BEHAVIORAL FINANCE – IMPACT ON DECISION MAKING

[1]M.Lakshmi Ramya [2]Edupuganti Poojitha

1.Assistant professor, Vignan's foundation for science and technology (VFSTR), Vadlamudi, Guntur, Andhra Pradesh.

2.II MBA , Vignan's foundation for science and technology (VFSTR), Vadlamudi, Guntur, Andhra Pradesh.

ABSTRACT:

In today's world investing in stocks and funds is made easy. Investors do not need any specific education or knowledge in order to purchase stocks. Current technology enhances fast trade between individual investors.

The concept of investing is seen as trendy. Therefore, people have a tendency to make illogical decisions not based on true knowledge or information of a certain investment object. These decisions are explained via several behavioral finance theories. The outcome of poor knowledge is that investors allow these theories to effect on their decision-making process, thus resulting in major losses.

The behavioral models can effect on individuals' decision-making whether actual investments are conducted via professionals or not. In this paper we will review a clear understanding of the behavioral finance and its significance in the financial decision making process.Major parts of the research are conducted based on a comprehensive study of books and articles concerning investment strategies and behavioral finance theories.

KEYWORDS: Behavioral finance theories, prospect theory, behaviors of men and women.

INTRODUCTION

According to conventional finance theory,the world and its participants are, for the most part, rational wealth maximizers. However, there aremany instances where emotion and psychology influence our decisions, causing us to behave in unpredictable or irrational ways.

Behavioral finance is a relatively new field that seeks to combine behavior and cognitive psychological theory with conventional economics and finance to provide explanations for why people make irrational financial decisions.

OBJECTIVES OF THE STUDY

The major objectives of the study are:

- To explore the kind of research undertaken available in the field of behavioral finance.
- To establish individual behavior through prospect theory.
- To highlight the gap between men and women in the areas of investment.

THE APPROACH OF BEHAVIORAL FINANCE THEORIES

- Perspectives regarding the application of behavioral finance theories among researchers differ.
- The issues of individual investors are not related to the actual strategy but to the implementation stage, it is necessary to interpret investor behavior via behavior finance theories.
- Therefore all the investment decisions that are not solely based are to be interpreted through behavioral finance theories.

- Investors have a tendency on reacting differently on an equivalent investment opportunity depending on whether it is explained in the context of gaining or losing money
- Prospect theory demonstrated that investors are more likely to take risks in order to prevent losses than to gain profit.
- Investors place a different value on gains than losses.

Literature Review

The following provides research material used as a basis for achieving the aim of this dissertation. This provide information of the theoretical study conducted on the area of examination.

Previous work on behavioral finance theories on investment perspective concentrates on providing the necessary background information for the study. The overall objectives presented in this were firstly to discuss individual investor issues and their relation to prospect theory.

Behavioral finance theories are strongly negatively correlated as one excludes the other. The issue of behavioral finance theories has become more prevalent during the past two decades.

Investors have only recently acknowledged their poor decision-making has originated from the psychological aspect of investing. Catherine New (2011) introduces the example of Dr. Maggie Baker who wanted to gain more profit with her investments in the mid-1990s. She allocated the majority of her stocks to the technology sector, which had grown its popularity amongst investors.

However, the price bubble of the technology sector broke in the beginning of January 2000. Dr. Baker lost the majority of the value of her investments. She claims behavioral finance theories controlled her decision making.

The majority of investors with or without relevant education are intelligent people. However, these past years have destroyed their self-confidence. Loss-making investors are desperate to know the reason for this. Behavioral finance is the key for interpreting investor behavior that leads to financial crisis (Statman, 2009).

Individual level

The majority of implications ofillogical decision-making on an individual level are interpreted on negative perspective. As stated in the approach of behavioral finance theories, the chain of misleading information is difficult to end.

The opinions of one investment advisor effect on the recommendations of the next one. It is in the nature of humans to absorb information from the world around them.

BEHAVIORAL FINANCE THEORIES – PROSPECT THEORY

In 1979, behavioral finance foundersKahneman and Tversky presented a concept called prospect theory. Prospect theory holds that people tend to value gains and losses differently from one another, and, as a result, will base decisions on perceived gains rather than on perceived losses. For that reason, a person faced with two equal choices that are presented differently (one in terms of possible gains and one in terms of possible losses) is likely to choose the one suggesting gains, even if the two choices yield the same end result.

Prospect theory suggests that losses hit us harder. There is a greater emotional impact associated with a loss than with an equivalent gain. As an example, consider how you may react to the following two scenarios:

1) You find$50 lying on the ground, and

2) You lose $50 and then subsequently find $100 lying on the ground. If your reaction to the former scenario is more positive than to the latter, you are experiencing the bias associated with prospect theory.

Kahneman and Tversky engaged in a series of studies in their work toward developing prospect theory. Subjects were asked questions involving making judgments between two monetary decisions that involved potential gains and losses. Here is an example of two questions used in the study:

1.You have 1,000 rupees and you must pick one of the following

Choice A: You have a 50% chance of gaining 1,000 rupees, and a 50% chance of gaining 0 rupees

Choice B: You have a 100% chance of gaining 500 rupees.

2. You have 2,000 rupees and you must pick one of the following choices:

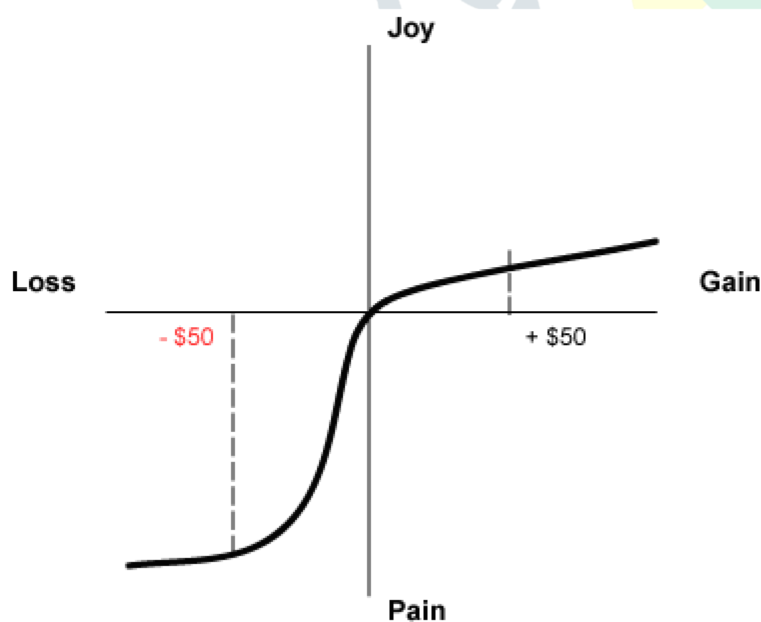
Choice A: You have a 50% chance of losing 1,000 rupees and a 50% chance of losing 0 rupees.

Choice B: You have a 100% chance of losing 500 rupees.

If these questions were to be answered logically, a subject might pick either “A” or “B” in both situations. People who are inclined to choose “B” would be more risk adverse than those who would choose “A”. However, the results of the study showed that a significant majority of people chose “B” for question 1 and “A” for question 2.

The implication of this result is that individuals are willing to settle for a reasonable level of gains (even if they also have a reasonable chance of earning more than those gains), but they are more likely to engage in risk-seeking behaviors in situations in which they can limit their losses. Put differently, losses tend to be weighted more heavily than an equivalent amount of gains.

This line of thinking resulted in the asymmetric value function:



Copyright © 2007 Investopedia Inc.

This chart represents the difference in utility (i.e. the amount of pain or joy) that is achieved as a result of a certain amount of gain or loss. This value function is not necessarily accurate for every single person; rather, it represents a general trend.

One critical takeaway from this function is that a loss tends to create a greater feeling of pain as compared to the joy created by an equivalent gain. In the case of the chart, the absolute joy felt in finding $50 is significantly less than the absolute pain caused by losing $50.

As a result of this tendency, during a series of multiple gain/loss events, each event is valued individually and then combined in order to create a cumulative feeling.

Thus, if you were to find $50 and then lose $50, you'd probably end up feeling more frustrated than you would if you hadn't found or lost anything.

This is because the amount of joy gained from finding the money is outweighed by the amount of pain experienced by losing it, so the net effect is a "loss" of utility.

How women are different to men in behavioural finance

Men are financial daredevils who like risk, and women are cautious and want security — that the standard cliché. Said another way, men are thought to be more risk-friendly than women. Or to rephrase the title of a bestseller, "men buy shares from Mars and women have a savings account on Venus."

Articles published in the Swiss newspaper NeueZürcherZeitung (NZZ), and in various other sources, shed some light on the combination of myth and reality in these gender-focused financial stereotypes. In an interview with the NZZ, Christine Schmid of Credit Suisse explained that the sub-discipline of gender finance deals with the social differences between men and women.

Anja Peter, of Bank Coop in Switzerland concurred that "naturally, there are differences between men and women, biologically and socially, and this is reflected in investment behavior."

For instance, women are generally more interested in such issues as ecology, ethics and microcredits. However, when it comes to the crunch, this interest does not always have an effect on the actual investment decision.Another study conducted at the Centre for Financial Research at the University of Cologne found that female fund managers switch around their portfolios less than their male colleagues. Furthermore, women's strategies, and the subsequent performance, tend to be more stable.

Women are risk aversers

Some researchers concluded that women can take more risk than men. They are more cautious than men because they generally had about half as much to invest as men.

Financial Career Barriers and Education

Even today it is sad that there are only a few women working as financial analyists and financial brokers.Schmid believes that women continue to gravitate to fields where there are other women but hopes that these barriers will break down over time.

Interestingly, studies by the German Comdirect Bank and the DAB revealed that while women had less confidence in their financial knowledge than men, this was not matched by poorer investment choices and management.

The study found that 58% of men rated their financial understanding as good or very good, but only 47% of women said the same. Furthermore, a large sample of almost half a million private portfolios demonstrated that in 2007 and the crisis year of 2008, women did 4-6% better than men on average.

Women going Forward

Over the time differences may not disappear but decrease but discrimations tend to decrease.

This in turn will lead to a number of new programs that focus on woman who invest. The International Finance Corporation's "Banking on Women" program is an example and has been followed by many others over time. The presence of female investment clubs is another sign of the times.

"self-conscious, pleasure oriented" younger women

"interested and open-minded active" women who are more interested in what the bank offers

"traditional conservatives" who are loyal and risk averse.

Changed scenario

The scenario was changed over the years that women successfully broken down many of the barriers in a male-dominated world. women constrained both their financial knowledge and activities. This situation is changing constantly.

Nonetheless, some of the clichés remain entrenched in the mind and some elements of the old role inevitably have stayed intact.Women tend to have lower financial risk tolerance than men and make smarter, more calculated decisions about their investments .What more women tend to be less competitive than men who are disposed to competing even when they are more likely to lose.

Though performance isn’t much different by gender in the professional investing world, women may be wiser investors than men. Many men are excellent, level headed investors. Many women are not. But if anything these findings ought to chip away the confidence gap that keeps men away women from investing in the first place.

CONCLUSION

Relevant theories used in this paper were choosen after a careful research of behavioral finance related books and journal articles. The behavioral finance model implemented was prospect theory. It exposes the consequences of individual stock investors being affected by behavioral finance models. It focuses on the behaviors that affect investment decisions. Even there are gender biases among males and females this research focuses on difference between females to that of males.

REFERENCES

1.S. U., & Mulyaningtyas, A. (2017). Eksplorasi Tingkat Efisiensi Pasar Modal Indonesia, Studi Kasus di Bursa Efek Indonesia. *Ekspektra: Jurnal Bisnis Dan Manajemen*, *1*(2), 103–123. https://doi.org/http://dx.doi.org/10.23159/ekt.v0i0.184

2.Ady, S. U., Salim, U., & Susanto, H. (2010). Analisis Variabel yang Berpengaruh terhadap Spread Harga Saham pada Industri Manufaktur di Bursa Efek Jakarta. *WACANA*, *13*(132).

3.Giridhari, M., & Debasish, S. (2011). A study on investmentperception among urban investors in orissa. *Journal of Management thought and practices*, 3(1), 1-26. Retrieved from http://www.grgsms.com/prerana-march2011.pdf

4.Kabra, G., Mishra, P. K., & Dash, M. K. (2010). Factors influencinginvestment decision of generations in India:An econometric study. *Asian Journal of ManagementStudy*, 2, 305-326.
Ritter, J. R. (2003). Behavioral finance. *Pacific-Basin Finance Journal*, *11*(4), 429-437.

5.Gervais, S., & Odean, T. (2001). Learning to be overconfident. *The Review of Financial Studies*, *14*(1), 1-27.

6.Ranganathan, K. (2006). A study of the Fund Selection of Behaviour of Individual Investors towards Mutual Fund- with Reference to Mumbai city. The ICFAI Journal of Behavioural Finance. vol. 3, pp. 63-88.
7.study on behavioral finance, behavioral biases, and investment decisions rupinder kaur gill1 & rubeena bajwa.

8.Banerjee, Arindam. 2011. *Application of Behavioral Finance in Investment Decisions: An Overview*. The Management Accountant 46 (10): 869 – 872.