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STUDY OF BEHAVIOURAL FINANCE WITH REFERENCE TO INVESTOR BEHAVIOUR

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ABSTRACT

While conservative and conventional finance accentuates theories such as portfolio optimization theory, the capital asset pricing model and the efficient markets hypothesis , the emerging field of behavioural finance investigates the more prominent psychological and sociological issues that impact the decision-making process of individuals, groups, and organizations. It holds out the prospect of a better understanding of financial market behaviour and scope for investors to make better investment decision based on an understanding of the potential pitfalls. This paper will discuss behavioural finance theories like overconfidence, loss aversion, the problem of inertia, financial cognitive dissonance, the theory of regret, and the prospect theory. In conclusion, the paper will provide strategies to assist individuals to resolve these "mental mistakes and errors" by recommending some important investment strategies

Keywords: Investment , Behavioural Finance

1. INTRODUCTION

Investment has always been considered as a science that deals with the study of capital market which then leads to a systematic plan of investment . However the recent trends and crisis of market says otherwise. It is found that investors are not always rational, rather investor's emotion has a major role to play with the investment decision. Therefore it is not sufficient to analyze Efficient Market Hypothesis and its drawbacks rather one has to go for a behavioral explanation of investor's irrationality in a consistent and correlated manner. [Misal D.M 2013]. For a while, theoretical and pragmatic evidence suggested that CAPM, EMH and other rational financial theories did a respectable job of predicting and explaining certain events. However, as time passed, scholars and economists started to find abnormalities and anomalies in the investor's behaviour that couldn't be explained by the conventional theories . While these theories could explain certain "perfect" events, the real world proved to be a very messy place in which market participants often behaved very unpredictably. These anomalies prompted academics to look to cognitive psychology to account for the irrational and illogical behaviors that modern finance had failed to explain. This is where Behavioral Finance comes into picture, it is the study of the effect of psychology on the behavior of investors and on financial market. The way in which an Investor behaves is not always rational or practical, which is why all the investment managers need to further acquaint themselves with the psychology of the Investors. The psychology factor has considerable impact on the way in which market behaves.

There is a huge psychology literature suggesting that people make systematic errors in the way that they think, Subprime Mortgage Crisis is the ideal example to settle this suspicion. It shows the dramatic effect of small investors on the market. It proves that, those usually expected deviations from the Investor's behaviour are not random, rather systematic. [Alok Kumar, 2013]

There are few peculiarities about an average investor's behaviour:

- They always think that Investments are often thought of as pieces of paper rather than part ownership of a company.
- They are often jumpy to sell a good stock.
- Investors often make a distinction between money easily made from investments, savings or tax refunds and hard-earned money
- People tend to think in extremes – the highly probable news is considered certain, while the improbable is considered impossible.
- They often take a short-term viewpoint. Recent market losses lead to suspicion and caution, while recent gains lead to action.
- Investors may overestimate their skills; attributing success to ability they don't possess and seeing order in information or data where it doesn't exist.
- Investors follow the crowd, and are heavily influenced by other investors or compelling news; they fail to check out the real facts.
- Investors become obsessed with prices and trend-watching, rather than solid information.

Ultimately, all of these theories and psychologies lead to a single issue which is lack of accuracy and these errors turn more robust and resilient when uncertainty, inexperience, attitudes and market pressures come together to weaken decision-making ability of an Individual. Behavioral finance studies the financial market specifically and in detail. It is further supported by Cognitive psychology which refers to how people think. Investors are irrational and overconfident. With or without significant knowledge about market movement, just on the basis of their recent experiences they create their preferences .These preferences may also create biases and bends. In the next chapter, the researcher attempts to explore the research already done in this field to form a base of evidence to support the existence of behavioural anomalies in financial decision making of an investor.

2. LITERATURE REVIEW

In the 1970s and early 1980s, researchers found enough evidences that the markets are efficient and investment decisions are taken rationally. However, over a period of time there have been major challenges to the rationality assumption. Such challenges, coming from behavioural finance, continue to advance the argument that the traditional finance theory's predictive power is no match to what investors observe and experience in the markets, in reality. Sewell [2001] defined the behavioral finance as the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets. Behavioral finance is of interest because it helps explain why and how markets might be inefficient. Jaakko [2011] study revealed that most investors had "affect" based extra motivation to invest in stock, over and beyond financial return expectations. Zaghlami [2009] study revealed that some psychological particularities that are not expected by the financial behavioral literature, the study was conducted on Tunisian investors. Mahendra [2008] study stated that irrational investment decision making is a widespread phenomenon. They study the perils of irrational decision-making in investments choice which finally can lead to great risk. Another milestone in Behavioral Finance growth was by Bondt and Thaler when they published , "Does the Stock Market Over-react?" .They revealed that people methodically and systematically over-react to unexpected and dramatic news events which leads to substantial inefficiencies in the stock market, which was both surprising and profound. In 1981, Kahneman and Iversky [2] introduced "framing". They exhibited the fact that psychological principles that rule the perception of decision problems and the evaluation of probabilities and outcomes produce predictable shifts of preference when the same problem is framed in different ways. Gradually a number of psychological effects and factors have been incorporated into behavioral finance only to strengthen the subject.

3. THEORIES OF BEHAVIORAL FINANCE

3.1 Prospect Theory

Tversky and Kanheman [1979] by way of developing the Prospect Theory showed how people manage risk and uncertainty. The theory explained the seeming regularity in human behaviours when judging risk under uncertainty. It showed that human beings are not consistently risk averse ; rather they are risk-averse in gains but risk-takers in losses.

According to Tversky and Kanheman, people place much more weight on the outcomes that are assumed as more certain than that which are considered simply probable, a feature known as the "certainty effect". People's choice are also affected by 'framing effect'. Framing refers to the way a problem is posed to the decision maker and their 'mental accounting' of that problem. Prospect theory shows that people do lot of mental accounting when they make financial decisions. They have a tendency to classify different financial decision problems under separate mental accounts, while overlooking the fact that it would be more rational to integrate all of these choices into one portfolio decision. In short , this theory says that people respond differently to equivalent situations depending on whether it is presented in the context of a loss or a gain. Most investors are risk averse when chasing gains but become risk lovers when trying to avoid a loss.

3.2 Regret Theory

Human beings have the affinity to feel the pain or the fear of guilt whenever a wrong decision is made. As such, to avoid this pain of regret or guilt, people tend to modify their behaviour, which may end up being absurd or irrational at times. Tversky and Kahneman [1974] recognized the impact of human heuristics on the decision-making process. Tversky at el. defined heuristic as a strategy that can be applied to a variety of problems and that usually–but not always–yields a correct solution. For example, some investors invest in the stocks of companies that have fallen considerably in a very short amount of time. In this case, the investor is anchoring on a recent "high" that the stock has achieved and consequently believes that the drop in price provides an opportunity to buy the stock at a discount Regret theory is about people's emotional reaction to having made an error of judgment. Investors may avoid selling stocks that have gone down in order to avoid the regret of having made a bad investment and the embarrassment of reporting the loss. They may also find it easier to follow the crowd and buy a popular stock : if it subsequently goes down ,it can be rationalized as every-one else owned it.

3.3 Anchoring

Anchoring is a phenomenon in which in the absence of better information, investors assume current prices are about right People tend to give too much weight to recent experience, extrapolating recent trends that are often at odds with long run average and probabilities. For example, some investors invest in the stocks of companies that have fallen considerably in a very short amount of time. In this case, the investor is anchoring on a recent "high" that the stock has achieved and consequently believes that the drop in price provides an opportunity to buy the stock at a discount.

3.4 Cognitive dissonance

The unpleasant emotion that results from believing two contradictory things at the same time. The study of cognitive dissonance is one of the most widely followed fields in social psychology. Cognitive dissonance can lead to irrational decision making as a person tries to reconcile his conflicting beliefs The consequences of investors putting too much weight on recent news at the expense of other data are market over or under-reaction. People show overconfidence. They tend to become more optimistic when the market goes up and more pessimistic when the market goes down. Hence, prices fall too much on bad news and rise too much on good news. And in certain circumstances, this can lead to extreme events.

3.5 Over confidence

Psychology has found that people have a tendency to have baseless confidence in their abilities and decisions. People generally rate themselves as being above average in their abilities. They also overestimate the precision of their knowledge and their knowledge relative to others. Overconfidence is closely related to the human inclination to have the positive view of world . While this can help you recover from life's disappointments more quickly, it can also become an ongoing source of poor decision making.[Barber and Odean [1999] This kind of overconfidence can be fatal as far investment is considered because it might lead you to believe your luck to be your skill [You almost believed that it didn't rain today coz you forgot your umbrella, right?]. In addition to that many investors also fall into the ploy of have confidence that they can pick winning investments. As a result, they sometimes put too much of their wealth in a single portfolio, which can be very risky. Research shows that picking winning investments is incredibly hard to do, even for professional investors. The same overconfidence might also push you to trade too much and too often, which may have an adverse effect on your return on portfolio.

3.6 Loss aversion

The human tendency to take extreme measures to avoid loss leads to some behaviours that can obstruct investing success. Loss aversion refers to the fact that people actually value gains and losses differently. Losses have more demonstrative impact than an equivalent amount of gains and are therefore gains more weight in the process of decision making. Behavioural finance suggests investors are more sensitive to loss than to risk and potential return. This means that investors sometimes hold on to losing investments hoping they will recover their losses while quickly selling winners to realise a gain. As a result, investors' 'risk profile' change depending on whether they are facing a loss or a profit. For example, in case of investment , someone who loses INR 10000 seems to feel worse than the satisfaction gained by someone who receives a INR 10000 profit. This suggest that losses are twice as influential, psychologically, as gains.

3.7 Problem of Inertia:

Inertia means that people fail to get around to taking action, even on things they want or have agreed to do. Inertia can act as a barrier to effective financial planning, stopping people from saving or making necessary changes to their investments. Because of the confusions in investing decisions, Individuals prefer to choose the path of least conflict. Instead of sealing their decision , they choose to wait and see. This might postpone the returns that they might have earned if the decision was not delayed.

4. SUGGESTIONS

When making an Investment there are million things that we believe thinking about , however the errors still happen ! Things to watch for in your own investment decision is to avoid excessive fund switching and prevention of risk. It is also important for the investors to be persistent when it comes to his investment plan and objectives , and not to get diverted elsewhere. Most people overate their skills and visions higher than those of others. They also fail to recognize the tendency to feel regret over certain investment decisions, rather than moving on and investing in a way that make their goals more achievable. Investors may assume, and this assumption is usually based on hope, that a bad investment will turn better. However this often-held perception that investing is similar to gambling, an investment's performance and hope for its better performance are not proven, in any scientific way to be aligned with one another. Recognizing trends like these are vital to understand why we make the financial decisions we make. And, investing while knowing all of these perceptions and assumptions , rather than investing blindly is the real use of behavioural finance. Below mentioned are the few key points to avoid behavioural Finance errors.

- The inconsistencies identified in an Investor's Behaviour are because of different prejudiced perception of an Individual. To avoid these inconsistencies and anomalies, it's required to foster and shape attitudes of an individual making decisions.

- The only remedy to avoid anchoring error is brain storming and hard thinking. The investor is required to carefully evaluate the right type and source of figures so that true potential of stock is identified. Rather than taking your decision on one or two parameters, try having a comprehensive view about your investment avenue. Take other people's opinions. Paying attention to a few "devil's advocates" could help in detecting unseemly benchmarks that may cause your strategy to fail.
- It is important for an investor to do Technical analysis of the decisions to be made rather than just doing the fundamental analysis. The reason behind this suggestion is that at times , fundamental analysis fails to explain short term variability in the price of securities. Technical analysis helps the investors where fundamental analysis is insufficient so both the methods should be considered at the time of decision making.
- Assuming that market is efficient, it would react on each and every piece of newly arrived information but it is still advisable for investors to check the relevancy of information before banking on it or before responding on it and the announcements from the companies should be adequately adjusted in the portfolio as soon as possible.
- Instead of following an all positive and joyful approach or expectation theory approach in selling or holding of stocks, the hedging approach should be used. The losing stocks should be sold off rather than assuming and hoping it to do better.
- Do remember that even the professional fund managers, who have access to the best investment/industry reports and computational models in the business, do struggle at achieving market-beating returns. Every day in the market is going to come with new twists and turns and so the investment techniques will constantly need refining. It is better to be wide awake and updated before you receive a big wake up call

5. CONCLUSION

Modern finance is based on the theory which describes people to behave logically and rationally. As the time passed people started to question this point of view as these anomalies started to prevail, that conventional finance had a difficult time in explaining. This is where the behavioural finance theories started to originate. Investors behave irrationally because of several reasons like, lack of information, overconfidence, fear of loss and so on. All of these psychological factors, investor end up making few mistakes , like , excessive trading , holding on to losing investments ,selling winners. The tendency of the investors to be over confident causes excessive trading while the fear of loss or risk aversion would prompt to selling a good stock / retaining the bad stock. Behavioural finance provides us with the insights on these anomalies. The emergence of the field of the behavioral finance has directed us to an insightful depth of our knowledge of financial markets This ever expanding new development in this field is expected to increase the efficiency and analytical power of investors' behavior and the entire financial markets in the future but, since behavioral finance is at its nursling stage of development, much more theoretical analysis and empirical testing are needed. This is the path of our future research.

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