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A BIRDS EYE VIEW ON BEHAVIORAL FINANCE TOWARDS INVESTMENT DECISIONS IN SHARE MARKET

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Behavioral finance is a part of finance that seeks to understand and explain the systematic financial market implications of psychological decision processes. It utilizes knowledge of cognitive psychology, social sciences and anthropology to explain irrational investor behavior that is not being captured by the traditional rational based models. Although behavioral finance does not claim that every investor would suffer from similar illusion, instead it sheds light on to take necessary initiatives to avoid such illusions, which influence the process of decision-making, particularly while making investments. This paper analyzes the concept of behavioral finance along with its four theories and various behavioral factors which affects the decision of investors in stock market.

Keywords: Behavioral finance, Behavioral factors, Investors psychology, Traditional finance, Investment decision

INTRODUCTION

Behavioral finance is a new academic discipline which seeks to apply the insights of the psychologists to understand the behavior of both investors and financial markets. It focuses upon how investor interprets and acts on information to take investment decisions. It explains that an individual does not always act rationally in their financial decisions and that their behaviors cause them to make different choices about their financial decisions (Harikanth and Pragathi).

Behavioral finance attempts to explain the emotional processes of investors involved and the degree to which they influence the decision making process. Thus, behavioral finance is the application of scientific research on the psychological, social, and emotional contributions to market participants and market price trends. It also studies the psychological and sociological factors that influence the financial decision-making process of investors (Atul Bansal, 2013).

RESEARCH SIGNIFICANCE

The concept of behavioral finance has emerged due to the difficulties faced by the traditional theories of finance. The role of behavioral factors that influence the investors in taking decisions in the share market creates the following points in the minds of researcher.

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The following points support how behavioral finance is far wider than traditional theories.

1. Financial theories assume that investors make rational decisions. However most studies conducted, revealed that investors don't act in a rational manner.
2. Behavioral finance explains how emotional processes influence the investors in decision making process.
3. Theories of Behavioral finance are structured upon the experimentally supported knowledge from social psychology but traditional finance theories are mere own assumptions of researchers and this type of market does not exist in real life.

OBJECTIVES OF THE STUDY:

1. To study the concept of behavioral finance.
2. To know the difference between traditional finance and behavioral finance.
3. To identify various behavioral factors influencing the decision of investor in stock market.

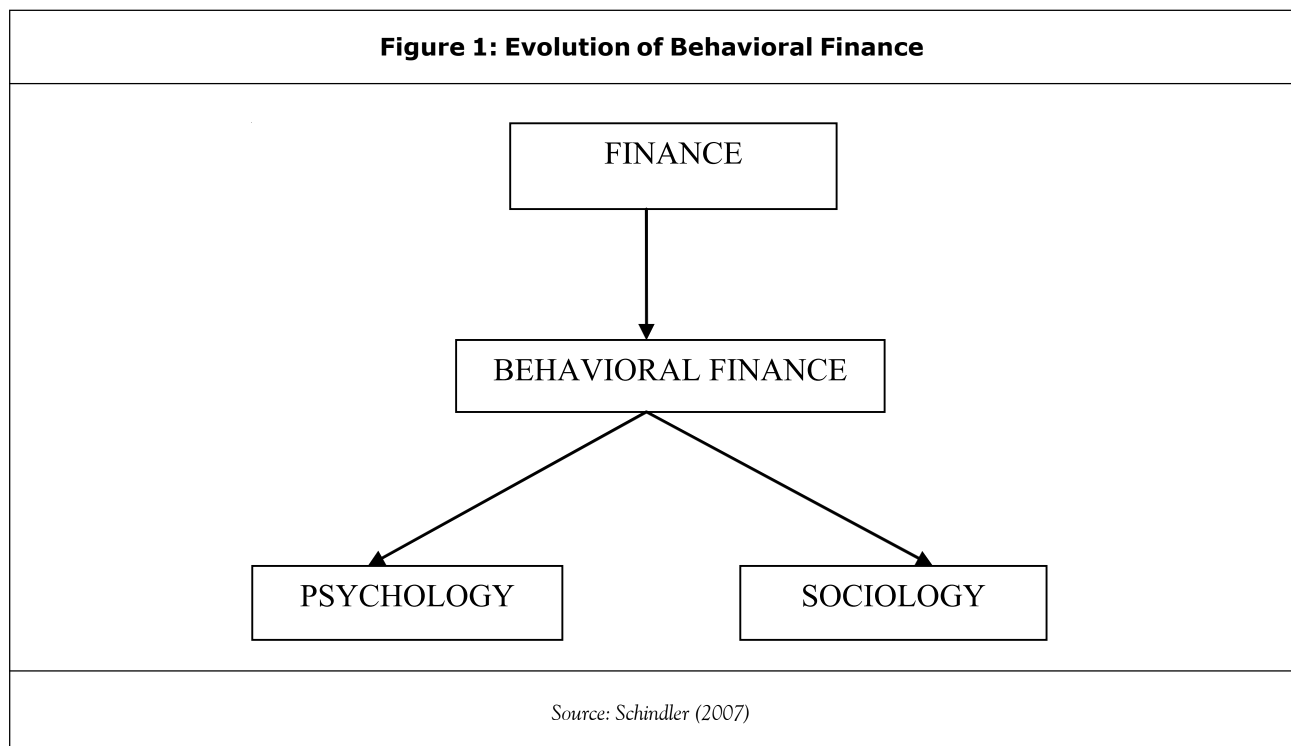
EVOLUTION OF BEHAVIORAL FINANCE

Behavioral finance is a concept that has become widely popular in recent years. The principles of behavior used by behavioral finance in practice, are based on psychology and sociology.

EMERGENCE OF BEHAVIORAL FINANCE

Traditional financial theory says that, the decisions made by the investors are usually rational. During several past years, investments are usually based on forecasting, performance, market timing. Whereas the modern theories suggest the investors make irrational decisions during their investments and psychological impact was found during these mistakes. Thus the subject of

Figure 1: Evolution of Behavioral Finance



Source: Schindler (2007)

behavioral finance which got popularity in the world of investment decisions and stock markets. Since many years, investors have been considering psychology an important factor while determining the market behavior, but formal studies have only been conducted in recent years in this field of behavioral finance. (Agha Jahanzeb, 2012)

FATHERS OF BEHAVIORAL FINANCE

Daniel Kahneman and Amos Tversky are recognized as the fathers of Behavioral Finance. Kahneman and Tversky have focused much of their research on the cognitive biases and heuristics (i.e., approaches to problem solving) that cause people to engage in unanticipated irrational behavior. Their most popular and notable works include writings about prospect theory and loss aversion (Amar Kumar Chaudhary, 2013).

TRADITIONAL FINANCE VS. BEHAVIORAL FINANCE

In traditional theories of finance investment decisions are based on the assumption that investors act in a rational manner. This means that they behave rationally so they earn returns for the money they invest in stock markets. To become successful in the stock market it is essential for investors to have rational behavior patterns. Rational behavior is also required to overcome tendencies.

Modern theory of investors' decision-making suggests that investors do not act rationally at every time while making an investment decision. They deal with several cognitive and psychological errors. These errors are called behavioral biases and are exists in many ways. Behavioral finance has been growing specifically over the last two decades as we find difference between the assumptions made in traditional finance theory and actual behavior of investors (Babaraju K Bhatt, 2014).

THEORIES OF BEHAVIORAL FINANCE

There are four theories of behavioral finance. They are as follows:

1. Prospect Theory
2. Regret Theory
3. Anchoring
4. Over-and-under reaction

Prospect Theory

Prospect theory explains the apparent irregularity in human behavior when assessing risk under uncertainty. It says that human beings are not consistently risk-averse; rather they are risk-averse in gains but risk-takers in losses. People place much more weight on the outcomes that are perceived more certain than that are considered mere probable, a feature known as the "certainty effect". People's choices are also affected by the 'Framing effect'. Framing refers to the way in which the same problem is worded in different ways and presented to decision makers and the effect deals with how framing can influence the decisions in a way that the classical axioms of rational choice do not hold. This theory says people respond differently to equivalent situations depending on the gains and losses. This is on the ground that people may make different choices in situations with identical final wealth levels. Most investors are risk averse when chasing gains but become risk lovers when trying to avoid a loss.

Regret Theory

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 everyone else owned it.

Anchoring

The assumption of rationality says that our thoughts and opinion should always based on relevant and fact. In reality, however, this is not always so rather. People have a tendency to attach or "anchor" their thoughts to a reference point even though that may hardly have any logical association with the decision at hand. Although the company is making more money, its stock price does not rise because investor assume that the change is earning is only temporary. Thus, the investor remain anchored to their previous view of the companies potential profitability because they have under-reacted to the new, positive information. This does not mean that investors will never move away from their initial reference point or anchor. They will realize that the company is likely to continue to be more profitable in the future and that its stock is probably an attractive potential investment.

Over and Under Reaction

Disproportionate reaction to news, both good and bad has been often seem in the financial market. They tend to become more optimistic when the market goes up and more pessimistic when the market goes down. Irrational optimism and unjustified pessimism are shown in over and under-reaction of investors.

VARIOUS BEHAVIORAL FACTORS WHICH AFFECTS THE DECISION OF INVESTORS IN STOCK MARKET

Some of the behavioral factors which affect the investment decision of investors in stock market are as mentioned below.

1. **Over confidence:** Psychologists are of the opinion that overconfidence causes people to overestimate their knowledge, underestimate risks and exaggerate their ability to control events. A common trait among investors is a general overconfidence of their own ability when it comes to picking stocks and to decide when to enter or exit a position. An overconfident investor makes too many trades and takes too much risk. They do not diversify their investment.

2. **Representativeness:** It is the tendency of investors to associate new event with a purpose of knowing the event and through which only they make investment. If a company make announcement of information pertaining to investment, the investor will correlate that announcement with the past announcements and makes decision on the basis of that past announcement without considering the fact that past announcement may not represent the present one so far.

3. **Herding:** Herding in financial markets can be defined as mutual imitation leading to a convergence of action. This is the common mistake where investors tend to follow the investment decisions that taken by the majority. As a result of this investor will not buy or sell a stock even if that decision is supported by

technical or fundamental analysis. Investor is pressurized by the influence by the peers. They are more concerned about what others think of their investment decision. As a result of herding behavior, investors lose their own individuality in the decision making process.

4. **Anchoring:** Anchoring is a psychological situation exists when investors give unnecessary importance to statistically random and psychologically determined 'anchors' which leads them to investment decisions that are not essentially 'rational'.

5. **Cognitive Dissonance:** Cognitive Dissonance can be defined as the mental conflict that people experience when they are presented with evidence that their beliefs or assumptions are wrong. As a result of this conflict, the investor ignores new information that contradicts known beliefs and decision. This behavior of investors leads to reduction in their ability to make rational and fair investments.

6. **Regret Aversion:** Regret Aversion is a psychological error that arises out of excessive focus on feelings of regret at the time of decision making, which turned out to be poor, mainly because the outcomes of the alternative are visibly better for the investor to see. The root cause of this type of error is the tendency that individuals hate to admit their mistakes. Because of such tendency investors may avoid taking decisive actions for the fear that whatever decisions they take will be sub-optimal in Hindsight. Because of unwillingness to admit and rectify mistakes in a timely manner could lead investors into holding onto a losing position for too long. Another downside is that it can stop investors from making an entry into the market when there has been a downtrend showing signs of ending and signals that it is a good time to buy.

7. **Mental Accounting:** Mental Accounting is the set of cognitive operations used by individuals and households to organize evaluate and keep record of financial activities resulting in a tendency for people to separate their money into separate accounts based on a variety of subjective reasons. Individuals tend to assign different functions to each asset group, which has Often irrational and negative effect on their consumption decisions and other behaviors. Mental Accounting refers to the codes of people use when evaluating an investment decision resulting in low or no diversification of investment.

8. **Hindsight:** Hindsight bias can be defined as the tendency to think that one would have known actual events that were coming before they happened. As a result of hindsight bias investors usually take wrong decision or pretend that the outcome of their decisions was known by them very earlier. If investor have loss on particular stock then too they will pretend as if they knew it earlier that they will loss, as a result of this they don't learn lessons from their wrong decisions and such decisions may be taken again in future also.

9. **Availability Bias:** The availability bias suggests that the recent memory, i.e., the available example influences more on investor's decision of investment, i.e., if investors have recently seen huge loss in one investment avenue then he will not invest in that avenue. Investors are more likely to be fearful of stock market if they have recently seen any stock market crisis.

10. **Conservatism:** Conservatism represents that the investor takes decision on the basis of his past information although faced with the new information or investor only partially adjust their view in the light of new information, i.e., investors who buy shares in a high profile company may be slow to adjust their view of the company's prospects even after the company's profitability deteriorates.

CONCLUSION

Behavioral finance represents a revolution in financial theory. The combination of financial theory with other social sciences resulted in the appearance of behavioral finance. The conclusion can be drawn that investors not always act in a rational manner due to the cognitive and psychological errors they have to deal with. The behavioral factors are important in financial markets because they influence the investors who make the financial decisions.

Under these circumstances a more comprehensive and careful decision making is not possible. Behavioral finance highlights the psychological edge of investment decision making process in strong contradiction to the Efficient Markets Hypothesis. It is obvious that the separation of an investor's personality and their investment decisions making is not possible. Therefore, it cannot be ignored the importance of understanding of the individual financial behavior of capital market investors. Behavioral finance is not a perfect replacement to classical finance paradigm, but it is an alternative solution to the difficulties faced by the traditional theory in explaining certain financial phenomena.

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