

Behavioural Finance as a New Paradigm in Finance : A Synopsis of its Related Themes and Mediated Biases

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ABSTRACT :

There has been considerable debate on the definition and validity of behavioural finance as the idea itself is still developing itself. It studies the psychological and sociological factors that influence the financial decision-making process of individuals, groups, and entities. Behavioural finance is a relatively recent and high impact paradigm which provides an interesting alternative to classical finance. It is very popular in stock market across the world for investment decisions. The scholars and academicians have started to develop and investigate an alternative theory of finance known as behavioural finance. It makes an attempt to explain and improve people's awareness regarding the emotional factors and psychological processes of individuals and entities that invest in financial markets. Behavioural finance scholars and investment professionals are developing an appreciation for the interdisciplinary research that is the underlying foundation of this evolving discipline. In the light of above, the present paper has discussed various themes within the arena of behavioural finance. The paper has also discussed some trading approaches for investors in stocks and bonds to assist them in manifesting and controlling their psychological roadblocks. The behavioural finance-driven structured guidelines for making investment choices will assist individuals by drawing attention to potential mental mistakes leading to increased investment returns.

Key Words : Finance, Psychology, New Paradigm, Themes, Biases, Theory of Regret

1. INTRODUCTION :

Behavioural finance is in conflict with the perspective of efficient market theory, which maintains that market prices are based on rational foundations, like the fundamental financial health and performance of a company. It is a sub-field of behavioural economics,

proposes psychology-based theories to explain stock market anomalies, such as severe rises or falls in stock price (Kenton, 2019). Behavioural finance is the study of the influence of the psychological factors on the development of financial markets. It attempts to explain and increase understanding of the reasoning patterns of investors, including the emotional processes involved and the degree to which they influence the decision-making process. There has been considerable debate over the real definition and validity of behavioural finance as the idea itself is still developing and refining itself. This evolutionary process continues to occur because many scholars have such a diverse and wide range of academic and professional specialties. It studies the psychological and sociological factors that influence the financial decision-making process of individuals, groups, and entities (Figure-1). Behavioural finance is a relatively recent and high impact paradigm which provides an interesting alternative to classical finance. It is very popular in stock market across the world for investment decisions. It helps to understand why people buy or sell stock without doing fundamental analysis and behave irrationally in investment decisions.

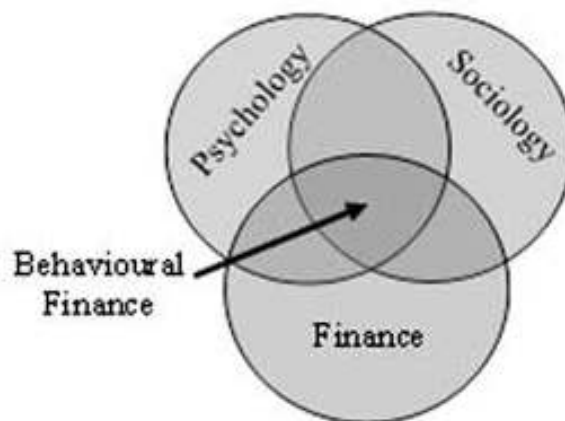


Figure-1: Behavioural Finance

The scholars and academicians have started to develop and investigate an alternative theory of finance known as behavioural finance. It makes an attempt to explain and improve people's awareness regarding the emotional factors and psychological processes of individuals and entities that invest in financial markets. Behavioural finance scholars and investment professionals are developing an appreciation for the interdisciplinary research that is the underlying foundation of this evolving discipline. In the light of above, the present paper has discussed various themes within the arena of behavioural finance, which are overconfidence, cognitive dissonance, regret theory, prospect theory and biases. These

themes are an introductory representation of the many different themes that have started to occur over the years. The behavioural finance-driven structured guidelines for making investment choices will aid individuals by drawing attention to potential mental mistakes leading to increased investment returns.

2. TRADITIONAL FINANCE VS BEHAVIOURAL FINANCE :

In traditional theories of finance, investment decisions are based on the assumption that investors act in a rational manner. This means that they behave rationally so they earn returns for the money they put in stock markets. To become successful in the stock market it is essential for investors to have rational behaviour patterns. Modern theory of investors' decision-making suggests that investors do not act rationally at every time while making an investment decision. They deal with several cognitive and psychological errors. These errors are called behavioural biases and are exists in many ways. Behavioural finance has been growing over the years specifically because investors rarely behave according to the assumptions made in traditional financial and economic theory.

3. PREVIOUS STUDIES REVIEWED :

An extensive comparison between the emerging discipline behavioural finance and standard finance by Statman (1995) who highlighted that behaviour and psychology influence individual investors and portfolio managers regarding the financial decision-making process in terms of risk assessment and the issues of framing. Shefrin (2000) describes behavioural finance as the interaction of psychology with the financial actions and performance of practitioners and recommended that these investors should be aware of their own "investment mistakes" as well the "errors of judgment" of their counterparts. Barber and Odean (1999) stated that people systemically make tracks from optimal judgment and decision making; the behavioural finance does enrich economic understanding by incorporating these aspects of human nature into financial models. Olsen (1998) describes the new paradigm to comprehend and forecast systematic behaviour of investors to make more accurate and correct investment decisions. The study highlighted that researchers have developed many sub-theories and themes of behavioural finance yet no cohesive theory of behavioural finance exist. Ricciardi and Simon (2000) emphasised the conventional academic finance emphasizes theories such as modern portfolio theory and the efficient market hypothesis, the emerging field of behavioural finance investigates the psychological and sociological issues that impact the decision-making process of individuals, groups, and organizations. The paper has discussed some general principles of behavioural finance including; overconfidence, financial cognitive dissonance, the theory of regret, and prospect theory. The paper recommended the strategies to assist individuals to resolve their investment decisions. Ritter (2003) has given a concise introduction of behavioural finance and rejected the traditional assumption of expected utility maximization with rational

investors in efficient market. The study shows that the two dimensions of behavioural finance are cognitive psychology and the limit of arbitrage when market will be inefficient. Chandra (2008) investigated the impact of behavioural factors and investor's psychology on their decision-making process based on the secondary data. The study found that retail investors can not always take rational decision as decision of investment is influenced by many behavioural factors such as greed and fear, cognitive dissonance, mental accounting, heuristics and anchoring etc. The study recommended that these behavioural factors must be considered while taking the investment decision. Chaudhary (2013) identified the reasons for irrational financial decisions by investors. The study demonstrates how emotions and cognitive errors influence investors in the decision making process and established various causes that led to behavioural finance are anchoring, overconfidence, herd behaviour, over and under reaction and loss aversions. Bhatt and Chauhan (2014) experimented that the behavioural finance integrates psychology and economics in finance theory. The study hinted that efficient market hypothesis has been the most important theory that explains the behaviour of agents in the financial markets but it neglects the impact of any human behaviour in investment process. The study has identified behavioural factors which have influence on investment decision of the investor. Keith and Tim (2018) have explored and linked the literature on heterogeneous preferences of investors to signalling theory, and apply it in the context of founding family governance by exploring the presence of investor clusters with varying utility functions with respect to founding family governance. The paper showed that nonprofessional investors use these signals in their investment choices. Latent class analysis identifies three distinct clusters within the sample that have conflicting utility curves with respect to founding family governance. Kenton (2019) reviewed the themes and opined that Behavioural finance attempted combine scientific insights into cognitive reasoning with conventional economic and financial theory. More explicitly, behavioural finance studies different psychological biases that human being possess and these biases lead to irrational investment decisions.

4. OBJECTIVES OF THE PAPER :

The objective of the paper is to study the various themes to establish the behavioural finance as a paradigm of finance.

5. THEMES OF BEHAVIOURAL FINANCE :

5. 1. Overconfidence:

The scholars from the fields of psychology and behavioural finance have studied the theme of overconfidence. People in general, have a tendency to overestimate our own skills and predictions for success. Mahajan (1992) defines overconfidence as an overestimation of the probabilities for a set of events. Operationally, it is reflected by

comparing whether the specific probability assigned is greater than the portion that is correct for all assessments assigned that given probability. The psychologists are of the view that overconfidence causes people to overestimate their knowledge, under-estimate risks and exaggerate their ability to control events. A common trait among investors is a general overconfidence of their own ability when it comes to picking stocks and to decide when to enter or exit a position. An overconfident investor makes too many trades and takes too much risk. They do not diversify their investment. In both the areas of psychology and behavioural finance the subject matter of overconfidence continues to have a substantial presence. As investors, we have an inherent ability of forgetting or failing to learn from our past errors known as financial cognitive dissonance, such as a bad financial decision. This failure to acquire from our past investment decisions further adds to our overconfidence problem.

5.2. Financial Cognitive Dissonance :

The theory of cognitive dissonance is a theme in the field of behavioural finance. Festinger's theory of cognitive dissonance (Morton, 1993) states that people feel internal tension and anxiety in a situation of experiencing conflicting beliefs. People attempt to reduce their inner conflict either with changing their past values and feelings or by means of rationalizing their choice. This theory may apply to investors or traders in the stock market who attempt to rationalize contradictory behaviours, so that they seem to follow naturally from personal values or viewpoints. The investors may experience dissonance during the mutual fund investment process, specifically, the decision to buy, sell, or hold (Goetzmann and Peles, 1997).

5.3. Theory of Regret :

The most well-known theme in behavioural finance is Regret Theory. The theory of regret states that an individual evaluates his or her expected reactions to a future event or situation (e.g. loss of Rs. 1 crore from selling the stock of i phone). The regret as the emotion caused by comparing a given outcome or state of events with the state of a foregone choice (Bell, 1982). Regret theory can also be applied to the area of investor psychology within the stock market. Whether an investor has contemplated purchasing a stock or mutual fund which has declined or not, actually purchasing the intended security will cause the investor to experience an emotional reaction. Investors may avoid selling stocks that have declined in value in order to avoid the regret of having made a bad investment choice and the discomfort of reporting the loss. Therefore, the investor can rationalize his or her investment choice more easily if the stock or mutual fund declines substantially in value. The investor can reduce emotional reactions or feelings since a group of individual investors also lost money on the same bad investment.

5.4. Prospect Theory :

Prospect theory deals with the idea that people do not always behave rationally. There are persistent biases motivated by psychological factors that influence people's choices under conditions of uncertainty. Prospect theory considers preferences as a function of "decision weights," and it assumes that these weights do not always match with probabilities. Specifically, prospect theory suggests that decision weights tend to overweigh small probabilities and under-weigh moderate and high probabilities. Schwartz (1998) articulates that investors tend to evaluate prospects or possible outcomes in terms of gains and losses relative to some reference point rather than the final states of wealth (Figure 2). This can be illustrated by considering two alternative choices of investment selection.

- * Choice 1 : A sure profit (gain) of Rs. 5 crore or
- * Choice 2 : An 80% possibility of gaining Rs. 7 crore with a 20 percent chance of receiving nothing.

Question : Which option would give you the best chance to maximize your profits?

Most people (investors) select the first option, which is essentially is a "sure gain or bet." Two theorists of prospect theory, Kahneman, Daniel and Amos Tversky (1979), found that most people become risk averse when confronted with the expectation of a financial gain. Therefore, investors choose choice 1 which is a sure gain of Rs. 5 crore. Essentially, this appears to be the rational choice if you believe there is a high probability of loss. However, this is in fact the less attractive selection. If investors selected Choice 2, their overall performance on a cumulative basis would be a superior choice because there is a greater payoff of Rs. 5.6 crore. On an investment (portfolio) approach, the result would be calculated by: $(Rs. 7 \text{ crore} \times 80\%) + (Rs. 0 + 20\%) = Rs. 5.6 \text{ crore}$.

The prospect theory exhibited that if investors are faced with the chances of losing money, they often take on riskier decisions aimed at loss aversion despite the fact that they may sometimes refrain from investing altogether. They tend to reverse / alter their revealed disposition toward risk. Lastly, this error in thinking relative to investing ultimately may result in substantial losses within a portfolio of investments, such as an individual invested in a group of mutual funds.

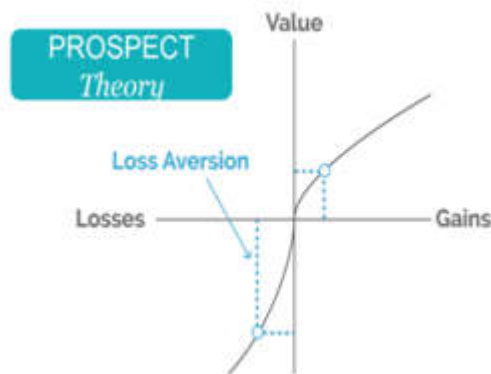


Figure-2: Prospect Theory

5. 5. Biases Mediated :

The psychological bias leads people to follow common trends without any deep thought of their own. The self-attribution bias, a habit of attributing favourable outcomes to expertise and unfavourable outcomes to bad luck or an exogenous event, is also closely premeditated within behavioural finance. Besides, people generally have persuaded with availability biases confirmation biases and disposition biases as discussed below.

5. 5. 1. Availability Bias :

The availability bias occurs when investors' memory of recent events makes them biased or believe that the event is far more likely to occur again. Many had a depressing view of the markets and expected more economic hardship in the coming years. The experience of having gone through such a negative event increased their bias or likelihood that the event could reoccur. In reality, the economy recovered, and the market bounced back in the years to follow. The availability bias suggests that the recent memory i.e., the available example influences more on investor's decision of investment i.e., if investors have recently seen huge loss in one investment avenue then he will not invest in that avenue. The investors are more likely to be fearful of stock market if they have recently seen any stock market crisis (Bhatt, and Chauhan, 2014).

5. 5. 2. Confirmation Bias :

People usually appear to be more inclined towards whatever information they have in their mind. Their existing beliefs have more impact on what decisions they make for their investments. Any information that passes by them, that supports their belief, immediately grab their attention. At times, they do not even confirm from other sources, if

their beliefs are valid or are based on some ground realities. Investors are guilty of confirmation bias when we seek out information, facts, and opinions that support what we already believe and ignore or discount information, facts, and opinions that are contrary to our belief. Confirmation bias can cause us to act without considering all available information.

5.5.3. Disposition Bias :

Disposition bias refers to a situation where investors sell their winners and swing on their losers. Investors' thinking is that they want to realize gains quickly. However, when an investment is losing money, they will hold on it because they want to get back to even or their initial price. The investors tend to admit their correct about an investment quickly ie, when there is a gain. However, investors are reluctant to admit when they made an investment mistake ie, when there is a loss. The flaw in disposition bias is that the performance of the investment is not tied to the entry price for the investor (Kenton, 2019). There is a range of deep-seated behavioural biases, which, although they might serve us well in various circumstances, tend to detract from investment success. These biases can affect the decisions an investor take on particular investments and the way we construct portfolios. Individual investors can fall victim to the biases, but as a part of human nature, professional investors and advisers are also vulnerable. One cannot cure the biases, but we can attempt to mitigate their effects using techniques such as feedback, audit trails for decisions, checklists, and devil's advocates to improve the chances of investment success.

6. CONCLUDING NOTE :

The standard finance or academic finance has been the dominant theory within the academic community. However, scholars and investment professionals have started to investigate an alternative theory of finance known as behavioural finance. Behavioural finance makes an attempt to explain and improve people's awareness regarding the emotional factors and psychological processes of individuals and entities that invest in financial markets. Behavioural finance scholars and investment professionals are developing an appreciation for the interdisciplinary research that is the underlying foundation of this evolving discipline. The behaviours described in this paper are exhibited within the stock market by many different types of individual investors, groups of investors, and entire organizations. This paper has discussed relevant themes within the arena of behavioural finance. The validity of all of these themes will be tested over time as the behavioural finance scholars eventually are working on the various concepts to be implemented. The debate on this issue should address which behavioural finance themes are relevant enough in today's scenario.

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