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A STUDY ON IMPACT OF BEHAVIORAL FINANCE IN INVESTMENT DECISIONS OF SMALL INVESTORS

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Decision-making is a complex activity. Decisions can never be made in a vacuum by relying on the personal resources and complex models, which do not take into consideration the situation. Analysis of the variables of the problem in which it occurs is mediated by the cognitive psychology of the manager. Decision-making can be defined as the process of choosing a particular alternative from a number of alternatives. It is an activity that follows after proper evaluation of all the alternatives. Recent research shows that the average investors make decisions based on emotion, not logic; most investor's buy high on speculations and sale low on panic mood. Psychological studies reveal that the pain of losing money from investment is really three times greater than the joy of earning money.

Keywords: Behavioural finance, Cognitive psychology, Investment decision, Speculation

INTRODUCTION

Behavioral finance is a relatively new field that seeks to combine behavioral and cognitive psychological theory with conventional economic and finance to provide explanations for why people make irrational financial decisions. It is our belief that the key to defining behavioral finance is to first establish strong definitions for psychology, sociology and finance. When studying concepts of behavioral finance, traditional finance is still the centrepiece; however, the behavioral aspects of psychology and sociology are integral catalysts within this field of study. Therefore, the person studying behavioral finance must have a basic understanding of the concepts of psychology, sociology, and finance to become acquainted with overall concepts of behavioral finance.

Behavioral finance seeks to find how investor's emotions and psychology affect investment decisions. It is the study of how people in general and investors in particular make common errors in their financial decision due to their emotions. It is nothing but the study of why otherwise rational people take some really thumbs investment decisions. Decision making is a process of choosing best alternatives among a number of

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alternatives. This decision has come out after a proper evaluation of all the alternatives. Decision making is the most complex and challenging activity of investors. Every investor differs from the others in all aspects due to various factors like demographic factor, socioeconomic background, educational level, sex, age and race. An optimum investment decision plays an active role and is a significant consideration.

Investor is a rational being who will always act to maximize his financial gain. Yet we are not rational being; we are human being; an integral part of this humanness is the emotion within us. Indeed, we make most of our life decisions on purely emotional considerations. In the financial world, investor's sometimes base their decisions on irrelevant figures and statistics, e.g., some investor may invest in the stock that have witnessed considerable fall after a continuous growth in recent past. They believe that price has fallen which is only due to short term market movements, creating an opportunity to buy the stock cheap. However, in reality, stocks do quite often also decline in value due to changes in their underlying fundamentals.

Cognitive dissonance is the perception of incompatibility between two cognitions, which can be defined as any element of knowledge including attitude, emotion, belief or behavior. The theory of cognitive dissonance holds that contradicting cognition serve as a driving forces that compels the mind to acquire or invent new thoughts or beliefs or to modify existing beliefs, so as to reduce the amount of dissonance (conflict) between cognition.

Festinger theory of cognitive dissonance states that individual attempts to reduce inner conflict in one of the two ways:

1. He changes his past values, feelings or options; and
2. He attempts to justify or rationalize his choice. This theory may apply to investors and traders in the stock market who attempt to rationalize contradictory behaviors, so that they seem to follow naturally from personal values or view point.

In "Financial Cognitive Dissonance", we change our investment styles or beliefs to support our financial decisions. For instance, investors who followed a traditional investment style (fundamental analysis) by evaluating companies using financial criteria such as, profitability measures, especially, profit/earnings ratios, started to change their investment beliefs. Many individual investors purchased retail internet companies in which these financial measures could not be applied. Since these companies have no financial track record, very little revenues and no net losses. These traditional investors rationalized the change in their investment style (past beliefs) in two ways: the first argument by many investor is the belief (argument) that we are now in a "new economy" in which the traditional financial rules no longer apply. This is usually the point and the economic cycle in which the stock market reaches its peak. The second action that displays cognitive dissonance is ignoring traditional form of investing and buying these internet stock simply based on price momentum.

Regret theory states that an individual evaluates his or her expected reactions to a future event or situations. Psychologists have found that individuals who make decision that turn out badly have more regret when that decision was more unconventional. This theory

can also be applied to the area of investor psychology within the stock market, whether an investor has contemplated purchasing a stock or mutual fund which has declined or not, actually purchasing the intended security will cause the investor to experience an emotional reaction. Investors may avoid selling stocks that have declined in value in order to avoid the regret of having made a bad investment choice and the discomfort of reporting the loss.

In addition, the investor sometimes finds it easier to purchase the "hot or popular stock of the week". In essence, the investor is just following "the crowd". Therefore, the investor can rationalize his or her investment choice more easily if the stock or mutual fund declines substantially in value. The investor can reduce emotional reactions or feelings since a group of individual investors also lost money on the same bad investment. In investing, the fear of regret can make investor either risk averse or motivate them to take greater risk.

Prospect theory deals with the idea that people do not always behave rationally. There are different psychological factors which motivate people in investment decision under uncertainty. It considers preference as a function of "decision weights" and it assumes that these weights do not always match with probabilities. It further suggests that decision weights tend to overweigh small probabilities and under-weigh moderate and high probabilities.

REVIEW OF LITERATURE

Behavioral Finance is a new emerging discipline that studies the irrational behavior of the investors. Perhaps the literatures consisting of behavioural finance can be best explained by the works of Tversky and Kahneman who were recognized as the fathers of behavioural finance. Their literary works include:

In 1973 they introduced availability heuristics. "A judgmental heuristic in which a person evaluates the frequency of classes or the probability of events by availability i.e., by the ease with which relevant instances comes to mind." The reliance on the availability heuristic leads to systematic biases. In 1974they introduced three heuristics that are employed while making judgments under uncertainty, representativeness, availability, anchoring and adjustment. In 1979 they presented a critique of Expected utility theory in their paper that appeared in Econometrical. In another important paper, Tversky and Kahneman 1981 introduced the concept of Framing. They showed that the psychological principles that govern the perception of decision problems and the evaluation of probabilities and outcomes produced predictable shifts of preference when the same problem is framed in different ways.

Behavioral economist Martin Weber (1999) makes the following observation, "Behavioral finance closely combines individual behavior and market phenomena and uses the knowledge taken from both the psychological field and financial theory" (Fromlet, 2001). Behavioral finance attempts to identify the behavioral biases commonly exhibited by investors and also provides strategies to overcome them. Behavioral finance has two building blocks: cognitive psychology and the limits to arbitrage. Cognitive refers to how people think. Though the literature is very large, a brief review has been presented. A few studies have been carried out to examine the investment preferences and practices of the individual investors.

Lewellen (1977) found that age, sex, income and education affect investors' preferences. Study

by Rajarajan (2000) revealed an association between lifestyle clusters and investment related characteristics.

Bandgar (1998) in his study found that investors are educated in investment decision making.

Soch and Sandhu (2000) have studied perceptions of bank depositors on quality circles, customer complaint cell, quality, priority banking, telebanking, and customer meets in private banks.

Study by Rafael La Porta *et al.* (2000) reveals that a strong investor protection is a manifestation of the security of property.

The investment decision making process of individuals has been explored through experiments by Barua and Srinivasan (1986, 1987 and 1991). They conclude that the risk perceptions of individuals are significantly influenced by the skewness of the return distribution. This implies that while taking investment decisions, investors are concerned about the possibility of maximum losses in addition to the variability of returns. Thus the mean variance framework does not fully explain the investment decision making process of individuals.

Gupta (1991) argues that designing a portfolio for a client is much more than merely picking up securities for investment. The portfolio manager needs to understand the psyche of his client while designing his portfolio. According to Gupta, investors in India regard equity debentures and company deposits as being in more or less the same risk category, and consider mutual funds, including all equity funds, almost as safe as bank deposits.

Investors may range from confident to anxious. Method of action is reflected in how methodical investors are, as well as how analytical and intuitive they are. This can range from careful to impulsive. Within these ranges, the model defines four personalities:

1. Individualist: Careful, confident and often takes a do-it-yourself approach
2. Adventurer: Volatile, entrepreneurial and strong-willed
3. Celebrity: Follower of the latest investment fad
4. Guardian: High risk averse and wealth preserver

NEED FOR THE STUDY

It is observed that investors are more reliable and attached with a particular type of investment avenues. So it becomes significant to study the motivational factors that compel them from selecting the investment avenues.

Recent research shows that the average investor makes decisions based on emotion, not logic; most investors buy high on speculation and sell low in panic mode. The main reasons for the variance were the tendency for the average investor to sell after a stock price has fallen a long way and then buy back in to the market after it has already raised a large amount. Effectively the average investor is buying high and selling low, and thus making losses. Also, the investors go for lesser risky investment avenues so that at least their principal amount is safe and they stay at break even point.

OBJECTIVES OF THE RESEARCH

The Objectives of the Study are

- To study the attitude of respondents towards

different financial instruments and to evaluate the awareness about various investment opportunities.

- To analyze investors savings and risk attitude towards different investment avenues.
- To identify the mistakes committed by investors in making systematic investment decisions.
- To suggest remedial measures to overcome the mistakes in making systematic investment decisions.
- To find out the investment pattern of the small investors of Ranchi district.
- To study investment decision-making process and to study the factors that influence investment behavior of small investors of Ranchi district.

METHODOLOGY

This research was based on the primary data obtained through a detailed questionnaire containing 25 questions. The first part of the questionnaire relating to socio-economic background of the respondents consisted of 9 questions relating to name, age, educational qualification, income, etc.

The second part of the questionnaire consisted of 16 questions relating to various factors of avenue selection for the study. The sample size was 30 and the respondents were randomly selected from the urban investors of Ranchi district of Jharkhand.

The primary data obtained from the questionnaire was analysed by using the simple descriptive tools like average and percentage. The analysis was performed using Microsoft Excel

Table: Data Analysis and Interpretation

Demographic Factors	Variable	No. of Respondents	Preference in Investment Avenues							
			Saving a/c	Bank Fixed Deposit	Ppf	Nsc	Po Savings	Govt. Securities	Mutual Funds	Real Estate
Gender	Male	20		12		1	1		2	1
	Female	10	1	8	2		1	1		
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Age	Between 20-30	14	1	10			1		1	1
	Between 30-40	12		9	1	1	1			
	Above 40	4		1	1			1	1	
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Qualification	Graduate	9	1	7			1			
	Post graduate	12		8			1	1	1	1
	Other	9		5	2	1			1	
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Occupation	Salaried	20	1	14	1		2	1	1	
	Business	4		3		1				
	Professional	5		3	1				1	
	Other	1								1
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33

Table (Cont.)

Annual income	Below Rs 2,00,000	4	1	2						1
	Rs 2,00,000-4,00,000	9		5			2	1	1	
	Rs 4,00,000-6,00,000	5		5						
	Above Rs 6,00,000	12		8	2	1			1	
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Investment objective	Income & capital	8		6	1				1	
	Long term growth	4		1	1		1	1		
	Growth & income	18	1	13		1	1		1	1
	Short term growth	-	-	-	-	-	-	-	-	-
	Others	-	-	-	-	-	-	-	-	-
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Investment purpose	Wealth creation	14		8		1	1	1	2	1
	Tax saving	8		6	2					
	Earn returns	7	1	5			1			
	Future expenses	1		1						
	Others									
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Investment factors	Safety of principal	16	1	10	1		2		1	1
	Low risk	4		3				1		
	High returns	9		6	1	1			1	
	Maturity period	1		1						
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Percentage of investment	0-15%	12	1	9			2			
	15-30%	15		9	2			1	2	1
	30-50%	3		2		1				
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Time period	0-1 years	3		1			2			
	1-5 years	14	1	11					1	1
	More than 5 years	13		8	2	1		1	1	
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33
Source of investment advice	Newspapers or news channels	4		2					2	
	Family or friends	15	1	11			2			1
	Internet	7		4	2	1				
	Advisors	4		3				1		
	Total	30	1	20	2	1	2	1	2	1
	Percentage	100	3.33	66.67	6.67	3.33	6.67	3.33	6.67	3.33

application package. Further, the secondary data had been obtained from various internet websites, journals, magazines and other published sources.

HYPOTHESIS

The two major hypothesis tested and analysed in this study are:

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H_1: There is influence of behavioural finance on investment decision

H_0: There is no influence of behavioural finance on investment decision

DATA ANALYSIS AND INTERPRETATION

It is observed from table that the respondents vary in age, occupation, gender, income, risk bearing capacity, etc. A total of eight investment avenues namely Saving Account, Bank Fixed Deposit, Public Provident Fund, National Saving Certificates, Post Office Savings Schemes, Government Securities, Mutual Funds and Real Estate were taken for study.

It can be observed that the investors take different investment avenues for meeting their Psychological, Social and Financial need. Table as provided above presents the demographic details of different investors varying in age, occupation, education, gender and their investment preferences to different investment avenues. In the above table out of eight avenues, investment in Bank fixed deposit is regarded as least risky avenue as compared to other available It shows that investors who are in the age group of 20 and above prefer to invest in safer investment avenues like Bank deposits, PPF, Post office saving schemes, etc.

Most of the Investors took Investment advice from their family or friends (please refer table above in which out of 30 investors 15 i.e. 50% took investment advice from their family or friends), which shows that the investors follow crowd (HERD BEHAVIOUR) without thinking logically and analysing the merits and demerits of a particular Investment avenue. Their main focus is on low risk investment and safety of principal, which means they do not follow high risk high return saying.

Hence, we may say that H_1 prevails i.e. there is influence of behavioural finance on investment decision.

Some of the common mistakes made by investors in designing their investment portfolio are identified as follows:

1. Investors fail to design their portfolio of investment avenues systematically.
2. Investors fail to diversify their portfolio.
3. Investors generally overestimate their skills, attributing success to ability they don't possess and seeing information or data which doesn't exist, i.e., investors are overconfident while making investment decisions.
4. Investors blindly follow the crowd (herd mentality) while making investment decisions which leads to wrong investment decisions.
5. Investors anchor on historical information.
6. Investors think that good times are permanent. They feel that ones they earn a good profit from their investment avenue , the investment would give them good returns permanently.
7. Investors are greedy and they want to earn money quickly (Instant gratification) which also leads to wrong investment decisions.
8. Investor's generally make short term investment decisions rather than long term investment decision.

RECOMMENDATION

1. Investors should carefully identify and analyse the general and behavioural factors affecting investment decisions and should design an appropriate portfolio of investments.

2. Proper diversification of portfolio can help an investor to avoid tragic losses and to overcome the behavioural biases and thus lead to successful financial planning.
3. Investors should not be overconfident while making investment decisions. They should not think that good times will be permanent.
4. Investors should not follow the crowd blindly rather they should think accurately and make rational investment decisions.
5. Investors should look out for accurate information and sufficient information before they make investment decisions. Lack of sufficient information also leads to making mistakes in taking investment decisions.
6. Investors should be patient before and after taking investment decisions. They should not aim at instant gratification (Earning quick profits).
7. Investors should always realize that past continuous events are all independent and are not co-related.
8. Investor's should always aim at long term investment decisions.
9. To reduce the influence of psychological biases, investors can establish realistic investment objectives in terms of returns and risk tolerance. The investor has to recognise the constraints such as liquidity, time horizon and taxes to achieve their objectives.
10. Investors should periodically review and keep track of their investment portfolio at least once a year. If the weights for each asset class diverge too much from the desired weights, the investor can consider reallocating the assets within the portfolio.

CONCLUSION

The study reveals that most of the time the investors invest in different investment avenues irrationally or illogically without considering and analysing the pros and cons of a particular Investment avenue. Behavioral finance provides explanations for why investors make irrational financial decisions. It demonstrates how emotions and cognitive errors influence investors in the decision making process. The various causes that led to behavioral finance are anchoring, overconfidence, herd behavior, over and under reaction and loss aversions.

Designing a systematic portfolio of investment is a very complex task for an investor, however while framing the portfolio of investments, an investor should not only consider the general factors but he should clearly understand the behavioural factors affecting investment decisions.

Behavioral factors play a vital role in the decision making process of the investors. Behavioral finance has created methods that can help investors identify typical mistakes while finding the right portfolio for them. The hope is that as many investors as possible will make use of this school of thought and that the markets will become as efficient as traditional finance assumes. However, the saying "There is no such thing as a free lunch" will always apply.Investors should be aware of the risks before making a decision, and choose the right combination of risk and return. Hence the investors should take necessary steps to minimize or avoid illusions influencing their decision making process, investment decisions in particular. Thus, we may conclude that there is influence of behavioural finance on investment decision.

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