



Comparative Study Of Traditional Finance And Behaviour Finance

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INTRODUCTION

Behavioral Finance just as the name suggests, yes it basically deals with how typically human beings behave when it comes to handling different financial decisions. However, it is not that simple and as such, there is an entire subject dedicated to behavioural finance. But, strangely the subject was not officially recognized only until the year 2002 when Daniel Kahneman was awarded the Nobel Prize in Economic Sciences. He is one of the founding fathers of behavioural finance. The mere ignorance of the subject per se until so late speaks volume about strong human behavioural bias. Unlike a classical financial theory, behavioural finance expects individuals to be more influenced by their emotions or reasonable biases rather than taking the rational approach. There are a large number of brains who are not quite willing to accept this discipline as it is often found to be more complex, instinctive, abstract etc. Further, the denial for the discipline is also because it can create doubt in the minds of many about the decisions of sophisticated investors and professional advisors.

Behavioral finance suggests that the structure of information and characteristics of participants of the market can play an essential role in the decision making of the investor as well as the overall outcome of the market. Behavioral Finance is about making the right decisions that are free from any kind of biases and errors. It helps in understanding investor behavior better and helps in improving the financial capability of individuals.

We all have to remember the Dot Bubble that happened in the year 2000 or the global financial crisis in 2007? We were all affected by that. But traditional finance models failed to predict the market. It was identified by various economists and the governments of several different countries that we lack behind on something. Later it was found that behavioral finance gives all the answers related to these mis happenings.

IMPORTANCE OF BEHAVIOURAL FINANCE

The prevalence of behavioral finance in our society was very beautifully demonstrated by John Keynes who was a British economist. In 1936, he stated that market behaviour is analogous to the behavior of the individuals who have to choose the winner at a “beauty contest”. In a beauty contest, the judges select that person as the winner whom his/her peers are likely to select, i.e. the judges are not interested in picking the most beautiful face, but they rather concentrate on selecting the one who is likely to please the other judges. If you notice carefully, you will see the investors use a similar approach of “consensus” wherein they all combine their expectations and act in unison. On the other hand, there are investors who are likely to trade on stocks that are expected to beat the consensus and avoid those stocks whose market value is considerably less than the fundamental value as per the consensus. Therefore, the concept of behaviour is applicable from the moment investors attempt to spot the future behaviour of fellow investors.

CONCEPT OF BEHAVIOURAL FINANCE

Behavioural finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on market. According to behavioural finance, investors’ market behaviour derives from psychological principles of decision-making to explain why people buy or sell stock. Behavioural finance focuses upon how investor interprets and acts on information to take various investment decisions.

In addition behavioural finance also places emphasis on investor’s behaviour leading to various market anomalies. Behavioural Finance (BF) is the study of investors’ psychology while making financial decisions. Investors fall prey to their own and sometimes others’ mistakes due to use of emotions in financial decision-making. For many financial advisors BF is still an unfamiliar and unused subject.

DEFINITION OF BEHAVIOURAL FINANCE:

Behavioural finance, with its roots in the psychological study of human decision-making, is a relatively new and evolving subject in the field of finance. In brief, behavioural finance is the study of investors’ psychology while making investment decisions. Being a relatively new subject, not much prodigious research literature is available in this subject.

However, some research studies have revealed that psychological biases such as emotions, fear, over-confidence, greed, and risk aversion influence investors’ behaviour that, in turn, influences stock markets. As such, there is a need for studying and understanding behavioural finance to exploit investors’ psychology for profits.

Behavioural finance is the study of investors' psychology while making financial/investment decisions. Sewell (2001) has defined behavioural finance as **“the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets”**. According to Shefrin (1999), “behavioural finance is the application of psychology to financial behaviour – the behaviour of investment practitioners.”

Some of the definitions of Behavioural finance can be summarized:

1. Lintner G. (1998) has defined behavioural finance as being study of human interprets and acts on information to make informed investment decisions.
2. Olsen R. (1998) asserts that behavioural finance seeks to understand and predict systematic financial market implications of psychological decision process.
3. Shefrin (1999), **“Behavioural finance is rapidly growing area that deals with the influence of psychology on the behaviour of financial practitioner”**.
4. Belsky and Gilovich (1999) have referred to behavioural finance as behavioural economics and further defined behavioural economics as combining the twin discipline of psychology and economics to explain why and how people make seemingly irrational or illogical decisions when they save, invest, spend and borrow money.
5. W. Forbes (2009) defined behavioural finance as a science regarding how psychology influences financial market. This view emphasizes that the individuals are affected by psychological factors like cognitive biases in their decision-making, rather than being rational and wealth maximizing.
6. M. Sewell (2007) has stated that behavioural finance challenges the theory of market efficiency by providing insights into why and how market can be inefficient due to irrationality in human behaviour.

Thus, behavioural finance is defined as the field of finance that proposes psychological based theories to explain stock market anomalies. Within the behavioural finance it is assumed that the information structure and the characteristics of market participants systematically influence individual's investment decisions as well as market outcomes. Behavioural finance can provide tools that can help them ‘get inside’ the head of their clients in order to build mutually beneficial relationships. Understanding how clients actually think and behave is a key ingredient in the recipe for success in acquiring and retaining clients. As such, BF is becoming a powerful force in the financial advisory field.

Behavioural finance tries to understand how people forget fundamentals and take investment decisions based on emotions. For decades, economists have argued about the rational behaviour of investors. Now psychologists are weighing in, and they are finding that human beings often do not act that way.

THEMES OF BEHAVIOURAL FINANCE

The four major themes of behavioural finance: over-confidence, financial cognitive dissonance, regret theory and prospect theory.

- **Over-confidence:**

How often do we come across people who apparently over-estimate their own skills and predictions for success? The behaviour of such people is defined to be over-confidence which eventually results in over-estimation of the probable outcomes of an event. Most of people are an active investor with long standing experience, but suffered several losses in the past primarily due to their over-confidence. But what is more disturbing is that they refuse to learn from their previous failed investment decisions.

- **Financial Cognitive Dissonance:**

It is another theory which states that people often feel anxious when they are subjected to their own conflicting beliefs. Most of the individuals try to bring down their inner conflict in either of the two following ways:

1. They alter their past values, feelings or opinions.
2. They try to rationalize or justify their choice.

This theory can be applicable to many individuals who are traders in the stock market and are required to rationalize their conflicting behaviours in order to make it look as if it followed naturally from their personal values.

- **Regret theory:**

According to this theory an individual usually assesses his expected reactions to a future event or situation based on some regret of the past. The theory can be associated with the emotion instigated by comparison of a given outcome with the outcome of a foregone choice. For instance, Trevor had to decide between investing in an unknown stock and a well-known stock. As an investor he knew that the known stock would give lower return than the unknown one, but he decided to go with the known stock because he is more comfortable with the regret of finding that the unknown stock performed better than the known stock.

- **Prospect Theory**

On the other hand, prospect theory states that people usually do not behave rationally. So you might come across people who hold one to persistent biases that are motivated by several psychological factors that are triggered under conditions of uncertainty. Some peoples are there who considers preferences as a function of “decision weights”, but their decision weights tend to overweight small probabilities and underweight moderate and high probabilities which eventually does not quite help in their case.

DECISION MAKING BIASES AND ERRORS OF BEHAVIOURAL FINANCE

Behavioural finance also covers various decision-making biases and errors and few of them are discussed below:

- **Self-deception:** We usually meet people who tend to limit their learning abilities due to self-deception. They are your those colleagues who think they know more than you and as such are not receptive to information that might be required to make an informed decision.
- **Heuristic simplification:** This bias is again associated with people who take into account incorrect and erroneous reasoning or adopt a wrong behaviour to arrive at a decision.
- **Emotion:** How often do we make a decision out of anger, happiness, ecstasy etc. I am sure we all tend to have many such instances in our day-to-day life. But this is basically how our moods affect our decision making.
- **Social Influence:** As a social being, most of our decisions are largely impacted by our peers which may include investment in a stock because most of our friends invested in that.

TRADITIONAL FINANCE VS BEHAVIORAL FINANCE

There are various criteria on which we can identify the difference between s Traditional theories and behavioral finance theories.

S.No.	BASIS	TRADITIONAL FINANCE	BEHAVIORAL FINANCE
1	Risk	The Traditional finance theory considers risk as an objective term that risk can be quantified. Risk can be calculated as beta, or risk can be calculated from the standard deviation.	But behavioral finance theories say that risk is subjective. One person can have a different level of risk-taking capacity than another person, and it cannot be objectively measured. Also, there are differences in the two theories concerning the Return.
2	Risk and return has a linear relationship	Traditional finance assumes that risk and return has a linear relationship; that is, if risk increases, the return will also increase	But behavioral finance says that there is an inverse relationship between perceived risk and perceived return. Here we are not talking about actual risk and actual return, because it is a personal risk. So the risk is perceived, and return is also perceived return.
3	Rationality	Based on the behavior, Traditional finance theories say that the decision-maker is rational.	In contrast, the behavioral finance theory states that human beings are irrational, and he would take all the decisions based on irrationality.

4	Consistency of decisions	Based on the consistency of decisions, Traditional finance assumes the decisions to be consistent; that is, the decision maker's behavior is also constant. That is $2+2=4$ (Always)	But Behavioral finance argues that the decision will be inconsistent because several factors are affecting that decision. For example, that particular human being's personality or the attitude of that person towards certain things will affect his decision.
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CONCLUSION

Psychology has a story to tell about investing, and it is different from the one economics tells,” says

Princeton Psychologist Daniel Kahneman. BF is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets.

Research in this area is emerging from the academia and the results are being taken into account in the field of money management. Finance practitioners use rules of thumb or heuristics to process data.

So, what can be said is that people are not always rational just like the market is not always efficient. Behavioural finance helps us in understanding why people usually do not make the decisions that they are supposed to, just like why the market acts unreliably at times. There are several researches which indicates that a large number of investors make decisions not based on logic but emotion which is usually seen in cases where the investors purchase stocks at higher price based on speculation and then sell off at lower price under panic. So, behavioural finance helps us in avoiding the decisions driven by emotion that ultimately leads to losses. While it is difficult to prove that it actually contributes in improving the performance, but it is easy to understand that there are certain biases that influence our investment decisions. Although it is impossible to eradicate them altogether, you should take steps to recognize your biases and safeguard yourselves from its shortcomings.