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BEHAVIOURAL FINANCE: A CHALLENGE TO MARKET EFFICIENCY**MULLA PARVEEN YUSUF****ASST. PROFESSOR****V.P.I.M.S.R****SANGLI****ABSTRACT**

Today, almost seven years after the global financial crisis of 2008, individual investors continue to vary in the face of geo-political uncertainty, rising global unemployment and the threat of market manipulation by high frequency traders. Predicting short term performance and returns is more difficult today than it was ever before. In developing country like India investors view towards stock market plays a vital role. Financial news acts like noise, clouding investor judgment, while investment pundits around every corner claim to know the next hot trend or home run stock pick like weather forecasters, economic forecasters must deal with a system that is extraordinarily complex, that is subject to random shocks, and about which our data and understanding will always be imperfect. Behavioral Finance is the study of how people make economic decisions. By understanding how people react, investors may be able to modify their behaviors to achieve more rational and profit maximizing outcomes. The main issue of studying behavioral finance is how to minimize or eliminate the psychological biases in investment decisions of the investors importance of making sound, rational investment decisions, while minimizing costs, taxes, and losses due to adverse decision making.

KEYWORDS

behavioural finance, market efficiency, investors, irrational behavior, bias.

1. INTRODUCTION

There are three sub fields to modern financial research.

1. **Theoretical finance** is the study of logical relationships among assets.
2. **Empirical finance** deals with the study of data in order to infer relationships.
3. **Behavioral finance** integrates psychology into the investment process.

Personal finance is the use of financial management principles with respect to individual or family or a unit which finances to manage money, budget, save and spend while taking into account various future risks and life events. We all want to increase our wealth and increase our well-being. We understand that we shouldn't spend money we don't have. But emotion and psychology influence our financial behaviors in unpredictable and irrational ways.

The **traditional financial theory** is based on Modern Portfolio Theory (Markowitz, 1952) and Capital Asset Pricing Model (Sharpe, 1964). The theory is based on the notion that investors act rationally and consider all available information in the decision making process, and hence investment markets are efficient, reflecting all available information in security prices. Behavioral finance, also referred to as behavioral economics, combines economics and psychology to analyze how and why investors make their financial decisions.

The field of behavioral finance, which has much in common with the field of cognitive psychology, offers a theoretical explanation for the sometimes irrational or emotional choices and actions of investors. Despite the supposition of neoclassical economics that the market is efficient and that investors are rational, investing behavior and market behavior can be widely irrational and inconsistent. Human being as an average investor has the tendency to sell its investment 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. Behavioural Finance seeks to understand this behavior, and considers rationality of people making financial investment decisions. Understanding Behavioural Finance will help to avoid emotion-driven speculation leading to losses, and thus devise an appropriate wealth management strategy. Behavioural Finance covers "individual and group emotion, and behaviour in markets. The field brings together specialists in personality, social, cognitive and clinical psychology; organizational behaviour; accounting; marketing; sociology; anthropology; behavioural economics; finance and the multidisciplinary study of judgment and decision making". (Source: Journal of Behavioral Finance)

2. THE HISTORY OF BEHAVIORAL FINANCE

The academic field of behavioral finance began in 1979 when psychologists Daniel Kahneman and Amos Tversky introduced prospect theory. Prospect theory introduced a rubric for understanding how the framing of risk influences economic decision-making. Amos Tversky and Daniel Kahneman developed the field of behavioral finance through their work on the psychology of risk. Their work and behavioral economics in general, challenges the basic assumptions of rationality inherent in the classical economic model of decision-making. Tversky and Kahneman studied three main areas: Risk attitudes, mental accounting, and overconfidence (Litner, 1998). Richard Thaler, in the 1980s, extended the scope of behavioral finance by making stronger connections between psychological and economics principles (Lambert, 2006). The field of behavioral finance has grown over the last three decades in large part as a result of the support that the field received from universities and research institutions.

3. DEFINITIONS OF BEHAVIORAL FINANCE

Belsky and Gilowich (1999) have referred to behavioral finance as a behavioral economics and further defined as combining the twin discipline of psychology and economics to explain why and how people make seemingly irrational or illogical decisions, why they save, invest, spend and borrow money.

Verma (2004) has defined behavioral finance tries to understand how people forget fundamentals and make investment based on emotions.

Swell (2005) asserts that behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets. Further in 2007, he has stated that behavioral finance challenges the theory of market efficiency by providing insights into why and how market can be inefficient due to irrationality in human behavior.

Behavioural finance argues that emotions and sentiment play a crucial role in determining the behaviour of investors in the market place and very often they act irrationally due to influence of psychological factor. Behavioral finance seeks to explain the rationality or irrationality of financial decision-making. It seeks to combine behavioral and cognitive psychology theory with finance to provide explanations for why people make irrational decisions.

Recent research has proved that the average investor makes decisions on emotion rather than on the basis of logic. Most investors buy high on speculation and sell low in panic mode.

4. THE BEHAVIORAL CRITIQUE

There are two categories of irrationalities:

1. Investors do not always process information correctly.
Result: Incorrect probability distributions of future returns.
2. Even when given a probability distribution of returns, investors may make inconsistent or suboptimal decisions.

Result: They have behavioral biases.

TABLE 1: TRADITIONAL FINANCE AND BEHAVIOURAL FINANCE

Traditional Finance	Behavioural Finance
Rational & Correct	Heuristic (Rule of Thumb)
Price reflects intrinsic value	Frame dependence social influence causes Mispricing
Risk & Return – prime factors for investors Decision	Risk & Return – frames Specific
Rational, Logical, Transparent & Objective	Herd instinct, Emotional and Sentimental

5. OBJECTIVES

- How investors make decision to buy and sell securities
- How they choose between alternatives
- Why is the stock markets so volatile
- Why are under and overvalued stocks difficult to identify?

6. BEHAVIOURAL FINANCE IN TWO PERSPECTIVE

❖ INVESTORS

- Are not totally rational
- Often act based on imperfect information
- Make “non-rational” decisions in predictable ways
- A suboptimal result in an investment decision can stem from one of two issues:
 1. You made a good decision, but an unlikely negative event occurred
 2. You simply made a bad decision (i.e., cognitive error)

❖ MARKETS

- May be difficult to beat in the long term
- In the short term, there are anomalies and excesses

There is no way to predict the price of stocks and bonds over the next few days or weeks. But it is quite possible to foresee the broad course of these prices over longer periods, such as the next three to five years

❖ Arguments in favor of Behavioral Finance

- More Realistic
- Psychological Foundation
- Increases Explanatory Power of Financial Models
- Solves Empirical Puzzles of Traditional Finance
- New approach to Traditional Finance

7. BEHAVIORAL FINANCE THEORY

People in traditional finance are rational. People in behavioral finance are normal. If you don't know who you are, the stock market is an expensive place to find out [Psychology Economics Adam Smith Scottish moral philosopher and a pioneer of political economy Meir Statman Professor of Finance (Leavey School of Business, Santa Clara University)]

FIG. 1: BEHAVIOURAL FINANCE THEORY

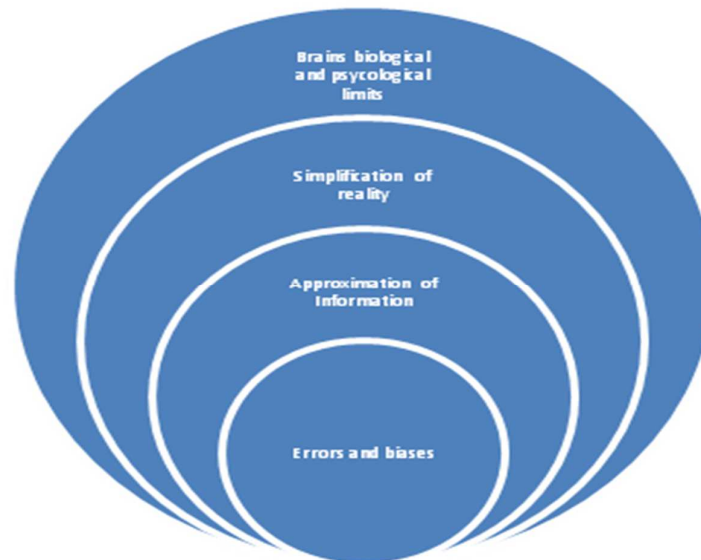
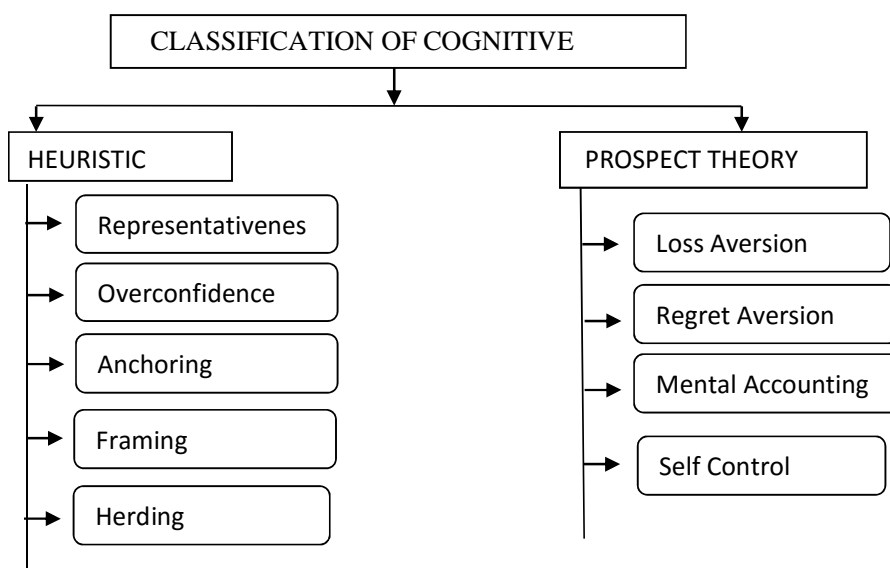


FIG. 2



- Representativeness -Heuristics Representativeness is a cognitive heuristic in which decisions are made based on how a given individual case appears to be independent of other information about its actual likelihood. In particular, many investors believe a well-run company represents a good investment. "If it is yellow in colour and shines, it probably is a gold" People tend to infer that a single observation is representative of the entire population. Normally people infer from small sample size and neglects learning for instance they take decision with 10 tosses to 1000 tosses.
- Overconfidence: Alpert and Raiffa (1982) showed that people are poorly calibrated in estimating probabilities and usually overestimate their precision of the knowledge and ability to do well. People are also overconfidence about good things happening in future than bad. In addition, people overestimate their confidence to the past positive outcomes and usually recall only their successes than their failures
- Anchoring - Reflects the use of irrelevant information as a reference for evaluating or estimating some unknown value or information. When anchoring, people base decisions or estimates on events or values that are known to them, even though these facts may have no bearing on the actual event or values. Judgment is based on similarity or patterns in random sequences. In the context of investing, investors will tend to hang on to losing investments by waiting for the investment to "break even" with the price at which it was purchased. Thus, these investors anchor the value of their investment to the value it once had, even though it has no relevance to its current valuation.
- Framing -The concept of framing involves attempts to overlay a situation with an implied sense of gain or loss. For eg.It is easier to pay 3,400 for something that you expected to cost 3,300 than it is to pay 100 for something you expected to be free."Economic impact is 100 for both cases" A loss seems less painful when it is an increment to a larger loss than when it is considered alone.-Daniel Kahneman
- Herding- Herding refers to the lemming-like behavior of investors and analysts looking around, seeing what each other is doing, and heading in that direction. Herding reflects the feeling of safety and well being by behaving in harmony with the group. There may not be a safety but a comfort like I lost money but at least I had company. It deals with Socionomics i.e. People are influenced by each other. Rationalize mood-induced moves of investors. 'Wise' crowds become foolish – especially as become more uniform.
- Prospect theory - Research (by Kahneman and Tversky) shows that while risk aversion may accurately describe investor behavior with gains, investors often show risk seeking behavior when they face a loss. "I can't quit now, I am too far down" Money managers may take bigger chances when things have not gone their way in an attempt to recover the losses. Proposed by two psychologists: Daniel Kahneman (won Nobel for Economics 2002) and Amos Tversky
- Loss Aversion - Investors do not like losses and often engage in mental gymnastics to reduce their psychological impact. Loss aversion reflects the tendency for people to weigh losses significantly more heavily than gains. Loss aversion can be observed in our tendency, when faced with a choice between a sure loss and an uncertain gamble, to gamble unless the odds are strongly against us Their tendency to sell a winning stock rather than a losing stock is called the disposition effect in some of the behavioral finance literature
- Regret Aversion - Investors do not like to make mistakes. People tend to feel sorrow and grief after having made an error in judgment. "makes people slow to act (unable to decide) One theory is that investors avoid selling stocks that have gone down in order to avoid the pain and regret of having made a bad investment
- Mental Accounting -Mental accounting refers to our tendency to "put things in boxes" and track them individually. For example, investors tend to differentiate between dividend and capital (gain) , and between realized and unrealized gains. Investment Example: the practice of buying dividend- paying stocks so that one can avoid "dipping into capital"- selling stock- to pay for life's necessities.
- Self control - Refers to people's belief that they have influence over the outcome of uncontrollable events Example: we like to pretend that we can influence the resulting dice roll by varying the force with which we throw a dice. (Hard – High, Gentle-Low) Similarly, investors like to look at charts, although charts are theoretically not helpful in predicting the future prospects for a stock.criticisms • Although behavioral finance has been gaining support in recent years, it is not without its

8. CONCLUSION

As one can observe from the differences between conventional and behavioural economics, their impacts reach onto diverse fields. While some aspects address the area of economic decision-making or market efficiency, others are connected to such exotic field like human happiness. Extending this realization, it is interesting to know how the assumptions made by behavioural economists are applied in practice. Findings from behavioural finance can be used in relation to retirement savings schemes within firms. For example, data suggests that company retirement schemes where participants are automatically enrolled with the option to leave the programme have a much higher participation rate than those schemes that participants need to actively sign up for themselves. This is mainly due to the phenomenon that people tend to be "lazy" when dealing with some parts of their personal finances, even though it would be to their advantage to be more proactive. Behavioral factors can help investors to avoid mistakes. Avoiding mistakes is called defensive behavioral finance applications in investment decision making. Many of the findings in behavioral finance appear to contradict each other, and that all in all, behavioral finance itself appears to be a collection of anomalies that can be explained by market efficiency.

9. FUTURE SCOPE

The two areas "Behavioral Finance" and "Behavioral Accounting" are connected because both are concerned with financial information and the behavior of its stakeholders. This is important because the information, which financial market participants are using to make their decisions, is not coming from anywhere. Instead, accountants are preparing such information in the form of annual reports and other financial data. If accounting information is a requirement for making financial decisions, behavioral insights about how accountants prepare such information are needed. Behavioral accounting is concerned with the relationship between the accounting information system, and human behavior. It is high time that we move away from narrow approaches such as the 'economic man' and develop new frameworks in accounting and finance, which focus on people and their behavior. The world is becoming more complex and simple answers are not suitable anymore

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