"RELEVANCE OF BEHAVIOURAL FINANCE IN INVESTOR'S DECISION MAKING PROCESS"

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Abstract: *Behavioural Finance is an evolving field that studies how psychological factors affect decision making under uncertainty. Investors are always assumed to be rational thinkers as per the traditional economic theories but they do not act rationally while making decisions, rather several factors influence their decisions whether it is related to stock market or personal financial investments. It is necessary to understand the major cause of irrationality in the markets. This paper attempts to have an insight about the key factors influencing the behaviour of the investors with respect to the demographics in relation to the investments and their personal financial decision making process. This study will be useful for investors to understand the common behaviours and identify their reactions while taking decisions.*

Keywords: Behavioural Finance, Psychology, Rationality

I. Introduction

Behavioural Finance is a study of the influence of the emotional factors on the economic and financial decision making process. Behavioural finance and behavioural economics are closely linked arenas of study which applies a thorough research on an individual's behaviour and emotional biases to better comprehend an individual's economic decisions and allocation of resources. Comparatively a new branch of finance, behavioural finance applies principles of psychology, sociology and economics to the field of finance. Adam Smith, the father of modern economics said that "there is an understanding to human psychology which is further advanced into behavioural finance today". Behavioural Finance is a study of the influence of the emotional factors on the economic and financial decision making process. Behavioural finance conjointly defines on the actual cause behind irrational decisions recognized by human psychology. Recent research have shown that majority of the investors take their decisions based on their emotions and not by their logic; buy more on expectations and sell low in fear.

II. Literature Review

Tversky and Kahneman (1981, 1992) focused much of their research on the psychological biases and heuristics that make people get engaged in unanticipated irrational behaviour. They argued that behavioural finance counterparts traditional finance theories that are important in the process of decision making but what affects individuals in the process is their sentiments and heuristics. They identified several differences in behavioural finance which occurs from the way any information is edged, viewed and inferred before making a decision. Richard Thaler during his study, closely noticed the shortcomings in the traditional economic theories and realized that unlike traditional theories, psychological theories account for irrationality in behaviours.

Jain and Dashora (2012) studied the importance of human behaviour and its effects on financial decisions by surveying a sample of 110 respondents. The decision factors which are influenced by the market movements, the human preferences, investment strategies of the investors in Udaipur and their perception are the most meaningful concepts of behavioural finance. This paper analyses the rationality of the investors in Udaipur during market fluctuations and announcements and their impact on age, income levels and education of the respondents. The empirical analysis proves that most of the decisions are influenced by the available market information. Sahni (2011) in the international journal in multidisciplinary and academic research tested the applicability of behavioural finance among Indian investors. He gives a glimpse to behavioural finance, studies the background of the financial theories. He concludes the research stating that behavioural theories contradict the modern financial theories. E. Vijaya (2014) studies the individual investor's behaviour and shows with the help of an empirical analysis that investors do not behave rationally while taking decisions.

III. Research Objective

The main objective of this study is to highlight the significance of the behavioural finance discipline in the study of investors' behaviour while taking decisions.

IV. Research Methodology

The paper is mainly conceptual and descriptive in nature and it is based on the different research papers, journals, articles related to behavioural finance available over internet based sources. Various other related books and journals which are available in physical form are also accessed.

V. Analysis and Discussion

Behavioural finance suggests that Investors financial decision-making is not driven only by the equilibrium models and they often prove to be irrational while making investment decisions. In other words as per the principles of behavioural finance human decisions are subject to several cognitive and emotional illusions. Some of those illusions can be grouped as follows:

- **Cognitive Dissonance**: It implies the mental discomfort felt by an investor while taking any decision against his belief or attitude. ―Cognitive dissonance is nothing but a feeling of discomfort or disharmony resulting from the contradiction with the set beliefs or attitudes.‖ [Sharma A.J., 2014 (1)]. In such a situation he tries to relieve his tension by following different irrational heuristics.
- **Herd Behaviour**: Herd means a group and in financial market context it implies to follow a group in respect of decision making. Many times investors knowingly or unknowingly reveal this type of behaviour which is completely against the rationality concept. ―It is often seen that in many cases a particular group forms and it goes in a particular direction. And when a new investor comes by his own nature of being a human just follows the trend of the group without any consideration of his own values or beliefs or analysis. He takes it for granted that when so many people are there in that direction, they all must have something which is profitable as an investor.[Sharma, A.J., 2014 (2)].
- **Loss Aversion**: Aversion means the feeling of dislike or disinclination and loss aversion means disliking or feeling uncomfortable about a loss. This psychological feeling was first proposed by Kahneman and Tversky (1979) in their famous prospect theory. Tversky (1991) further used this concept in his study about making decisions under certainty. To date many scholars have studied the effect of loss aversion on decision making under different situations.
- **Mental Accounting**: Mental Accounting; a concept first named by Richard Thaler in an attempt to describe the way in which a person subjectively frames a transaction in their mind the utility they receive or expect. People weigh the money value on the basis of the source from which that income has been generated. This is also a bias in investment decisions. Although having the same value, investors place different weights on an income earned as interest and income from lottery. There are many other such theories available in the field of behavioural finance which challenges the conventional finance theories of rational choice.
- **Anchoring:** Anchoring describes how individuals tend to focus on recent behaviour and give less weight to longer time trends. The anchor is the most recently remembered price. The tendency of investors to use this anchor enforces the similarity of stock prices from one day to the next. The tendency of past prices to serve as anchors may explain the observed tendency for trends in individual stocks prices to be reversed.
- **Hindsight Bias**: Tendency to view events as being more predictable after it is known. Regret a loss even though due care was taken while buying a stock.
- **Endowment Effect**: Attaching more value to what one possesses. May lead to lopsided portfolio or holding on to an overvalued stock in the portfolio However, not accurately gauge the actual or market value of stocks in the portfolio.
- **Disposition Effect**: Being very uncomfortable with a loss or a potential loss and take wrong decision. May lead to selling all winner stocks and retaining losing ones.
- **Overconfidence Bias:** Overconfidence causes people to overestimate their knowledge, underestimate risks, and exaggerate their ability to control events. The concept of Overconfidence derives from a large body of cognitive psychological experiments and surveys in which subjects overestimate both their own predictive abilities and the precision of the information they have been given. People are poorly calibrated in estimating probabilities—events they think are certain to happen are often far less than 100 percent certain to occur. Overconfidence does not necessarily mean that individuals are ignorant or incompetent. Rather, it means that their view of themselves is better than is actually the case.
- **Representativeness Bias:** Representativeness is judgment based on overreliance stereotypes. The investors' recent success; tend to continue into the future also.
- **Gamblers' Fallacy Bias:** Gamblers' Fallacy arises when investors inappropriately predict that trend will reverse and are drawn into contrarian thinking. Gamblers' Fallacy is said to occur when an investor operates under the perception that errors in random events are self-correcting. For instance, if a fair coin is tossed ten times and it land on heads each time, an investor who feels that the next flip will result in tails can be said to be suffering from this bias.

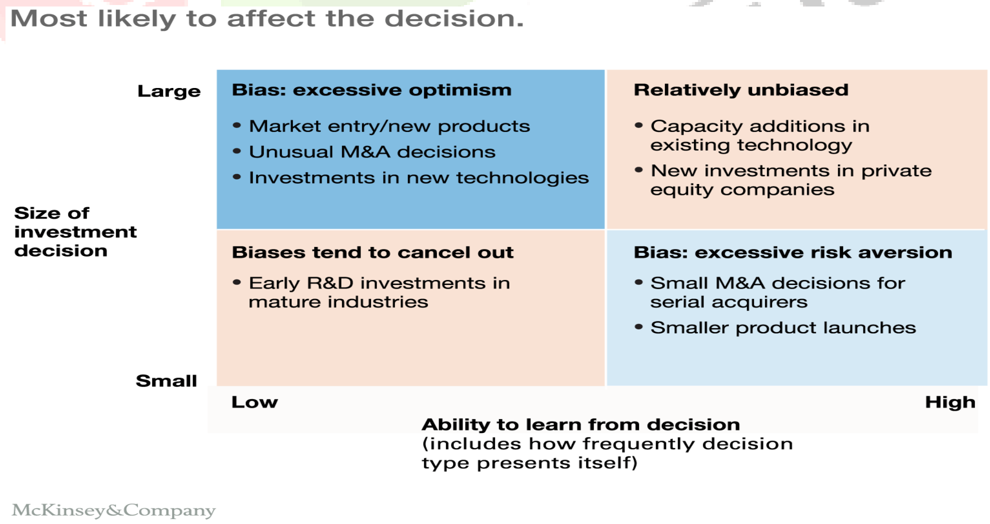

Figure 1: Investor's Decision Making Framework (Source: Mckinsey&Co.)

Behavioural finance discipline has come to an existence as a result of the shortcomings researched out of the efficient market theory. This development has highlighted different anomalies of securities market behaviour which are overlooked by the traditional finance theories. But it is to be noted that both efficient market theory and behavioural finance are related to investor behaviour, i.e. how the investors make decisions regarding investment in securities market. These disciplines have never tried to show the ways of raising finance in financial market. Rather we can say that if the biases put forwarded by the behavioural finance are given due consideration by the investors while making investment decisions then their decisions would be more efficient and this in turn will build their confidence about investment. This efficiency in investment decisions would also reduce the bubbles and crisis situations in financial market as seen every now and then in the stock market. Such bubbles and crisis vulnerabilities discourage the new investors to come out and invest. So if such situations are controlled, which is possible by following the behavioural finance principles would definitely bring more investors to the securities market. So although not directly but indirectly behavioural finance would definitely help to raise finance in the financial market.

a. Behavioural Finance and Decision Making

Decision-making can be defined as the process of choosing a particular alternative from many available alternatives. It is a complicated multi-step process involving analysis of various personal, technical and situational factors. There are no exceptions in the case of making decisions in the stock markets either. Taking investment decisions is the most crucial challenge faced by investors. Some personal factors are age, education, income etc. On the technical side, investment decisions can be derived from various models of finance, for e.g. the capital asset pricing model (CAPM). Decisions should not be reached without considering situational factors that take into account the environment, the market psychology in other words. Effective decision making in the stock market requires an understanding of human nature in a global perspective on top of financial skills. Investors can educate themselves about the various biases they are likely to exhibit and then take steps towards avoiding it thus improving their effectiveness. Some common mistakes made by investors are selling too soon while booking profits, holding too long while facing losses, buying overpriced stocks based on market sentiments and positive evaluation by all and sundry.

VI. Conclusion

Today, Behavioural finance is a rapidly growing area that deals with the influence of psychology on the behaviour of financial practitioners. Behavioural Finance explains the psychology effect on the financial activities and argues that financial phenomena can be better explained due to the fact that financial market participants are not rational and their decisions are limited. The growth of behavioural finance is definitely a positive aspect to better study the investor behaviour. Behavioural finance alone cannot be said to be a perfect one because the discipline is not too old to accept as a theory. And the behavioural finance is only a collection of ideas and thoughts which are descriptive and advisory in nature but they are not exhaustive. More discussions and studies are required to point the limitations of behavioural finance itself so as to refine it to be a good theory.

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