INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT

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BEHAVIOURAL FINANCE: A NEW PERSPECTIVE FOR INVESTMENT IN FINANCIAL MARKET

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ABSTRACT

Despite the intentions of many market participants to behave rationally, the outcome of their decisions often falls short of what could be considered optimal. These mistakes are repeated which results in emotions and affect rational thinking. Behavioural finance is a new subject, which merges concepts from the field of financial economics and psychology to understand the human behaviour in financial markets. Lot of research work has been carried out in this field since one and half decades to build a model of human behaviour in relation to investment strategies. Behavioural finance studies how emotional biases that are individual or collective create anomalies in financial markets. This discipline will therefore not only help improve one's own decision making, but will also contribute to a comprehensive understanding of actual behaviour on the part of market participants. This paper reviews the significance of behavioural finance; explain Decision-making irrationalities according to behavioural finance and its impact on market performance.

KEYWORDS

Behavioural Finance, Heuristics, Mental Accounting. Prospect Theory, Traditional Finance.

INTRODUCTION

The term behavioural finance covers a new branch of capital market analysis born some years ago in USA. Here, the disciplines of economics and psychology meet. It is conceded by many investors in the past that psychology plays a key role in determining the behaviour of markets. But in the recent times a series of formal studies have been undertaken in this field of study. The earliest paper of Paul Slovic (1972) on individual' misperceptions about risk and Amos Tversky and Daniel Kahneman's paper on "Judgement under Uncertainty: Heuristics and Biases", (1974), and decision frames (1979) played a determining role. Tony Brabazon (2000), remarks that these studies were at variance with rational, self-interested decision maker posited by traditional finance and economic theory.

There are several definitions on behavioural finance, which agree with each other. Decision making related with behavioral finance, can be defined as the process of choosing a particular investment alternative from a number of alternatives. It is an activity that follows after proper evaluation of all the alternatives (Mathews, 2005).

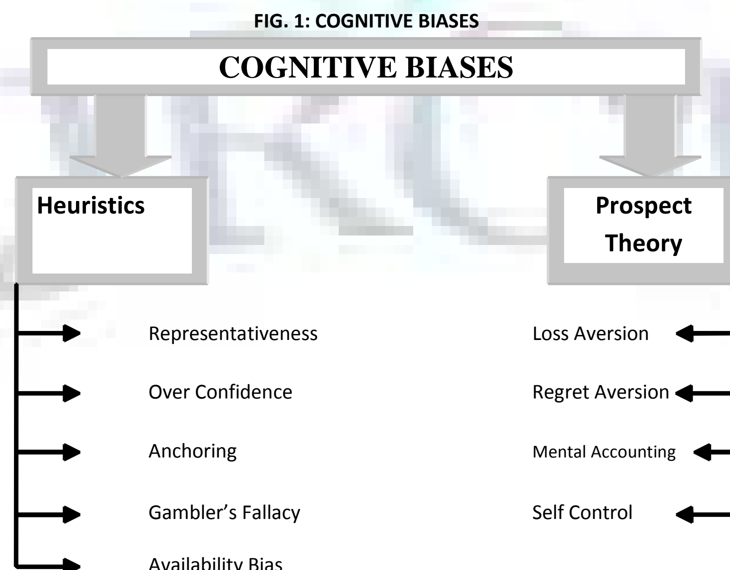
Lintner (1998) defines behavioural finance as "the study of how humans interpret and act on information to make informed investment decisions". Thaler (1993) defines behavioural finance as 'simply open-minded finance' claiming that 'sometimes in order to find the solutions to an (financial) empirical puzzle it is necessary to entertain the possibility that some of the agents in the economy behave less than fully rationally some of the time'.

Olsen (1998) asserts that 'behavioural finance does not try to define 'rational' behaviour or label decision making as biased or faulty; it seeks to understand and predict systematic financial market implications of psychological decision processes'. Behavioural finance in essence simply recognises that human beings, individually and collectively, behave as humans with their natural psychological qualities. The quintessence of behavioural finance studies is that behavioural tendencies of investors and their decisions making is likely to have a considerable impact on financial market behaviour.

WHETHER INVESTORS ARE RATIONAL?

The most important objective of an investment being making money and creating wealth, various strategies are adopted to meet this objective. For years, under traditional financial economics, we have learnt about asset pricing models, which heavily believe on the assumption that investors are *rational* and *utility maximising*. However, the evidence of the stock market performance and experiments by behavioural theorists over the past few years have proved that investors are less than rational and ordinary human beings. In addition, the studies made in the field of behavioural finance prove that there are several other factors that determine decisions of investors. Peter L. Bernstein in "Against the Gods" states that the evidences available from various studies reveals repeated patterns of irrationality, inconsistency, and incompetence in the ways human beings arrive at decisions and choices when faced with uncertainty. Cognitive psychologists have compiled the experimental evidences of investor psychology and call it as cognitive biases, which may be due to heuristics. These can be grouped into two classifications cognitive biases due to heuristic decision processes and biases caused by the adoption of mental frames, as noted in prospect theory (Figure 1).

FIG. 1: COGNITIVE BIASES



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HEURISTIC DECISION PROCESSES

Heuristics refer to rules of thumb which humans use to make decisions in complex, uncertain environments (Tony Brabazon 2000). The decision making process is not strictly a rational one where all relevant information is collected and objectively evaluated, rather the decision maker takes mental 'short cuts' in the process (Kahneman and Tversky 1974). There may be good practical reasons for adopting a heuristic decision process, particularly when time available for decision-making is limited. Various studies made under behavioral finance have concluded that, the heuristics decision processes may result in poorer decision outcomes. Typical examples of biases resulting from the use of heuristics include:

Representativeness
Overconfidence
Anchoring
Gambler's fallacy
Availability bias

REPRESENTATIVENESS: It refers to the tendency of decision makers to make decisions based on stereotypes that are to see patterns where perhaps none exist. An example of representativeness is called by Amos Tversky and Kahneman as the 'law of small numbers'. Smaller the sample, the result will be a chance rather than meaningful. Investors tend to assume that recent events will continue in the future also and seek to buy hot stocks and to avoid stocks, which have performed poorly in the recent past. This behaviour could provide an explanation for investor overreaction, an effect that was suggested by DeBondt and Thaler (1985). This characteristic of some investors in the selection of stocks is termed as a tendency to rely on stereotypes when making investment decisions.

OVERCONFIDENCE: It may be termed as unwarranted faith in one's intuitive reasoning, judgements, and cognitive abilities. The concept of overconfidence derives from a large body of cognitive psychological experiments and surveys in which investors overestimate both their own predictive skills and the accuracy of information they have with them. Odean and Brad Barber (2001) found that overconfident investors overestimate the probability that their personal assessment of a security's value is more accurate than the assessments offered by others. Overconfident investors trade excessively as a result of their belief that they possess special knowledge compared to others in the market. Overconfident investors underestimate their downside risks. Finally they end up in the poor performance of their portfolio.

ANCHORING: It is the tendency of the investors to fix or anchor to a default number on the basis of their own recent observations. This can lead investors to expect a share to continue to trade in a defined range or to expect a company's earnings to be in line with historical trends, leading to a possible under reaction to trend changes.

GAMBLER'S FALLACY: Arises when people inappropriately predict that a trend will reverse. For example, if a fair coin is tossed repeatedly and tails comes up a larger number of times than is expected, a gambler may incorrectly believe that this means that heads is more likely in future tosses (Colman, Andrew 2001). This fallacy of the investors may force them to take decisions which are contrary to their own expectations.

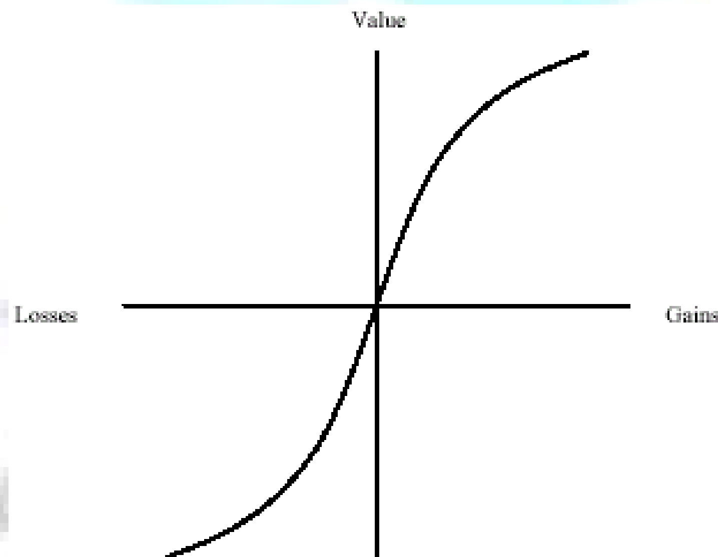
AVAILABILITY BIAS: It emerges when people place undue weight on available information in making a decision. Availability is used to estimate "frequency or probability by the ease with which instances or associations come to mind" (Tversky & Kahneman, 1973). Humans estimate the probability of an outcome based on how easy that outcome is to imagine by them. Availability bias causes investors to over-react to market conditions whether they are positive or negative.

Though the above examples of cognitive biases are widely observed, behavioural finance does not claim that all investors will suffer from the same illusion simultaneously. Investors are susceptible to such biases based on other variables such as their experience in the field of investment.

PROSPECT THEORY

The second set of biases that impact on investment decisions of investors are grouped under prospect Theory, which was developed by Kahneman and Tversky *(1979)*. In its original form, it is concerned with behaviour of decision makers who face a choice between two alternatives. The definition given by the authors is: "decision making under risk can be viewed as a choice between prospects or gambles." Decisions subject to risk are deemed to signify a choice between alternative actions, which are associated with particular probabilities (prospects) or gambles. The most central element of the prospect theory is the S-shaped value function depicted in Figure 2.

FIG. 2: PROSPECT THEORY



Source: Prospect Theory of Kahneman & Tversky

The shape of the function is concave in the region of gains and convex in the loss region, reflecting risk aversion in the domain of gains and risk seeking in the domain of losses. An interesting property of the value function is that it is steepest at the reference point. This implies that a given change in gains or losses has a smaller effect on the value experienced by an investor when the distance to the reference point is large.

This theory describes several states of mind that can be expected to influence an individual's decision-making processes. The key concepts under prospect theory include:

Loss aversion
Regret aversion
Mental accounting
Self control

LOSS AVERSION: People generally feel a stronger impulse to avoid losses than to acquire gains. According to Kahneman and Tversky, people weigh all potential gains and losses in relation to some benchmark reference point. The value function that passes through this point is asymmetric; and its profile implies, given the same variation in absolute value, a bigger impact of losses than of gains. The result is that risk-seeking behaviour prevails in the domain of losses, while risk-averse behaviour prevails in the domain of gains. This depicts the tendency of people to show greater sensitivity to losses than gains. Even when the amount of gain and loss are of the same size, the mental penalty associated with the loss is more than the mental reward associated with the gain. This phenomenon is termed as loss aversion.

REGRET AVERSION*:* This aversion is the desire of the people to avoid the feeling of the pain of regret due to their poor investment decisions or for losing a good investment opportunity. Regret averse people try to avoid two types of mistakes a) errors of commission (misguided actions) and b) errors of omission (opportunities foregone). An investor, who experiences a loss, regrets for his investment decision. An investor who missed an opportunity to invest in something, that later appreciated in value, regrets for his failure to invest and gain profits. The notion of regret aversion may encourage investors' herding behaviour and making them to invest in 'respected companies' as these investments carry implicit insurance against regret (Koening 1999).

MENTAL ACCOUNTING: Mental accounting describes people's tendency to code, categorise, and evaluate economic outcomes by grouping their assets into any number of non-interchangeable mental accounts. Individuals organises their world into separate mental accounts. Investors tend to treat each element of their investment portfolio separately. This can lead to inefficient decision-making. The main idea underlying mental accounting is that decision makers tend to separate the different types of gambles they face into separate acts, and then apply prospect theoretic decision rules to each account by ignoring possible interaction between the accounts.

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.

IMPLICATIONS OF BEHAVIOURAL FINANCE FOR FINANCIAL MARKETS

There are evidences generated by empirical researchers that the behavioural finance can be effectively applied to understand the patterns of behaviour adopted by the investors. Shefrin (2000) opines from his studies that 'heuristic driven and framing effects cause market prices to deviate from fundamental values'. Olsen (1998) suggests that behavioural finance offer an explanation for empirical evidence, which casts doubts on existing financial models.

Market behaviour of investors if tainted by the behavioural biases result in over or under reaction to price changes or news, frequent trading of stocks, lack of proper collection and analysis of information, build more focus on good and popular stocks. This may further give rise to anomalies in stock market. It is imperative to develop new models of investment theory incorporating concepts of behavioural finance.

CONCLUSION

Despite the argument against the propositions of behavioural finance, it provides solid theoretical and empirical foundations for the study of irregularities found in the financial markets. Behavioural patterns that have traditionally been ignored by proponents of rational decisions are made transparent with the aid of prospect theory.

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