attempted to investigate impact of demographic factors like age, gender, investment experience and behavior bias (overconfidence and risk averse) on investment decision making of individual in Aligarh District of Uttar Pradesh. The paper suggests that age, gender and investment experience have huge impact on overconfidence of the investors. The findings of this study can be utilized by portfolio managers or any financial experts.

Bryan Fong proposed an original “behavioral finance representative agent model”, which elucidated how the fake news’ empirical price impacts can continue in finance in spite of challenging the efficient-market hypothesis. They found that modern fake news phenomena are increasing very rapidly because of social media. Recent studies have shown that fake news can impact security markets and the financial system. Still the amount of information or research available on this topic is very limited. And that limited research is mostly focused on political and social aspects of the fake news rather than on financial aspect.

Ioannis Branikas and Gabriel Buchbinder studied advertising acquaintance and investor consideration from super bowl commercials. They found that after Monday’s game attention of investors in areas with high viewership increases significantly for both local and non-local companies that air advertisements. Non-local firms with high advertising exposure in a region attract more interest than local firms with low exposure, suggesting that marketing has a stronger impact on investor attention than the local bias.

Hema Neelam, Dr. P. Amaraveni In this research paper the findings show where do the women investors of Warangal district invest their money. A sample of 300 women were taken. It was found that women were investing mainly in gold, real estate, post office savings and life insurance corporation (LIC). Majority of the women didn’t want to invest in risky options of investment. They wanted to play safe. It was concluded that age was a factor that impacted investment decision.

EVOLUTION OF BEHAVIOURAL FINANCE

The foundation of Behavioural finance can be outlined from almost 200 years ago. Some of the original books written in 1800’s and 1900’s marked the beginning of Behavioural finance school. In 1841, Charles Mackay wrote the book “Extraordinary Popular Delusions and the Madness of Crowds”. This book is often cited as the best book on market psychology. The incidents covered in this book confirm that greed and fear have always been a driving forces of the financial market. Gustave Le Bon’s work in “The Crowd: A study of the popular mind” written in 1895 is considered as most influential works in social psychology. George Selden wrote “Psychology of The Stock Market” in 1912. This was one of the first books to talk about the use of psychology in the stock market. These three books and many other works forms the foundation of applying psychology and sociology in the field of Behavioural finance.

Behavioural finance is an inter disciplinary subject. Hence, to understand the topic from all different perspective there are many books and works of other scholars. The works of the experts of other fields like sociology, psychology, anthropology, economics, etc. are also important to understand the subject completely. These books of some of the scholars cover a wide range of subject matter including: group behavior, financial mistrust, individual behaviour panics, crashes, speculative behaviour, crowd psychology, investor psychology, trader psychology, bubbles, investment strategies and theories, and investor personality.

In the early 1980s, known as the first generation of Behavioural finance, mainly focused on people’s shortcuts and errors as they make choices. The second generation of Behavioural finance accepts people’s wants and distinguishes wants from errors, thereby providing a truer portrait of normal people.

BEHAVIOURAL BIASES

There are a lot of self-defeating or counter-productive behaviours which bring human beings down. Financial behaviourists call these biases.

1. **Anchoring bias:** It occurs when people depend too much on the pre-existing information available and make the financial decisions based on that basis. It is a tendency of people to estimate worth or value of anything based on certain numbers that they have. For e.g., if you see a shirt that is more expensive and then you see a relatively cheaper shirt and you buy the latter.
2. **Disposition effect:** It is a tendency to sell profit making investment too early and then sticking to investment that have their value dropped down. Even experienced investors mistime their investment moves.

3. **Mental accounting:** It is a tendency to assign our funds into separate 'accounts' which affects the way we spend. Because of this tendency to we don't think carefully about buying something. We may end up buying something which may not be important and this leads to not saving up the money for bigger things. It leads to overspending.
4. **Herd behavior bias:** It is a tendency to copy and follow others. It is also known as bandwagon effect. It is a psychological phenomenon where people justify a course of action that is correct because everyone is doing it. It may result in panic buying and selling. It leads to investment bubble which are not good. For example, the dotcom boom of late 1990's. At that time everyone was investing in internet companies despite the fact that some companies were not financially sound.
5. **Overconfidence bias:** Here people overestimate their abilities. It may lead people to think they are better than expert or even average investors. It leads to risky investment.
6. **Confirmation bias:** It is a type of cognitive bias that involves preferring something that supports your previous beliefs or values. It makes people less likely to engage with different information or viewpoints which challenges their beliefs. This bias may lead investors to think that their investment is absolutely right even if the information they used to make that investment maybe flawed.
7. **Experiential bias:** It occurs when investor's think that the events which occurred recently may happen again. For example, the financial crises of 2008 led many investors to think that in the future also the market would be seeing economic hardships. In the future the markets recovered but many investors had exited the stock market. For this reason, it is also known as recency or availability bias.
8. **Loss aversion bias:** It is a phenomenon where a potential loss is apparently more severe than an equivalent gain. For example, If a person losses Rs.1000, the pain of that loss will be more than the happiness gained in finding the same amount of money.
9. **Familiarity bias:** It is a tendency to invest in what they know and prefer to stay in their comfort zone. It is a bias that stops us from investing in other assets or investments that we are not familiar with. There is not much diversification which can reduce risks.

SOLUTIONS TO OVERCOME BIASES

Biases are the major obstacles to investment success. Even the most logical and rational investor make poor decision based on erroneous conclusion and emotional reaction to a news.

Investors need to manage and control their emotions. In order to understand emotions, we need to fully understand them. When things don't go our way, we shouldn't get angry or make hasty decisions. We need to know things or situation that trigger our negative emotions. Once we know our triggers, we can use them to our advantage. Sometimes investors develop unhealthy attachment towards a stock. They might think that it is a great stock but it may turn out to be an average stock or even loss-making investment. For this an investor needs to do proper stock research before investing. Loss aversion bias should be tackled with strong emotion and not by letting emotions overpower the mind.

Confirmation bias leads to narrow minded viewpoints. And the investment patterns tend to be the same which may not be highly profitable. So, investors need to seek contrary opinions. Different viewpoints and values may broaden the mind. So, the investor may get some new ideas or pattern that can turn out to be successful.

To overcome anchoring bias, one should practice critical thinking. Which means not depending on the first information that is available. One should do a thorough research and find out the negatives.

CONCLUSIONS

Many of the Behavioural biases are strongly set into the ways investors process, think, and feel. Investors can try to overcome these biases. Investors can improve the way make their decisions by crafting a system of accountability, reframing the wins and losses, and trying to stay away from the herd mentality. Investors who have a tendency to avoid the Behavioural biases are more likely to earn the investment success.

Every person at one time or another has made a mistake or behaved irrationally in terms of over confidence or loss aversion or simply following whatever we have heard. Although policy makers, researchers, investment professionals, and investors may continue to debate whether markets are efficient and investors are rational, Behavioural finance has made great strides in understanding observed behavior.

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