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BEHAVIOURAL FINANCE: A KEY TO SUSTAIN THE INVESTMENT

Dr. G. B. SABARI RAJAN
ASSOCIATE PROFESSOR
GRG SCHOOL OF MANAGEMENT STUDIES
COIMBATORE

ABSTRACT

The traditional structure of finance stresses the theories of modern portfolio theory and the efficient market hypothesis, the evolving field of behavioural finance investigates the psychological and sociological issues that impact the decision-making process. This paper will discuss some general principles of behavioural finance including omission bias, the utility of money, availability heuristic, framing, probability weighting. In conclusion, the paper will provide strategies to assist individuals to resolve these mental mistakes and errors by recommending some important investment strategies.

KEYWORDS

availability heuristic, behavioural finance, framing, market hypothesis, omission bias, portfolio theory, utility of money.

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1. INTRODUCTION

Mid of 1990s, a new field known as behavioural finance began to emerge in many academic journals, business publications, and even local newspapers. The foundations of behavioral finance, however, can be traced back over 150 years. Several original books written in the 1800s and early 1900s marked the beginning of the behavioral finance school. Originally published in 1841, MacKay's Extraordinary Popular Delusions and The Madness of Crowds presents a chronological timeline of the various panics and schemes throughout history. This work shows how group behaviour applies to the financial markets of today. Le Bon's important work, The Crowd: A Study of the Popular Mind, discusses the role of "crowds" and group behavior as they apply to the fields of behavioral finance, social psychology, sociology, and history. Selden's 1912 book Psychology of the Stock Market was one of the first to apply the field of psychology directly to the stock market. This classic discusses the emotional and psychological forces at work on investors and traders in the financial markets. These three works along with several others form the foundation of applying psychology and sociology to the field of finance. Today, there is an abundant supply of literature including the phrases "psychology of investing" and "psychology of finance" so it is evident that the search continues to find the proper balance of traditional finance, behavioral finance, behavioral economics, psychology, and sociology.

The uniqueness of behavioral finance is its integration and foundation of many different schools of thought and fields. Scholars, theorists, and practitioners of behavioral finance have backgrounds from a wide range of disciplines. The foundation of behavioural finance is an area based on an interdisciplinary approach including scholars from the social sciences and business schools. From the liberal arts perspective, this includes the fields of psychology, sociology, anthropology, economics, and behavioral economics. On the business administration side, this covers areas such as management, marketing, finance, technology, and accounting.

This paper will provide a general overview of the area of behavioral finance along with some major themes and concepts. In addition, this paper will make a preliminary attempt to assist individuals to answer the following two questions:

How can investors take into account the biases inherent in the rules of thumb they often find themselves using?

How can investors "know themselves better" so they can develop better rules of thumb?

In effect, the main purpose of these two questions is to provide a starting point to assist investors to develop their own trading strategy and investment philosophy by using the concepts of behavioural finance.

2. OBJECTIVES OF THE STUDY

1. To study the Behavioral Finance concepts
2. To understand the principles to influence the investment decision.

3. RESEARCH METHODOLOGY

Nature of Study: Descriptive study

The secondary source of data been collected through books and journals. The same information is taken as a base for conceptualizing the paper.

4. DISCUSSION

4.1 TRADITIONAL FINANCE

The present accepted theories in academic finance are referred to as standard or traditional finance. The foundation of standard finance is associated with the modern portfolio theory and the efficient market hypothesis. In 1952, Harry Markowitz developed modern portfolio theory. Modern Portfolio Theory (MPT) is a stock or portfolio's expected return, standard deviation, and its correlation with the other stocks or mutual funds held within the portfolio.

With these three concepts, an efficient portfolio can be created for any group of stocks or bonds. An efficient portfolio is a group of stocks that have the highest expected return given the amount of risk assumed, or, on the contrary, contains the lowest possible risk for a given expected return. Another main theme in standard finance is known as the Efficient Market Hypothesis (EMH). The efficient market hypothesis states the premise that all information has already been reflected in a security's price or market value, and that the current price the stock or bond is trading for today is its fair value. Since stocks are considered to be at their fair value, proponents argue that active traders or portfolio managers cannot produce superior returns over time that beat the market. Therefore, they believe investors should just own the "entire market" rather attempting to "outperform the market." This evidence is supported by the fact that the S&P 500 stock index beats the overall market approximately 60% to 80% of the time. Even with the pre-eminence and success of these theories, behavioral finance has begun to emerge as an alternative to the theories of standard finance.

4.2 OMISSION BIAS

The omission bias is an assumed type of Cognitive bias. It is the tendency to judge harmful actions as worse, or less moral than equally harmful omissions because actions are more obvious than inactions. It is contentious as to whether this represents a systematic error in thinking or is supported by a substantive Moral theory. For a consequentialist judging harmful actions as worse than inaction would indeed be inconsistent, but deontological ethics may, and normally does, draw a moral distinction between doing and allowing. The bias is usually showcased through the Trolley problem.

4.3 UTILITY OF MONEY

Utility of Money assumes that the investors are rational, and that they make decisions in ways that increase their expected utility from money made or lost. We will specify various axioms, and show under what circumstances we frequently and reliably violate those very assumptions. Utility of Money will make us to

comprehend, what economists mean when they talk about risk aversion, indifference curves, budget constraints, and how we utilize both to optimize our consumption, some rational utility axioms, and under what circumstances these axioms fail to describe the way most people behave.

4.5 AVAILABILITY HEURISTIC

The availability heuristic, also sometimes referred to as availability bias, is a cognitive bias that can cause people to incorrectly assess the likelihood of events. In particular, when we are asked to estimate the likelihood of a particular event, we will often rely on our memory. This makes sense. If it's easier for us to recall an instance of an event in the recent past, then it's probably more likely to occur than events for which we have no recollection. However, the extent to which we can remember an example of an event upward biases our estimates on likelihood events.

4.5 FRAMING

Bias due to framing may be the single most significant factor in behavioural finance. A decision "frame" is the decision-maker's view of the outcomes and risks associated with particular choice. Decision frames are largely controlled by the formulation of the problem. It has been shown extensively, in hundreds of studies with thousands of participants, that the way decision is "framed" can cause respondents to switch their selection between options. Often, small changes in vocabulary, without altering any options available, can cause a decision maker to change his / her selection among choices, and in predictable ways.

4.6 PROBABILITY WEIGHTING

Probability weighting predicts how we tent to distort event probabilities. In particular, we tend to over-weight low probabilities, and underweight high ones. We will categorize the circumstances in which each of these biases is most prominent; as well as understanding how our brains interpret changes in probability, and how sensitive we are to some probability changes but not others. In many ways in which probabilities are reported inaccurately in the reporting. These errors creep in partly because of ambiguities in the way of representing relative probabilities versus absolute probabilities. The representation is always looking for the most eye-catching way in which to report probabilities.

5. CONCLUSION

From the beginning of time, the traditional system of finance has been the dominant theory within the academic community. However, academicians and professionals have started to investigate an alternative theory of finance known as behavioral finance. It makes an attempt to explain and progress people's awareness regarding the emotional factors and psychological processes of individuals and entities that invest in financial markets and products. Behavioral finance scholars and investment professionals are developing an appreciation for the interdisciplinary research that is the underlying foundation of this evolving discipline.

This concept work has made an attempt in omission bias, the utility of money, availability heuristic, framing, probability weighting. These five topics are the introductory representation of many different themes that have started to occur during the decade.

The validity of all of these topics will be tested over time as the behavioral finance scholars eventually research and implement concepts, or as other practices start to vogue or are rejected.

In closing, we believe that the real debate between the two system of finance should address which behavioural finance themes are relevant enough today to be taught in the classroom and published in new editions of finance textbooks. A prospect theory deserves mention by finance academics and practitioners, to offer students, faculty, and investment professionals an alternative viewpoint of finance.

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