



ROLE OF BEHAVIOURAL FINANCE IN INVESTMENT DECISIONS

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ABSTRACT:

Behavioural finance is not a new subject in the field of finance and is very popular in stock markets across the world or investment decisions. Many investors have, for long considered that psychology plays a key role in determining the behaviour of markets. However, it is only in recent times that a series of concerted formal studies have been undertaken in this area. Behavioural finance combines the twin disciplines of psychology and economics to explain why and how people make seemingly irrational or illogical decisions when they spend, invest, save and borrow money. According to the theory of behavioural finance, the financial practitioners must acknowledge and understand behavioural finance, that is, the application of psychology to financial behaviour, in order to avoid many of the investment pitfalls caused by human errors.



In the present scenario, behavioural finance is becoming an integral part of the decision-making process, because it heavily influences investors performance. They can improve their performance by recognising the biases and errors of judgement to which all of us are prone. Understanding the behavioural finance will help the investors to select a better investment instrument and they can avoid repeating the expensive errors in future.

KEYWORDS: Behavioural Finance, Efficient Markets Hypothesis, Investor's Decision, Mental Accounting.

EMERGENCE OF BEHAVIOURAL FINANCE

In the early years, investment was based on performance, forecasting, market timing and so on. This produced very ordinary results, which meant that investors were showered with very ordinary futures, and little peace of mind. The field and study of finance has long been based around the idea of "efficient markets." This term may mean different things to

different people, but the Efficient Markets Hypothesis (EMH), which classical finance theory is built upon, states that at any given moment in time the price of any and all assets and securities being traded is correct and reflects all available information. The EMH also includes the law of one price, which means that there is only ever one price for an asset at any moment in time. The idea of correct prices is a neat and clean way of thinking, but the real question that begs answering is

whether or not the law of one price actually exists. First off, if truly efficient markets exist, how can there be "bubbles" in stock markets? Let alone the number and severity of bubbles that we have recently endured. In addition, how reasonable is it that all people are 100% rational decision makers as the EMH posits? Basic logic should throw this idea out the window as there should be absolutely no way that a casual investor, or even further yet a novice investor, will ever

trade and invest at the same level of rationality as a professional trader for an investment bank. Traditional theory argues that “smart money” investors, or those with the highest level of knowledge about financial markets, will counteract any noise caused by those that are trading “irrationally” through arbitrage, however over the past few decades there has been a mounting amount of evidence against the idea of complete arbitrage. Beginning in the 1980’s, finance theorists first began to consider the idea that the laws of investing were not quite as clean as they had originally theorized. And, as computers have become more powerful it has become possible to analyze the mountains of data to prove these thoughts true. From the collective messiness in breakdowns of traditional finance theory a new field within finance has sprung up. This new field has been named aptly named behavioral finance.

REVIEW OF LITERATURE

To fully understand behavioral finance as it is today, one must first learn how it came to be. Shiller (2003) helps readers take this first step as the author offers a great overview of the behavioral finance’s evolution through the decades. In the 1980’s, the consistency of the efficient markets model was starting to be challenged. One issue that troubled the efficient markets complete acceptance was the problem of excess volatility. Several theories were formed to describe the wide swings in stock prices, however it proved challenging to reconcile the idea that a stock price was the present value of all future dividends (as most finance theorists would argue) with the volatility observed in stock prices. This meant that finance was either completely wrong about what made up the value for a stock, or investors were not fully rational. Following this revelation, Shiller pushed the idea that markets might be efficient on the micro level, but wildly inefficient on the macro level. In summary, this means that individual stock movements make more sense than the movement of the entire market. In the 1990’s, the amount of evidence contrary to efficient markets had become so much that behavioral finance started to gain traction as a legitimate field. Shiller then goes on to list several concepts that behavioral finance attempts to explain. The first of which are feedback models. Feedback models attempt to show that when investors trade they actually often trade based off of other investors rather than off new information. This can lead to inefficiencies and bubbles that traditional theory cannot explain. Another of Shiller’s main concepts is the differentiation of smart money and ordinary investors. In the Efficient Markets Hypothesis (EMH), it is assumed that smart money can fully offset any noise caused by sub-optimal decision making, however according to Shiller this is not the case in application. In Behavioral Finance the conclusion of his piece, Shiller stresses that the field at the time of his writing (2003) was far from fully researched, but that there is more than enough evidence to validate its existence and justify future research. Complementing to Shiller’s piece Heukelom (2014) provides a comprehensive account of how behavioral economics and finance were founded on the personal level. Behavioral economics (which by many definitions includes behavioral finance) began largely as the result of prospect theory as developed by Daniel Kahneman and Amos Tversky. Interestingly, Kahneman and Tversky were both psychologists with no or little training in classical finance. Prospect Theory proved useful to economics however, because it attempts to model the way people actually make decisions as opposed to simply relying on the utility decision-making strategies that made up finance theory. As Heukelom goes on to write, prospect theory argues that people make decisions based on the potential value of gains and losses rather than the utility of the decision. Richard Thaler, who was already a finance theorist at the time added the economic and finance theory necessary to apply prospect theory to financial markets. All three of these men, Amos Tversky, Daniel Kahneman, and Richard Thaler, are today considered to be among the founding fathers of behavioral finance.

Behavioural Finance merges the concepts of finance, economics and psychology to understand the human behaviour in the financial markets and to form winning investment strategies. Behavioural finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets. Behavioural Finance is the study of how these mental errors and emotions can cause stocks or currency to be overvalued or undervalued, and to create investment strategies that gives a winning edge over the others investors. Behavioural Finance focuses on identifying mental mistakes regularly made by investors. These strategies do more than just examine

the fundamentals of companies or the feelings of investors. They incorporate how the brain solves problems and, in certain instances, might be most prone to making a mistake.

In the present scenario, behavioural finance is becoming an integral part of the decision-making process, because it heavily influences investor's performance. They can improve their performance by recognising the biases and errors of judgement to which all of us are prone. Understanding the behavioural finance will help the investors to select a better investment instrument and they can avoid repeating the expensive errors in future.

OBJECTIVES OF THE STUDY

The following are the objectives of the paper

1. To present the emergence of Behavioural Finance in India and
2. To minimise or eliminate the psychological biases in investment decision process with the help of Behavioural Finance

SOURCES OF DATA

The sources of data for the study includes several relevant research papers published in books and journals, several web sites (list given in references) information. This paper is the outcome of a rigorous analysis of the literature surveyed.

Behavioural Finance Principles and Its Implications:

Under the traditional financial theory, the decisions makers are rational. In contrast, modern theory suggests that Investors financial decision-making are not driven by due considerations. The decisions are taken by them are also often inconsistent. Put in another way, human decisions are subject to several cognitive illusions. These are grouped into two

- I. Heuristic Decision Process, and
- II. Prospect theory

I. Heuristic Decision Process:

It refers to rules of thumb which humans use to made decisions in complex, uncertain environments. The reality, the investors decision making process are not strictly rational one. Thought the investors have collected the relevant information and objectively evaluated, in which the mental and emotional factors are involved. It is very difficult to separate. Sometimes it may be good, but many times it may result in poorer decision outcomes. It includes representatives, overconfidence, anchoring, gamblers fallacy and availability bias.

- 1. Representatives:** It is a tool that the brain uses to classify things rapidly. While representatives help the brain organise and quickly process large amounts of data, it is a shortcut that can cause investors to overreact to old information. For example, say a company A is a small family managed business. Based on this information investors would typically classify A as slow to respond to change, unprofessional, un-transparent etc. while the reality might be just the opposite. Representatives can cause investors to make errors in financial markets. If a company has repeatedly delivered poor results, investors will sometimes become disillusioned with it. In their minds, the company has the traits of a lousy company and, like most lousy companies; it will continue to deliver poor results in the future. Investors in these instances overreact to the past, negative information and ignore valid signs of improvement. Although it may be poised to deliver good results, the company is overlooked and its stock undervalued. This is not to say investors won't ever change their view. If the company continues its improvement over time, investors will eventually overcome their representatives error. And the company will start to look like a potentially attractive investment. This is one of the mental shortcuts that make it hard for investors to correctly analyse new information. It helps the brain organise and quickly process

large stock of data, but can cause investors to overreact to old information. For example, if a company is repeatedly giving losses, investors will become disillusioned with this past data, and thus may overreact to past information by ignoring valid signs of recovery. Thus, the stock of the company is undervalued because of this bias.

2. **Overconfidence:** There are several dimensions to confidence. It can give more courage, and is often viewed as a key to success. Although confidence is often encouraged and celebrated, it is not the only factor to success. The investors who are cautious and analytical can achieve success and others have to withdraw. Yet, confidence, especially self-confidence, is often viewed as a positive trait. Sometimes, the investors overestimate their predictive skills or assuming more knowledge than they have. Many times it leads excessive trading.
3. **Anchoring:** It describes the common human tendency to rely too heavily, or anchor on one trait or piece of information when making decisions. When presented with new information, the investors tend to be slow to change or the value scale is fixed or anchored by recent observations. They are expecting trend of earning is to remain with historical trend, which may lead to possible under reactions to trend changes. Mental mistakes can also cause investors to under react to new, positive information about a company. One shortcut that causes this is anchoring - a tool the brain uses to solve complex problems by selecting an initial reference point and slowly adjusting to the correct answer as it receives additional information. Bargaining is a good example of how anchoring works. A well-trained car salesman negotiates with potential customers by starting at a high price and slowly reducing the price over time. His goal is to anchor the customer to the high price (regardless of the actual value of the car) and let the customer feel he negotiated a good deal by getting a lower price. Anchoring also can cause securities to be mispriced. For example, should a company suddenly report substantially higher earnings, the market will on occasion under react to this change. Although the company is making more money, its stock price does not rise because investors assume that the change in earnings is only temporary. They remain anchored to their previous view of the company's 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. Similar to representatives, as investors get better information about the company over time, they will eventually overcome mental mistakes caused by anchoring. They will realise that the company is likely to continue to be more profitable in the future and that its stock is probably an attractive potential investment.
4. **Gamblers fallacy:** It arises when the investors inappropriately predict that trend will reverse. It may result in anticipation of good or poor end.
5. **Availability bias:** The investors place undue weight for making decisions on the most available information. This happens quite commonly. It leads less return and sometimes poor results also. Not everybody has same degree of information. Some people prefer to see business news but others may like to see the serials on other channel. Obviously the first one may have more information, as compared to second.

II. Prospect Theory:

The second groups of illusions which may impact the decision process are grouped in prospect theory. This theory is developed by Kahneman and Tversky. They discussed several states of mind which may influence an investor's decision making process. Prospect theory suggests that people respond differently to equivalent situations depending on whether it is presented in the context of a loss or a gain. Typically, the investors become considerably more distressed at the prospect of losses than they are made happy by equivalent gains. Prospect theory consists the key concepts such as Loss aversion, Regret aversion, Over and under reaction, Mental Accounting, Self-control.

1. **Loss aversion:** Loss aversion is an important psychological concept which receives increasing attention in economic analysis. The investor is a risk seeker when faced with the prospect of losses, but is risk-averse when faced with the prospects of enjoying gains. This phenomenon is called loss aversion.

2. **Regret Aversion:** It arises from the investors desire to avoid pain of regret arising from a poor investment decision. This aversion encourages investors to hold poorly performing shares as avoiding their sale also avoids the recognition of the associated loss and bad investment decision. Regret aversion creates a tax inefficient investment strategy because investors can reduce their taxable income by realising capital losses. Regret theory is about peoples emotional reaction to having made an error of judgement, whether buying a stock that has gone down or not buying one they considered and which has subsequently gone up. 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 rationalised as everyone else owned it. Going against conventional wisdom is harder since it raises the possibility of feeling regret if decisions prove incorrect.
3. **Over-and Under-reaction:** The consequence of investors putting too much weight on recent news at the expense of other data is 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 had news and rise too much on good news. And in certain circumstances, this can lead to extreme events. Behavioural Finance seeks to identify market conditions in which investors are likely to overreact or indirect to new information. These mistakes can cause misplaced securities. And the goal of Behavioural Finance strategies is to invest in these securities before most investors recognise their error - and to benefit from the subsequent jump in price once they do.
Of course it is more likely that some combination of the above is behind a investor reaction for example stock market crashes may be explained using prospect theory and investor over-reaction. The attractive feature of Behavioural Finance investment strategies is that they have an advantage over most traditional approaches to investing. Most investors use information-based strategies. They try to generate good returns by acquiring better information about companies or by processing information better than their peers through a unique, quantitative strategy. But gaining advantages through these methods is becoming increasingly difficult. A combination of the Internet and the increasing power of microprocessors are making information more readily available and easier to process for all investors. Behavioural Finance strategies, however, take advantage of human behaviour and human behaviour changes very slowly. The brain has evolved over centuries, its approach to solving complex problems, and the tools it uses to solve them, are unlikely to change in the near future.
4. **Mental Accounting:** Mental accounting is the set of cognitive operations used by the investors to organise, evaluate and keep track of investment activities. Three components of mental accounting receive the most attention. This first captures how outcomes are perceived and experienced, and how decisions are made and subsequently evaluated. A second component of mental accounting involves the assignment of activities to specific accounts. Both the sources and uses of funds are labeled in real as well as in mental accounting systems. The third component of mental accounting concerns the frequency with which accounts are evaluated and choice bracketing. Accounts can be balanced daily, weekly, yearly, and so on, and can be defined narrowly or broadly. Each of the components of mental accounting violates the economic principle of fungibility. As a result, mental accounting influences choice, that is, it matters.
5. **Self Control:** It requires for all the investors to avoid the losses and protect the Investments. As noted by Thaler and Shefrin investors are subject to temptation and they look for tools to improve self control. By mentally separating their financial resources into capital and available for expenditure pools, investors can control their urge to over consume.

CONCLUSION

Behavioural finance is relevant in many ways. It educates investors about how to avoid biases, designing long and short term strategies to exploit biases. It is believed that perfect application of Behavioural finance can make an Indian investor successful, making fewer mistakes. Even if we learn to identify some common psychological and cognitive errors that plague even the wisest investment professional, it may be enough.

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