OVERVIEW OF BEHAVIOURAL FINANCE

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ABSTRACT

An introduction to behavioural finance, including a review of the major works and a summary of important heuristics. This study aimed to provide a brief introduction to behavioral finance and this essay is motivated by the new tendencies of research in future. It provides good information's to the rational investors to functioning in efficient markets.

Keywords: Behavioral Finance; Decision-making process; Investors'; Stock market;

1 INTRODUCTION

Behavioural finance is the study of the incorruptibility of psychology on the behaviour of financial practitioners and the subsequent effect on markets. Behavioural finance is of interest because it helps explain why and how markets might be inefficient. For more in sequence on behavioural finance, see Sewell (2001). Decision-making is a complex activity. Decisions can never be made in a emptiness by relying on the personal resources and complex models, which do not take into consideration the situation. Analysis of the variables of the problem in which it occurs is mediated by the cognitive psychology of the manager. A situation based on decision-making activity encompasses not only the specific problem faced by the individual but also extends to the environment. Decision-making can be defined as the process of choosing a particular alternative from a number of alternatives. It is an activity that follows after proper evaluation of all the alternatives1. They need to update themselves in multidimensional fields so that they can accomplish the desired results/ goals in the competitive business environment.

2 REVIEW OF LITRATURE

Back in 1896, Gustave le Bon wrote The Crowd: A Study of the Popular Mind, one of the greatest and most inuential books of social psychology ever written (le Bon 1896). Selden (1912) wrote Psychology of the Stock Market. He based the book `upon the belief that the movements of prices on the exchanges are dependent to a very considerable degree on the mental attitude of the investing and trading public'.In 1956 the US psychologist Leon Festinger introduced a new concept in social psychology: the theory of cognitive dissonance (Festinger, Riecken and Schachter 1956). When two simultaneously held cognitions are inconsistent, this will produce a state of cognitive dissonance. Because the experience of dissonance is unpleasant, the person will strive to reduce it by changing their beliefs. Pratt (1964) considers utility functions, risk aversion and also risks considered as a proportion of total assets. Tversky and Kahneman (1973) introduced the availability heuristic: `a judgmental heuristic in which a person evaluates the frequency of classes or the probability of events by availability, i.e. by the ease with which relevant instances come to mind.' The reliance on the availability heuristic leads to systematic biases. In 1974, two brilliant psychologists, Amos Tversky and Daniel Kahneman, described three heuristics that are employed when making judgments under uncertainty (Tversky and Kahneman 1974):

Objectives of the study:

- To study or understand the new applied science of good decision making.
- To study and managing behavioural decisions and preferences of the investors.
- To give the suitable behavioural oriented explanations for the financial disaster.
- To study the explore ways of the decision makers and companies have implemented behavioural finance advance and how to develop your suitable policy.

3. APPEARANCE OF BEHAVIOURAL FINANCE

The principal objective of an investment is to make money. In the early years, investment was based on performance, forecasting, market timing and so on. This produced very ordinary results, which meant that investors were showered with very ordinary futures, and little peace of mind. There was also a huge gap between available returns and actually received returns which forced them to search for the reasons. In the examining process, they identified that it is caused by fundamental mistakes in the decision-making process. In other words, they make irrational investment decisions. In recognizing these mistakes and means to avoid them, to transform the quality of investment decisions and results, they realized the impact of psychology in investment decisions. Several years ago, the researchers began to study the field of Behavioral Finance to understand the psychological processes driving these mistakes. Thus, Behavioural finance is not a new subject in the field of finance and is very popular in stock markets across the world for investment decisions.

Many investors have, for long considered that psychology plays a key role in determining the behaviour of markets. However, it is only in recent times that a series of concerted formal studies have been undertaken in this area. Paul Slovic's2 paper on individual's misperceptions about risk and Amos Tversky and Daniel Kahneman's papers on heuristic driven decision biases3 and decision frames4 played a seminal role. The results of these studies were at variance with the rational, self-interested decision-maker posited by traditional finance and economics theory.

4.BEHAVIOURAL FINANCE PHILOSOPHY AND ITS IMPLICATIONS

Under the traditional financial theory, the decisions makers are rational. In contrast, modern theory suggests that Investors financial decision-making are not driven by due considerations. The decisions are taken by them are also often inconsistent. Put in another way, human decisions are subject to several cognitive illusions. These are grouped into two and have been depicted.

6. HEIRISTIC DECISION PROCESS

The decision process by which the investors find things out for themselves, usually by trial and error, lead to the development of rules of thumb. In other words, it refers to rules of thumb which humans use to made decisions in complex, uncertain environments7. The reality, the investors decision making process are not strictly rational one. Thought the investors have collected the relevant information and objectively evaluated, in which the mental and emotional factors are involved. It is very difficult to separate. Sometimes it may be good, but many times it may result in poorer decision outcomes. It includes:

1. delegative ness:

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)8 concluded that analyses are biased in the direction of recent success or failure in their earnings forecasts, the characteristic of stereotype decisions

2. boldness:

There are several dimensions to confidence. It can give more courage, and is often viewed as a key to success. Although confidence is often encouraged and celebrated, it is not the only factor to success. The investors who are cautious and analytical can achieve success and others have to withdraw. Yet, confidence, especially self-confidence, is often viewed as a positive trait. Sometimes, the investors overestimate their predictive skills or assuming more knowledge then they have. Many times it leads excessive trading.

3. secureness:

It describes the common human tendency to rely too heavily, or 'anchor' on one trait or piece of information when making decisions. When presented with new information, the investors tend to be slow to change or the value scale is fixed or anchored by recent observations. They are expecting the trend of earning is to remain with historical trend, which may lead to possible under reactions to trend changes.

4. Gamblers fallacy:

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

5.Accessibility bias:

The investors place undue weight for making decisions on the most available information. This happens quite commonly. It leads less return and sometimes poor results also.

panorama theory

This theory is developed by Kahneman and Tversky9. The second groups of illusions which may impact the decision process are grouped in prospect theory. He discussed several states of mind which may influence an investor's decision making process.

1. ***Loss aversion***:

Loss aversion is an important psychological concept which receives increasing attention in economic analysis. The investor is a risk-seeker when faced with the prospect of losses, but is risk-averse when faced with the prospects of enjoying gains. This phenomenon is called loss aversion10. Ulrich Schmidta, and Horst Zankb11 discussed the loss aversion theory with risk aversion and he aceepted the Kahneman and Tversky views.

2. ***Regret Aversion***:

It arises from the investors' desire to avoid pain of regret arising from a poor investment decision. This aversion encourages investors to hold poorly performing shares as avoiding their sale also avoids the recognition of the associated loss and bad investment decision. Regret aversion creates a tax inefficient investment strategy because investors can reduce their taxable income by realizing capital losses.

3. ***Mental Accounting***: Mental accounting is the set of cognitive operations used by the investors to organise, evaluate and keep track of investment activities. Three components of mental accounting receive the most attention. This first captures how outcomes are perceived and experienced, and how decisions are made and subsequently evaluated. A second component of mental accounting involves the assignment of activities to specific accounts. Both the sources and uses of funds are labelled in real as well as in mental accounting systems.The third component of mental accounting concerns the frequency with which accounts are evaluated and 'choice bracketing'. Accounts can be balanced daily, weekly, yearly, and so on, and can be defined narrowly or broadly. Each of the components of mental accounting violates the economic principle of fungibility. As a result, mental accounting influences choice, that is, it matters12.

4. ***Self Control***:

It requires for all the investors to avoid the losses and protect the investments. As noted by Thaler and shefrin13 investros 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.

6.Conclusions

Though the above examples of illusions are widely observed, behavioural finance does not claim that all the investors will suffer from the same illusion simultaneously. The susceptibility of an investor to a particular illusion is likely to be a function of several variables. For example, there is suggestive evidence that the experience of the investor has an explanatory role in his regard with less experienced investors being prone to extrapolation (representativeness) while more experienced investors commit gambler fallacy14.similarly, behavioural factors play a vital role in the decision making process of the investors. Hence the investors has to take necessary steps to minimise or avoid illusions for influencing in their decision making process, investment decisions in particular.

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