



BEHAVIOURAL FINANCE – A NEW PERSPECTIVE

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Abstract-Behavioral theories are viewed as a relatively new phenomenon in the security markets. Therefore, examining the subject is essential in order to understand the changing world of investments. Current technology enhances fast trade between individual investors. The concept of investing is seen as trendy. Therefore, people tend to make illogical decisions not based on true knowledge or information of a certain investment object. These decisions are explained via several behavioral finance theories. The outcome of poor knowledge is that investors allow these theories to effect on their decision-making process, thus resulting in major losses. The behavioral models can affect on individuals' decision-making whether actual investments are conducted via professionals or not. The concept of investing is extensive as it can include all the aspects of purchasing items expected to gain more value in the future (art, antique, securities etc.). Therefore, it has been decided to narrow down the subject to concentrate on stock trading and the impact of behavioral finance on individual portfolio investors.

This research paper attempts to highlight a new perspective on the study of behavioural finance. In this study, the aim is to establish the existence of such fundamental issues, driven by various psychological biases, in the investment decision-making process. Behavioral economists firmly believe that psychological factors influence investment decisions. They argue that today's investment decisions demand a better understanding of individual investors' behavioral biases. However, many economists believe completely in the application of traditional theories in the decision-making process and hence do not consider the concept of irrational behavior. Behavioral finance therefore studies the influence of psychology on the behavior of portfolio investors and their consequent reactions in stock market investing. In this context, it seems relevant to check whether the behavioral factors have an influence on the decision-making process of portfolio investors. A questionnaire will be formulated and distributed among the clients of two brokerage firms in India and their investment decisions and effects of behavioral factors on it will be studied. The focus is on individual investors as they are more likely to have limited knowledge about application of traditional theories in decision-making and hence are prone to making psychological mistakes. The primary analysis would be focused on determining whether behavioral factors affect the investors' decision to buy sell or hold stocks.

Keywords: Behavioural Finance, Stock Markets, Biases, Cognitive Errors, Rational Investor, Psychology.

1. INTRODUCTION

The volume of empirical and theoretical research in the field of Behavioural Finance has grown over the recent years. This specialized field merges the concepts of finance, economics, and psychology to understand the implications of human behavior in the financial markets, to form long term winning investment strategies. Behavioural finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets. The principal objective of an investment is to make money. We usually assume that investors always act in a manner that maximizes their return rationally. The Efficient Market Hypothesis (EMH), the central proposition of finance for the last thirty-five years rests on an assumption of rationality. But it has been proved that people are ruled as much by emotion as by cold logic and selfishness. While the emotions such as fear and greed often play an important role in poor decisions, there are other effects like cognitive biases, heuristics (shortcuts) that take investors to incorrectly analyze new information about a stock or currency and thus overreact or under react while making portfolio investment decisions. Behavioural Finance is the study of how these psychological and mental errors or emotions can cause stocks or currency to be overvalued or undervalued, and therefore aim to create such investment strategies that give a winning edge over the other portfolio investors.

2. BACKGROUND

Let us understand the behaviour of a rational or a logical investor. This rational investor is assumed to act rationally in the following ways:

- He makes decisions to maximize the expected utility.
- He is fully informed with unbiased information.
- There is the absence of any distortion of judgment based on emotions.

It must also be considered that the risk resides not only in the price movements of dollars, gold, oil, commodities, companies, and bonds but also lurks inside us – in the way we misinterpret information, fool ourselves into thinking we know more than we do, and overreact to market swings. Information is useless if we misinterpret it or let emotions sway our judgment. Human beings are irrational about investing. Correct behavior patterns are therefore important to successful long run investing – so to be financially successful one has to overcome these biased

DOI Number: <https://doi.org/10.30780/IJTRS.V04.I08.002>

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tendencies, if we can recognize these destructive urges, we can avoid them. Behavioural Finance combines the disciplines of economics and psychology specifically to study this phenomenon.

3. FINANCIAL BUBBLES IN STOCK MARKETS

A speculative market bubble occurs when the actions by market participants' results in stock prices to deviate from their fundamental valuation over a prolonged period of time. Speculative bubbles are difficult to explain by rational trading behavior, and theories have been put forward to explain market psychology through behavioural finance. They propose that when the significant proportion of trading activity in the market is characterized by positive feedback behavior, it may result in asset prices to shift away from their fundamental valuation. This price deviation encourages rational investors to trade in the same direction.

Speculative trades are based upon investors' private information held today and are designed to provide investors with higher returns in the next period when that private information is fully revealed to the market. This implies a positive correlation in returns as market incorporate the information into prices. Trades due to portfolio rebalancing, or hedging, is not information based and occurs when a trader may increase (or decrease) his stock holding by buying (or selling) a portion of his stock holding. This will be accomplished by increasing (or decreasing) the stock price to induce the opposite side of the trade.

4. HOW IMPORTANT IS THE INTRINSIC VALUE?

What are the implications for corporate managers? It is believed that such market deviations make it even more important for the executives of a company to understand the intrinsic value of its shares. This knowledge allows it to exploit any deviations, if and when they occur, to time the implementation of strategic decisions more successfully. Here are some examples of how corporate managers can take advantage of market deviations:

- Issuing additional share capital when the stock market attaches too high a value to the company's shares relative to their intrinsic value.
- Repurchasing shares when the market underprices them relative to their intrinsic value.
- Paying for acquisitions with shares instead of cash when the market overprices them relative to their intrinsic value.

Two things must also be considered regarding this aspect of market deviations.

Firstly, these portfolio investment decisions must be grounded in a strong business strategy driven by the goal of creating shareholder value.

Secondly, managers should be careful of the real time analyses claiming to highlight and predict market deviations. Furthermore, the deviations should be significantly visible in both size and duration. Provided that a company's share price eventually returns to its intrinsic value, in the long run, managers would benefit from using a discounted-cash-flow approach for such strategic decisions.

It can thus be summarized that for strategic business decisions related to the portfolio investments, the evidence strongly suggests that the stock market does reflect the intrinsic value.

5. INVESTING IRRATIONALITIES OF A PORTFOLIO INVESTOR

Often turbulence in the market isn't linked to any perceivable event but to investor psychology and cognitive biases. A fair amount of portfolio losses can be traced back to real time investor choices and their reasons for making them. These may be as following;

5.1 Herding

Cognitive biases are based on feelings rather than facts. Emotions can overpower any otherwise rational investor's thinking during times of stress. All of us likely have made irrational decisions during our lives. Some cognitive biases include loss aversion, overconfidence, self-control, status quo, endowment, regret aversion, and affinity.

The distinction between cognitive and emotional biases is critical when assessing risk tolerance. Advisors often need to adapt to client behaviors caused by emotional biases because it is hard to transform the way people feel and act. With cognitive biases, however, advisors have an opportunity to modify or transform a clients' thinking and to also moderate their investment behaviors.

Herding specifically refers to following the crowd. There are two actions that characterize the herd mentality of portfolio investors:

- Panic buying action
- Panic selling action

6. HOLDING OUT FOR A RARE TREAT

Some portfolio investors, praying for a reversal for their stock prices, hold onto them for considerable periods of time, other investors, settling for limited profit, sell stock that has otherwise a great long-term potential. One of the



big ironies of the investing behaviour is that most portfolio investors are risk averse when chasing gains but become risk lovers when trying to avoid a loss.

If one is shifting from non-risk capital into high-risk investments, they are contradicting every rule of prudence and due diligence to which the stock market ascribes and may lead to long run losses of wealth.

7. ISSUES RELATED TO INTRINSIC VALUE AND COGNITIVE BIASES

One of the most important issues in the study of behavioural finance is whether the assumptions of investor rationality are realistic or not.

The concept can be explained with the help of an example. Let's assume that Mr. X invests and manages his portfolio in an efficient market. Here only seconds are available for a response to the information news. There are a great number of factors that affect the decision of Mr. X. Further, these factors can also affect each other. How can Mr. X draw the right judgments when the information is updated very frequently? Probably Mr. X works on a computer, throughout the day, on which a utility function program is installed for his work. Every decision Mr. X is based on the calculation given by his computer. As soon as the portfolio is rebalanced, the computers utility function program analyses possible new alternatives. This process goes on and on over the course of the day. Obviously, Mr. X does not show any joy, when he wins and no panic when he loses. The thought is, can a human brain behave like this? We know that a human brain can master only few pieces of information at a single point of time efficiently. So, how could one possibly absorb all the relevant information and also at the same time process it all correctly? People use simplifying mental heuristics (shortcuts) in order to control the complexity of information received by the human brain. Psychological research has shown that the human brain often uses shortcuts to solve complex problems. These heuristics are rules or strategies for information processing, which help to find a quick, but not necessarily optimal, solution. Once the information is simplified to the manageable level, people use judgment heuristics. These shortcuts are needed to resolve the decision making as quickly as possible. Heuristics are also used to arrive at a quick judgment, they can, however, also systematically distort judgment in certain situations called, cognitive biases.

7.1 Simplification Bias

The first step in reducing complexity is to simplify the decision. However, it also adds the risk of arriving at a non-rational conclusion which may be considerably different from an otherwise rational decision.

7.2 Mental Accounting

People focus on one account (say the purchase of share x) in particular when weighing things, relationship with other commitments or accounts (say the purchase of share y) are usually ignored. For instance, Company A produces bathing costumes, and company B produces raincoats. Both companies are startups in market, extremely efficient and innovating so that purchasing shares in these companies would be a profitable proposition to any rational investor. A financial gain, however, depends to a large extent on the weather in both cases, Company A will produce huge profits if the weather is fine, while Company B will make a loss, even though this may be kept to a minimum, due to its efficient management strategies. The situation is reversed in the case of bad weather. With mental accounting bias, either investment is risky when seen in isolation. But if we take into account the mutual effect of the uncertainty factor, i.e. the weather, then a combination of both shares becomes attractive for investment, and at the same time a secure investment.

7.3 Availability Constraint

People differ in the degree of information available to them. Some people prefer to see business news on CNBC TV 18, NDTV PROFIT. But others may like to see the serials on STAR PLUS. Obviously, the first category may have more information, as compared to the second which would definitely result in different portfolio investment decision making of the two investor groups.

7.4 Representativeness

This is one of the mental shortcuts that make it hard for investors to correctly analyze new information. It helps the brain organize and quickly process large stock of data, but can cause investors to overreact to old information. For example, if a company is repeatedly giving losses, investors will become disillusioned with this already available past data, and thus may overreact to the past information by ignoring healthy valid signs of recovery. Thus, the stock of the company becomes undervalued because of this cognitive bias.

8. CHALLENGES TO THIS PERSPECTIVE

Under the paradigm of traditional financial economics, portfolio investment decision makers are considered to be rational and utility maximizing. The assumption of rational expectations is simply an assumption – an assumption that could very well not be true in the real sense.

DOI Number: <https://doi.org/10.30780/IJTRS.V04.I08.002>

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Behavioural finance as a study, has enough potential to be a valuable supplement to the traditional and standard financial theories in making portfolio investment decisions. The following fundamentals of behavioural finance highlight the challenges which need to be observed and addressed.

- Hubris hypothesis: it is the tendency to be over-optimistic. It results from a psychological cognitive bias. The investor gets swayed by the momentum that is generated in the markets in the recent past.
- Sheep theory: It is a phenomenon where all the investors are running towards the same direction. They follow the herd – not voluntarily, but to avoid being trampled and left behind.
- Loss aversion: According to this bias the portfolio investors take more risk when threatened with a loss. Thus, the mental penalty associated with a given loss is greater than the mental reward from the gain of the same size.
- Anchoring: This causes investors to under-react to available new information. This can lead to portfolio investors to expect a company's earning to be in line with their historical trends, leading to possible under reaction to any changes in trend.
- Framing: The way people behave depends on the way their decision problem is framed. Even when the same problem that is framed in different ways can cause people to make different investment choices.
- Overconfidence: This leads people to think that they know more than they actually do. It leads portfolio investors to overestimate their market predictive skills and believe they can time the market considerably well.

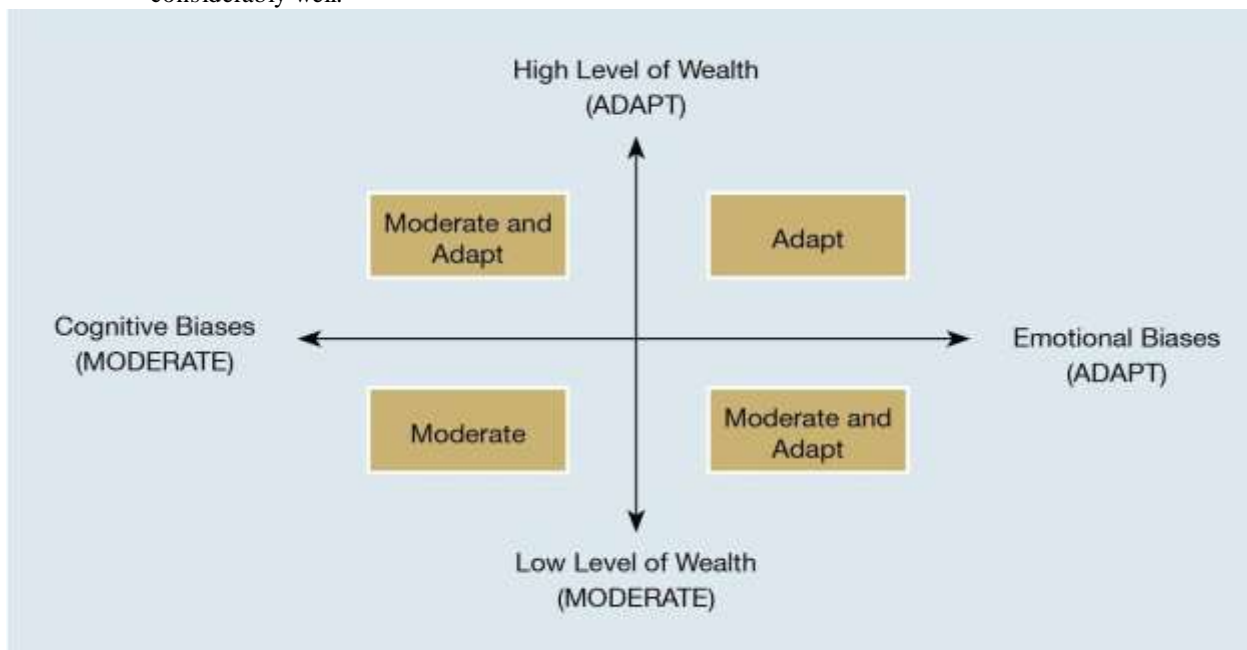


Fig. 8.1 Type of Bias and Level of Wealth

9. RELEVANCE TO INDIAN STOCK MARKETS

Behavioural finance holds definite clues and appears logical in the light of the current IPO craze where Indian markets are concerned. The herd mentality is evident in the aggressive scramble for equities. As the positive information of excess subscriptions becomes visible, a larger number of investors jump onto the bandwagon. When prices of the equities start rising, everyone is thinking on similar lines: I am going to sell on listing and book the profits. Can money making realistically be so simple? Are life and the financial markets so very predictable? One will see investors selling the equities as soon as they get the allotments. Herd mentality will be in the picture with people trying to sell faster than their neighbor, thus effectively eroding the real stock values at a faster rate. Greed thus becomes the ultimate graveyard. In markets as well long run sustenance is difficult with mature portfolio investors standing out in the crowd.

It is believed that the perfect application of the study of behavioural finance can make an Indian investor successful and making fewer mental errors when he is aware of them. Even if are able to clearly identify some common psychological and cognitive errors that effect even the wisest investment professionals, it may be sufficient. Simply put, the economic theory starts with a flawed basic assumption that the investor is a rational being who will always act to maximize his financial gains. Yet, in practical, they are not rational beings, but human beings.

In the functioning of stock markets, behavioural finance can effectively explain situations such as why the portfolio investor holds on to the stocks that are crashing visibly, foolishly sell stocks that are rising, ridiculously overvalue

DOI Number: <https://doi.org/10.30780/IJTRS.V04.I08.002>

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stocks, jump in late and never find out the right price to buy and sell stocks. Timing and pricing thus become important in the entire analysis.

Let's take the example of the recent discovery of gas by Reliance Industries. The equity started becoming attractive as everyone started buying on the available information. Newspapers started flashing stories as to the size of such a discovery and predicting equity prices.

But let us analyze the actual situation without ignoring the mental heuristics. Gas has been discovered but the same needs to be drilled which actually takes a lot of time and money. What is the quality of the gas? How many wells would be needed for drilling? How much time will it take? How much money would be required and what are the plans to finance the same? How easy is it going to be to extract the same? These are all important and pertinent questions. In this time gap, there are numerous uncertainties the company will need to work out before the actual profits are reaped. However, analysts start predicting the future profitability of Reliance and on positive hopes, investors start buying the stock at rising prices.

This is how mental heuristics and cognitive biases work when the human brain takes a shortcut in processing information and does not process the full information and its implications. Thus, behavioural finance has a key role to play in the aggressive Indian capital market, the very nature of the market makes it an important study of research.

CONCLUSION

Knowing the heuristics shall help the investors to which they are usually susceptible and this will help them in neutralizing and avoiding to some extent the distortions in the mental perception and assimilation of information. This will, in turn, help the investor to take a rational investment decision and get an edge over the other not-so-rational investors, influenced by cognitive biases.

More research on behavioural finance must deal with not only the asset pricing but also in areas like project appraisal, investment decisions and other areas of corporate finance so that managers and leaders can avoid the mental decision traps. Psychology and irrational behavior become important while studying financial markets. Behavioural finance is therefore relevant in many ways according to the new perspective. It educates portfolio investors about how to avoid cognitive biases, designing long and short-term investment strategies to exploit biases; and being aware that decision-makers in financial markets are human beings influenced by cognitive biases. It must also be realized that an implicit assumption of behavioural finance is that their findings at the individual level are also scalable to market level.

SCOPE FOR FURTHER STUDY

We have seen a powerful market recovery in asset prices in the wake of the global financial crisis 2008. We cannot forget, however, that more than \$15 trillion in asset values evaporated in 2008–2009, wiping out considerably the gains earned in the comparable bull markets of the 1990s and early 2000s. During the global financial crisis, portfolio investor clients were horrified and did not know what to do. Of course, in hindsight, the correct thing to do was to ride out the storm; some investors sold out and regret it to this day. History has also proved from time to time that markets are cyclical, so another bear market will occur again, it is just a matter of time. When times are good, as they have been for the past eight years, the advisory services may not be relevant because they haven't had to deal with panicky, stressed-out clients. But, knowing that the global stock markets can grow suddenly turbulent, financial advisors must be able to correctly diagnose to a great extent irrational behavior and advise their clients accordingly regarding portfolio investments. That means incorporating behavioural finance into the investment practices. This can all be researched further empirically and country wise separately relevant to the data particular to each geographical location and cognitive biases of portfolio investors. It can also be further studied in terms of developing, developed and emerging market economies and how this factor is of relevance when compared globally on a single platform.

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