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BEHAVIOURAL FINANCE: ITS BUILDING BLOCKS

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ABSTRACT

Behavioural finance encompasses research that drops the traditional assumptions of expected utility maximization with rational investors in efficient markets. The growth of behavioural finance research has been fuelled by the inability of the traditional framework to explain many empirical patterns, including stock market bubbles. Behavioural finance is built on three main building blocks .Hence an attempt has been made to understand the concept of 'behavioural finance 'by identifying its building blocks. The three building blocks of behavioural finance are sentiment, behavioural preference and the limits to arbitrage (when markets will be inefficient). The result shows that the behavioural finance has great utility and can be put to varied uses.

KEYWORDS

Arbitrageurs, Behavioural finance, Biases, Building blocks.

INTRODUCTION

Behavioural finance is a rapidly growing discipline that deals with the influence of psychology on investment decisions and its subsequent effect on the markets. Behavioural finance is a new paradigm which supplements the standard theories of finance, by introducing behavioural aspects to the decision making. It is a part of finance that seeks to understand and predict systematic financial markets. Behavioural finance is an emerging and prospective area that needs to be given due importance. Behavioural finance combines behavioural and cognitive psychological theory with conventional financial economics and academic finance. This discipline emerged due to certain flaws in traditional finance. In modern world people are interested to make profit by investing in different investment avenues. So decision making related to investments are more important and Behavioural finance plays a significant role in this regard as it has shifted the focus from efficient market to human decision making. According to Behavioural finance, investors are not rational, and markets are not efficient. However, investors can be considered to be 'normal', and they design portfolios according to the rules of Behavioural Portfolio Theory. Thus it explains why investors do not always take decisions in the expected lines, and why the market do not behave rationally as they are normally expected to behave. It also helps in devising appropriate investment strategies to avoid emotion driven speculation that could lead to losses. In this paper we attempts to throw light on the concept of Behavioural finance. It identifies the main building blocks of behavioural finance. It also attempts to know major applications of Behavioural finance.

OBJECTIVES OF THE STUDY

- To understand the concept 'behavioural finance'.
- To identify the building blocks in behavioural finance.
- To know about the applications of behavioural finance.

BEHAVIOURAL FINANCE

Behavioural finance studies how the emotion and psychology of the investor affects investment decisions. Linter defines "behavioural finance is the study of how much humans interpret and act on information to make informed investment decisions".
Weber observes that "behavioural finance closely combines individual behaviour and market phenomenon and uses the knowledge taken from both the psychological field and financial theory".
According to De-Bondt, Behavioural finance as "a theory which explores financial issues with the help of ideas borrowed from cognitive psychology."
Shelfies termed Behavioural finance as "a study of human fallibility in competitive markets."
Behavioural finance provides explanations to the questions

- Why do people make irrational financial decisions?
- Why investors behave the way they do?

Behavioural finance helps in devising appropriate investment strategies to avoid emotion driven speculation that could lead to losses.

DIVISIONS OF BEHAVIORAL FINANCE

According to Pompian (2006), Behavioural finance is divided into two:

- **Macro behavioural Finance:** Macro behavioural finance explains the investment behaviours, with particular reference to the general market anomalies on the effective market hypothesis.
- **Micro behavioural Finance:** Micro behavioural finance strives to explain the investment habits of individuals, particularly those who differentiate themselves from the rational investors.

BUILDING BLOCKS OF BEHAVIOURAL FINANCE

Behavioural finance is built on three main building blocks (De Bondt and et al., 2008).They are:

- Sentiment
- Behavioural preference
- Limits to Arbitrage

SENTIMENT

In stock market, sentiment can be equated with investor error which originate at the level of the individual investor. At the individual level there are number of rules of the thump which can lead to a number of biases. A few biases that work at the level of sentiments are as follows:

A. **REPRESENTATIVENESS**: This bias can be said to be the over reliance on stereotypes.
B. **ANCHORING**: In anchoring bias, investors put heavy reliance on one piece of investigation with the exclusion of others. This may not be adjusted subsequently.
C. **OVER CONFIDENCE**: This is the habit of the investor to over value their abilities or knowledge. Due to this the investors may under estimate risk or overestimate their capability to beat the market.
D. **AVAILABILITY BIAS**: When investors over weight easily accessible information, it is availability bias.

BEHAVIOURAL PREFERENCE

Investors have a number of behavioural preferences which work against accepted theories. Stock markets often move in response to many factors un related to the true value of the individual stocks. For instance, reporting of lesser than expected gross domestic product, or the presentation of a gloomy picture for the coming quarter by an official of the industry leader, results in substantial loss of value in the market. In reality, this reduction in market value would have nothing to do with the financers, profits or the individual corporate that would have lost ground. It all happens due to the working of certain investor moods associated with irrational fear. This mood creates pessimism about the future economic condition in the minds of investors, thereby making them to favour selling to buying.

LIMITS TO ARBITRAGE

Limits to Arbitrage is the third building block of behavioural finance which states that there is a limit on arbitrage. Arbitrage is defined as "the simultaneous purchase and sale of the same or essentially similar security, in two different markets at advantageously different prices" (Sharpe and Alexander, 1990). Arbitrageurs normally take opposite arbitrage positions when they discover an asset that is wrongly priced on a market. Thus a quick and effective arbitrage due to the availability of enough and adequate substitute securities will help to restore a quick equilibrium. Though theoretically, this may sound conclusive, empirical findings contradict this model.

Behavioural finance argues that deviations from the fundamental value created by actions of irrational traders will not be attractive investment opportunity for arbitrageurs who are rational. Even in a situation when an asset is widely mispriced, the arbitrage strategies that are designed to correct mispricing can be risky and costly and may be rendered unattractive. Due to this, there is a possibility that deviations from fundamental value may remain unchallenged for relative long periods. As the mispricing increases the gap between long and short positions gets wider which is contrary to the strategy of rational arbitrageurs. When this tendency continues over a period of time arbitrageurs may be forced to square off their positions even before the mispricing is corrected, thereby suffering losses.

APPLICATIONS OF BEHAVIOURAL FINANCE

Behavioural finance has great utility and can be put to varied uses. It helps in informing finance professionals about their investment habits making required recommendations that facilitate investment decisions and having proper communication with clients. It also enables investors to develop effective investment strategies and avoid common, mental mistakes and biases.

Behavioural finance offers to help in the following areas;

- Keeping track of instances of overconfidence.
- Resisting the natural urge of being over optimistic/overconfident
- Communicating realistic odds that aid in success to the client.
- Choosing appropriate framing for each client, and
- Assessing how far the client is risk averse.
- Acknowledging the complexity of psychological processes in social cognition and underlying financial behaviours
- Incorporating and blending behavioural data into theories of finance.

CONCLUSION

Future is uncertain. No one can be sure as to what will happen in the next moment, once a particular course of action is decided. Anybody acts under conditions of uncertainty. Any decision making process requires appropriate use of mental and financial resources to acquire and process information. In stock market, deviations takes place in every seconds. So it is very difficult to take decisions relating to investments. Behavioural finance helps the investors to take prompt decisions timely. Investors are normally oriented towards the past while making financial decisions. This orientation takes place by fixing certain reference points such as returns generated in past, and basing future returns. Behavioural finance helps the investors to reduce uncertainties and biases, in taking investment decisions.

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