A STUDY ON THE IMPACT OF BEHAVIOURAL FINANCE IN INVESTMENT DECISION MAKING

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ABSTRACT

Market sentiments have been observed to sway wildly from positive to negative and back, in the shortest timeframes like weeks, days and hours. In this context, understanding irrational investor behaviour deserves more importance that it has ever had. This paper investigates the influence of the behavioural finance and its application in decisions of an investment.

Key words: Behavioral Finance, Investor Behaviour, Investment Decisions

INTRODUCTION

Successful investment requires a special kind of judgement and flair in analysing market behaviour which is associated more with psychology than with pure fact and formula. All the movements of men are motivated by their minds. The human mind is more emotional than factual in its decision making. So, it follows, that an understanding and recognition of mass psychology is the dominant factor in making many correct decisions since the best psychologist are usually the best investors. Every individual is different from others due to various factors which include demographic factors like age, sex, marital status education level, social and economic background; same is the situation with the investors. The most critical challenge faced by them is the investment decision is that they act in a rational manner and usually follow their instincts and emotional biases while making investment decisions. Investors' perception towards investment decision making is a very interesting topic, a study of which gives to understand how various fundamental issues driven by psychological factors influence human behaviour in the process of investment decision making.

BEHAVIOURAL FINANCE: MEANING

Humans are social creatures that have unique values and that have a tendency to make decisions in accordance with their emotions and behaviour. It has been observed for a long time that human beings are not always rational and their decisions are not always objective. It is at this point that Behavioural Finance brings a novel perspective to analyze those areas that traditional finance failed to explain or had in explaining.

Finance can be broadly defined as the study of how scare resources are allocated by humans, and how these resources are managed, acquired and invested over time. Behavioral Finance focuses on how investors interpret knowledge in order to make investment decisions based on information and how they act with their investment decisions. It was developed as a result of increasing interest of psychologists in economics. It is the offspring of psychology and economics. It is the study of the influence of psychology on the behaviour of investors and the subsequent effect on markets. As it is known that, one of the most important factors in investment decisions is the emotions. Behavioral Finance approach investigates the influence of emotions on investment decisions.

According to Sewell (2010)[4],"Behavioral finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets.

"Behavioural Finance is, in general, the application of psychology to the field of finance."

Even though this is a short definition, it can explain Behavioural Finance very well. In case we need a broader explanation, we can divide the branch of finance in question into two branches. These would be[5]:

•Macro-behavioural finance and

•Micro-behavioural finance.

While the Macro-behavioural finance covers the investment behaviours that strive to explain the anomalies on the effective market hypothesis, Micro-behavioural finance strives to explain the individual investors who differentiate themselves from the rational investors indicated by the classical economical theory. Even though it has been understood that behavioural finance has an important role in the investment decisions of individuals, tradition finance should not be disregarded. Thus, an individual's investment decisions would basically be in the form of two types of reasoning. This type of reasoning will be related to the risk perceptions of the individuals and would cover the concepts of behavioural finance (subjective risk criteria) and traditional finance (objective risk criteria)[6].

Why there is a necessity of 'Behavioral Finance' for investment decision making?

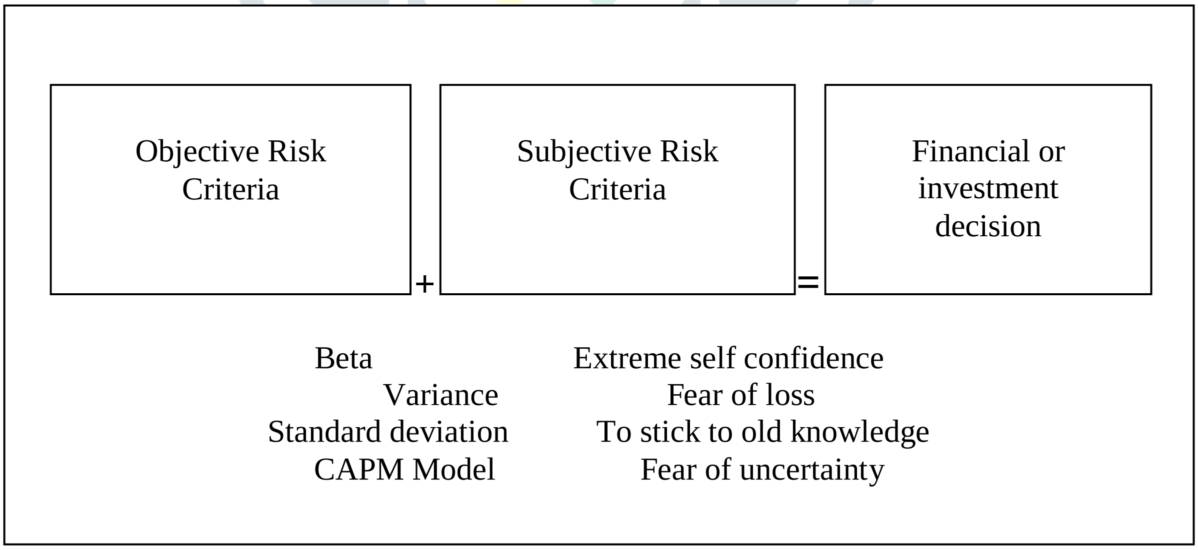

Fig: Evolution of an investment decision

Behavioural Finance argues that behaviours and mood states of humans are determinant factors in shaping their investment preferences and has demonstrated great progress. It is expected that this particular area of finance would be researched in more detail and that research would focus on this field.

EMERGENCE OF BEHAVIORAL FINANCE

The unpredictability of human behaviour has led to emergence of a new field in psychology termed as '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 normal 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 investigative 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 renovate 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 Behavioural 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.

LITERATURE REVIEW

The aim of this section is to present some of the key literary works of Daniel Kahneman and Amos Tversky, recognized as the Fathers of Behavioural Finance. (Heukelom, 2007), (Kahneman and Tversky, 1971), (Kahneman and Tversky, 1972[9], 1973), Tversky and Kahneman (1981).

INVESTORS' BEHAVIOUR TOWARDS INVESTMENT DECISIONS

Even though the fundamental investment rules and principles remain the same, investment climate and investor behaviour change from time to time and place to place. Individual investor behaviour in the capital market is factored by their income, education, reading habits, cognition levels, etc. Investor preferences differ with respect to alternative investment avenues, assets and market segments in the securities market. The track records of companies and of the promoters have an influence on investment decisions. The investment motives also vary through capital gains, dividends, bonus, rights, tax benefits and other relevant factors which also influence investors' decisions. Some of the common causes of Behavioral Finance are described below:

i. Over confidence

One of the most common investor behaviours is overconfidence in their judgement towards the market. In this most basic form, Overconfidence can be summarized as unwarranted faith in one's intuitive reasoning, judgements, and cognitive abilities(Pompian, 2006).

ii. Self- attribution

This kind of investors will typically support the information that favours their beliefs and they will undervalue or do not take into consideration the information that is against them. They usually see the failure to get the returns as the result of the factors that are beyond their control.

iii. Loss aversion

The third behaviour is known as loss aversion. This means that holding on to the investment becomes more attractive than selling if the value of the investment goes down because the investor is willing to tolerate more risk. This behaviour often happens to the investors that dislikes the losses much more than the gains. They called this the disposition effect. The investor will usually hang on to the losing stock with a hope that the price of the stock will bounce back. They will sell the gaining stock rather than the losing stock.

iv. Representativeness

The fourth behaviour will be representativeness. Representativeness is judgment based on overreliance stereotypes. The investor will usually make strong conclusions from a very small sample. This means that they actually ignore or underestimate the effects of random chance. The investor should analyze the investment results for a longer time period before making the judgement that they choose the right stock broker and they are investing at the right investment.

v. Cognitive dissonance

They will effectively jump through mental hoops in order to reduce or avoid inconsistencies. This actually means that the investor will just simply ignore the information that is against their existing belief. They will even avoiding themselves from finding any new information because they afraid that the new information is against their initial opinion. Once the investor has decided that they make the right choice, they will believe it even though there is evidence proving that their choice is wrong.

vi. Herd behaviour

The other common behaviour is the Herd behaviour. It is the tendency for individuals to mimic the actions of a larger group, though, individually, everyone is not necessarily too make the same choice. This herd mentality is the result of two reasons. Firstly, there may be a social pressure of conformity. Most people do not want to be outcast from the group they belong. Secondly, there is a common rationale that a large group is unlikely to be wrong.

CRITICAL ROLE OF BEHAVIORAL FINANCE IN INVESTING

Just recollect the type of our own investment decisions and mistake we made in past would highlight the essence of behavioural finance. The frequent mistakes can be selling winners soon and holding onto losers, buying expensive stocks, just creating an attachment to a company and holding their stock without selling it even in the event of profit, getting anxious on seeing our purchase price translating into quotational losses, buying when others are buying and throwing stocks irrationally due to panic in the market. These behaviours of investors are to be taken seriously, as it erodes their profits drastically due to this action. Just as any game involves overcoming the opponents, here the larger question is overcoming own emotional indiscipline to comes out successful, and make wise decisions. As the legendry investor, Warren Buffet has observed "It is only when you combine sound intellect with emotional discipline."

An understanding of how our emotions results in irrational behaviour is indispensable foe any investor. The study of behavioural anomalies helps in this regard. It helps in disciplined investing, which is critical and relevant especially in this type of markets which is highly volatile and unpredictable.

It is not that the great investors do not suffer from these behavioural anomalies; it is just that they understand the importance of emotions while investing and train themselves out of acting emotionally. Intelligence and brilliance carries the day, but it is the wisdom that endures. This wisdom can be a product of various factors:

- Discipline and ability to stay in the course in spite of all the temptations.
- Learning from one's own experiences and mistakes.
- More than intelligence, it is common sense.
- Wisdom gained from the literature of past successful investors like Benjamin Graham, Warren Buffet, Peter Lynch, to name a few.
- One's ability to control ones emotions and understand the emotions of others.

CONCLUSION

They can improve their performance by recognizing their biases and errors of judgement to which we are all prone. Several psychological and behavioral factors such as anchoring, overconfidence, herd behavior, over and under reaction and loss aversions influence investors in decision making. In essence, behavioral finance approach investigates the behavioral patterns of investors and tries to understand how these patterns guide investment decision. Various safeguards are needed to control mental error and psychological roadblocks while investing in stocks and mutual funds in stock market. A well-organized trading strategy is required to control these mental roadblocks to all types of investors.

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