IMPACT OF BEHAVIORAL FINANCE ON INVESTMENTS DECISIONS

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ABSTRACT

Traditional finance theories suggest that individuals make rational investment decisions after carefully considering risk and return factors to maximize their gains while limiting their losses. Behavioral finance challenges the traditional financial theory and suggests that multiple biases impact individual investment decisions. These include heuristic biases such as anchoring, representativeness, gamblers fallacy and more; and Loss aversion, Mental accounting as elaborated under prospect theory. The research paper aims to understand how these biases impact investment decision making process and what steps can be taken by individual investors to make rational decisions. Analyzing how practical considerations limit individual decision making, the paper concludes that individual investors need to carefully mine data and consider external factors before undertaking investments. Understanding the behavioral finance will help the investors to select a better investment instrument and they can avoid repeating mistakes in future.

Key words: Prospect theory, Heuristic biases, Behavioral Finance, Traditional Financial Theory , Investment, Decisions

Introduction

Behavioral finance is the field in finance that proposes psychology based theories to explain stock market anomalies. It is assumed that the information structure and characteristics of market participants systematically influence individual's investment decisions as well as market outcome. The investor is being influenced by information structure of market and features of market participants. Behavioral finance is a framework that augments some parts of standard finance and replaces other parts. It describes the behavior of investors and managers; it describes the outcomes of interactions between investors and managers in financial and capital markets; and it prescribes more effective behavior for investors and managers. Behavioral Finance, a study of investor market behavior that derives from psychological principles of decision making, to explain why people buy or sell the stocks they do. The linkage of behavioral cognitive psychology, which studies human decision making, and financial market economics. Behavioral Finance focuses upon how investors interpret and act on information to make informed investment decisions. Investors do not always behave in a rational, predictable and an unbiased manner indicated by the quantitative models. Behavioral finance places an emphasis upon investor behavior leading to various market anomalies. ‘This area of enquiry is sometimes referred to as "behavioral finance," but we call it "behavioral economics." Behavioral economics 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.’ Belsky and Gilovich.

Earlier studies was done on as the investor was rational and do always prefer on classical theory of economies .The traditional approach to corporate finance embodied by the practice of value based management is based on rational behavior , capital asset pricing model (CAPM) and Efficient model hypothesis models(EMH). The behavioral finance prevents investor from acting as rational as traditional approach. In behavioral finance concept the investor rationality is determined by several demographic economics and cognitive factors. One of the examples could be market sentiments. Market sentiment is a major force driving the momentum in stock prices in securities. Similar anomalies could be heuristics, opportunism, overconfidence etc. For a growing economy it is very important to understand the individual investor behavior which could be of great help for policy makers, researchers, investment agents as well as managers to prepare themselves for the mood of investors.

The field of behavioral finance and investor behavior attempts to understand and explain investor’s decisions by combining the topic of psychology and investing on micro and macro level prospective. The decision making process of investors incorporates both quantitative and qualitative aspect that is based on the specific features of investment. Evidence of market anomalies show that many traditional paradigm assumptions were invalid. Thus behavioral finance researcher turned to be observed behaviors to develop models that describe how investors actually reach their decisions. The behavior finance topics are behavioral finance decisions theory, heuristics , overconfidence , herding and cognitive account etc. The emerging areas of research are behavioral portfolio theory, behavioral asset pricing model and adaptive market hypothesis. Investor behavior examines the cognitive factors and emotional issues that individual financial experts and traders reveal during financial planning and investment management process. In practice individual make judgments and decisions that are based on past events, personal belief and preferences.

Investing in financial markets in recent decades has become popular not only among institutional investors but also individual investors. As with the bubble of information technology the information has become available worldwide in seconds speed. Undoubtly, investment decisions depends upon the object and its financial status in the future, but often short term price changes are driven by market participants that are not always based on logic, sometimes as inspired by mood or instantly received news. Behavioral finance describes about two important aspects, micro and macro behavioral finance. Micro behavioral finance analysis behavior and deviations of individual investors and this separates them from strictly rational person, acting according to stern mathematical –static model. Whereas micro behavioral finance discloses and describes anomalies of efficient market hypothesis that could be explained by models of people behavior. But in recent times the internet stock bubble of the late 1990s and financial crises of 2007 and 2008 demonstrate the importance of understanding the behavioral finance. Though foundation of behavior finance can be traced back throughout financial history. Behavioral finance is the offshoot of behavioral economies.

The traditional investment was based on classical paradigms which are as

- Portfolio is based on the expected return and risk.
- Is subject to risk based capital asset pricing model and pricing of contingent claims.
- Modigliani-miller theorem.
- Efficient model hypothesis.
- Rational investor.

However, the traditional paradigm of finance avoids the anomalies of present investor and prediction like

- Why does an investor trades
- How does an investor trade.

- How does an investor composes portfolio.
- Why do stock return very due to risk.
- Why investor make one or another decision.

The principles of Behavioral finance and its implications are as,

Heuristics: Rule of thumb, Avoiding probabilities, Representiveness, Bias, Anchoring , overconfidence, Gamblers Fallacy.

Prospect: Subjective decision making, state of mind, Loss aversion, Mental accounting.

Market: past trends, News reaction, popular Stocks, Experience.

Herding: Following others actions, Gossip, Cognitive Conflict, Emotional Bias.

Researchers are continually adding to our knowledge in this field, six established tenets of behavioral finance will add greatly to an understanding of investors. The six are: Loss aversion, anchoring, familiarity bias, mental accounting, the gambler's fallacy, and Representativeness. Let's examine each, discuss implications for advisers and their clients, and the action steps an adviser can take to improve outcomes.

Loss aversion is that most tools used to measure or assess risk tolerance should not be taken as gospel. People no doubt honestly respond to questions asked in risk tolerance questionnaires, but experience demonstrates that they act and feel quite differently when an actual market downturn occurs and the value of their holdings decline. As we'll see when we look at anchoring, loss aversion can lead to investing behavior that is sometimes irrationally risky and at other times irrationally risk averse.

Anchoring leads to longer-term portfolio problems for investors, who often tend to position the price they paid for a security as an anchor. Investors tend to focus on on a single figure or fact while making investment decisions. The reasons for these could be multiple – too much data to process, not enough time, or simply a lack of understanding. Relying heavily on a single trait or 'anchoring' might lead to significant under-earning or loss of potential earnings. By ignoring important pieces of information and adjusting financial decisions based on a single fact, investors tend to bias their investments and might lose out in the long-run.That is why investors tend to under-react to new information

Heuristic, to use the psychological term to describe our rule-of-thumb way of making judgments to come to certain decisions quickly based on experience. When confronting a new situation or set of facts, our minds race to find similarities to past events and then come up with a conclusion or assessment of the current situation. All too often, however, this familiarity bias can lead us astray

Mental accounting as the cognitive operations we use to organize, evaluate and keep track of financial activities. In essence, we think about money in a compartmentalized way, which affects how we behave. Take someone who earns a salary and a bonus. Instead of thinking of the two as merely the constituents of annual income (one pot of dollars), many people tend to think of the salary component as one pot from which they pay for rent, food, auto bills and other expenses, while the bonus pot goes for trips, splurges or lump-sum savings. Essentially, because of our tendency to engage in mental accounting, we think of a dollar as being different (more valuable, easier to risk, etc.)

Gamblers Fallacy : It arises when investors inappropriately predict that tend will reverse. It may result in anticipation of good or poor end.

Representativeness: The investors recent success; tend to continue into the future also. The tendency of decisions of the investors to make based on past experiences is known as stereotype. Debont (1998) concluded that analyses are biased in the direction of recent success or failure in their earnings forecasts, the characteristics of stereotype decisions.

LITERATURE REVIEW

The literature available on the subject emphasizes the evidence of how behavioral factors affect on investment decisions of investors. There seems to be certain degree of correlation between behavioral finance theory factors and investors behavior towards investment . Barberis, N., A. Shleifer, and R. Vishny. (1998). A Model of Investor Sentiment, The model is based on psychological evidence and produces both underreaction and overreaction for a wide range of parameter values. Fama, E(1998). “Market Efficiency, Long-Term Returns, and Behavioral Finance.” In studies of long-term stock return anomalies, overreaction to new information is as common as underreaction, and post event continuation is as frequent as post event reversal. Shefrin, H (2000)Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing. Hirshleifer, D(2001) “Investor Psychology and Asset Pricing, The purely rational approach is being subsumed by a broader approach based upon the psychology of investors. In this approach, security expected returns are determined by both *risk* and *mis valuation*. Heuristics are defined as the rules of thumb, which makes decision making easier, especially in complexand uncertain environments (Ritter, 2003) by reducing the complexity of assessing probabilities andpredicting values to simpler judgments.Grinblatt, M., and B. Han(2005) “Prospect Theory, Mental Accounting, and Momentum.” .” The tendency of some investors to hold on to their losing stocks, driven by prospect theory and mental accounting, creates a spread between a stock’s fundamental value and its equilibrium price, as well as price underreaction to information. Wood, A.(2006) that the committee chair proactively neutralize both the behavioral and social obstacles that impede a committee’s successful achievement of its goals.Fischer and Gerhardt(2007) find that individual investor investment decisions deviate from recommendations of financial theory. Kannadhasan k(2008) found that investors decisions are influenced by psychological factors and the psychological effect is created by the fear of losing money. (Sharpe*et al*.,2008). At an individual level risk taking in one domain haslittle or no relationship with risk taking in another domain. It isimportant to note that risk taking is domain-specific.Ramakrishna reddy and c. Krishnaidu(2009), “ Investment behavior of rural investor,” A study in investor perception and preference assumes a greater significances in the formation of policies for the development and regulation of securities markets in general, and protection, promotion of small and household investors.Gaurav Kabra, Prashant kumar Mishra and Manoj Kumar Dash,(2010) in the article titled “ factors influencing investment decisions of generation of India, it was found there is difference in investment decisions and risk tolerances varies with age and gender among men and women.Abhijeet Chandra and Ravinder Kumar (2011)found that psychological components seem to be influencing individual investors decisions..Michal kastner(2014) found that there is impact of cognitive factor and human judgment error while making investment decisions.

SUGGESTIONS FOR INVESTORS

While it isn’t possible for investors to completely let go of such biases and have the inherent realization that such biases are present, a few things can be kept in mind to ensure rational decision making that maximizes returns and minimizes loss.

 Awareness: Well-read investors that are aware of the biases present while making investments are in a better position to tackle such biases.

 Find Data: Investors aren't alone in the market. It's important to find out sources that think differently than they do and then correspond data and reasoning with them to come to a conclusion. Chances are that the investor will end up making a much more informed decision.

 Diversify: A great investor will always diversify. As the old saying goes, 'don't put all your chickens in one basket'. Diversification across industries and sectors ensures that investors realize higher returns while at the same time minimize risk of losing their entire investment.

 Investment Goals: It's important that individuals realize and quantify their investment goals before leaping on to the investment bandwagon. This gives clarity of thought and helps investors avoid behavioral biases while making short-term changes for achieving those long-term goals.

 Analyze Trends: While past 'winners' seem to be a good choice for investing, the law of long-term averages tends to ensure that last year's best performing assets may not perform that well this year. Hence, it's important to not place undue importance on past performance and expect the success to continue in the current year as well.

 Track Mistakes: Everybody ends up making errors. Traders and investors may find themselves at the bottom of the pit multiple times and may feel that this is it. However, it's important to learn from those mistakes and get back on track keeping in mind the learnings so as to avoid the same in the future.

CONCLUSIONS

Traditional finance theorists and behavioral finance economists are constantly at loggerheads with each other. While much has been said and written about behavioral finance as a field, there is no formal one writing that has been able to completely identify and conclude that stock market anomalies are a by-product of behavioral biases.. The field of behavioral finance has grown considerably in the past decade. That said, it does not negate the efficient market hypothesis completely. It does, however, give several possible reasons as to why anomalies occur in an efficient market and why stock prices divert from their fundamental values. Behavioral financial theories are extremely important for individual investors since biases in behavior and psychological differences play a key role in investment decision making process. Though the above examples of illusions are widely observed, Behavioral finance does not claim that all the investors will suffer from the same illusion simultaneously. There is evidence that investor with less experience being prone to representativeness while investor with more experience commit gambler fallacy. Hence the investors has to take necessary steps to minimize illusions for influencing in their investment decisions.

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