EXPLORING THE BEHAVIORAL SIDE OF FINANCIAL DECISIONS

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ABSTRACT:
Financial decisions are pivotal and are affected by a number of variables. We all take these decisions at various levels and in different situations then why some people are more seasoned in taking those decisions than others. How it happens and most importantly why this happens? The scope of this study is to find those exact set of reasons or variables which affects crucial decisions at large. The central objective of the study also focuses to explore if the level of education plays an indispensable role in it or not? The study also discovers, after a deliberate search, the various ways through which a beginner can make financial decisions as accurate as professionals. In a nutshell, this study endeavor to perceive why you do, what you do? And how it gets it done in the best way possible!

KEYWORDS: Financial decisions, variables, education, professionals

INTRODUCTION:

“If decision-making is a science, Judgment is an art” - Anonymous.

We all take various decisions in our day to day life. All these decisions mainly revolve around taking Routine decisions, Strategic decisions, Tactical, operational decisions, Organizational and Personal decisions as well. Among all these decision making the most critical is Financial Decisions. It’s no more a secret that whole world exert itself for Financial security. Even in Maslow’s hierarchy of needs it was ranked second after Physiological needs under Safety needs. So, if everyone has to take financial decisions in their life then why some people are better than others while taking these decisions? Is this is because of thinking process, experience or its a difference in Brain wiring? If so then is there any possibility to train the brain to take better financial decisions? If yes then how? Well, various disciplines of knowledge tired their level best to decode this and that’s how Behavioral finance came into the picture. Behavioral finance is a sub field of Behavioral economics. It’s a sweet blend of Economics, Psychology and finance. The main aim of Behavioral finance was to observe the various anomalies of the stock market with the help of various prevailing theories like Efficient Market Hypothesis (EMH) etc. It studies the...
reasons behind why people make certain financial or Investment choices. Some of the main component of behavioral finance consist of Mental accounting, herd behavior, anchoring. All these components of Behavioral finance works on three prevailing themes of behavioral economics – Heuristics (rule of thumb cheat codes), Framing (anecdotes and stereotypes affecting decisions) and Market inefficiencies (which talks about market concepts like mis-pricing etc) conspicuously economics and psychology are quite interlinked. Many of the celebrated microeconomics theories used the disciples of psychology to prove those theories like the theory of Moral sentiments by Adam Smith and Conspicuous consumption theory and many more. One of the major drawbacks of Behavioral economics or Finance is that they study the “Mechanism” or the “Behavior” infusing the decisions neglecting the entire system which runs these Mechanisms or Behaviors i.e. The Brain itself. This gap gave birth to a new dimension of Behavioral finance i.e. Neurofinance, which we will cover separately in the twin part of this paper.

BACKDROP OF THE STUDY

This paper purely focuses on the Behavioral side of financial decision making process. We will observe the various variables which affects or effects the decision making process. As a research group we are more keen to observe if the level of education actually helps in better financial decision and financial risk management. To do this, we orchestrated a focus group comprises of Forty (40) individuals which are further divided into four (4) sub categorizes as follows.

✧ Category 1 - Non- Financial People
✧ Category 2- The Beginners
✧ Category 3- The Amateur
✧ Category 4- The Professionals

These categories consist of 10 participants each which are from diversified streams of works. It comprises of Home makers, students, undergrads, MBA graduates, PhD Holders, Engineers, Part time Intra- day traders, banking professionals and full Time Investors as well. The age group of these participants ranges from as min as 19 years to as high as 56 years. A quintessential questionnaire was prepared for the study comprising of 14 questions. These questions covers the various dimensions of the study including age, profession and various psychological and scenario based questions. The collection of data is done by using one to one interview method.

Category 1 mainly consist of home makers, students, small business owners and farmers. The sole reason behind selecting respondents from diversified fields for this segments was to observe the response by these respondents as they process a very limited amount of knowledge or expertise in comparison of other categories. Coming to Category 2, this segments comprises of people who had the exposure of market. They are not professionals but have a worm eye view regarding the
functioning and working mechanism of secondary markets. A majority of the respondents from this category are university students, lecturers, Business owners, and working class. These respondents have more knowledge and expertise in comparison of the category 1 and are also more qualified. Respondents in Category 3 are people such as part time traders, Investors, students and working people who see secondary markets as an additional source of Income. The students here have an experience of more than a year in this category. In this category there were many respondents who are specialist in finance and have advance skill and knowledge in the field. The reason they are not in the fourth category i.e the professionals is simple. These people in category 3 have other sources of income and investment returns does not constitute huge portion of their income. In simple words since Returns on Investment was not the main source of their Income, that’s why they were in category 3 not in 4.

Coming to category 4, the name is self explanatory that it consists of professionals. These respondents are highly trained, certified and have a huge exposure of market and investments. Taking huge investments decisions are their daily work and they also deal with huge amount of stress and risk as well. Here, the respondents are Full time traders, Bankers, Portfolio Managers and Discount Brokers.

Need for Study:

- Observe the investment behavior.
- Explore the ways to increase financial accuracy.
- Observe the patterns among different groups under observation.

REVIEW OF LITERATURE:

◆ Behavioral Finance and Neuro Finance and Research Conducted in This Area

In their paper titled Behavioral Finance and Neuro Finance and Research Conducted in this area conducted this whole research on the idea that behavioral finance shows some impact on the capital market decisions. A detailed presentation of behavioral finance a comparison between cognitive psychology and economics and a study of neuro financing is observed to conclude that behavioral finance does not show much impact on market finance in comparison to modern finance. So to study on Capital market behavior we have to take into consideration both modern finance and behavioral aspects.

◆ ROLE OF BEHAVIOURAL FINANCE IN INVESTMENT DECISIONS

In his article titled Role of Behavioral Finance in Investment Decision observes that behavioral finance now plays an important role in decision making of the investors. It helps the investors reduce the errors of investment and better investment options by studying the psychology in deciding investment options. This article considers prospect theory and heuristic decision process
to get into the conclusion that behavioral finance reduces the illusions taken by investor and will help in comforting decisions. This paper also focused on the ways to minimize or eliminate the biases in decision making.

◆ **Role of Behavioral Finance in the Financial Market**

In her article, it focused on the ways to bring out the difference between tradition finance and behavioral finance. The positive reflection about the article is they have brought out the limitations of the conventional finance. As finance is the heart of business this paper has attempted to study the recent trends and improvements in them and concludes that behavioral finance is not the only element to bring discipline in finance but to an extent it makes it sensible. The paper also attempts to throw some light on the development of the Behavioral finance in spite of the presence of other theories and also discuss a few behavioral finance principles and their significance in the financial market study.

◆ **A STUDY OF BEHAVIORAL FINANCE AND INVESTOR’S EMOTION IN INDIAN CAPITAL MARKET**

This paper deals only to the Indian market in specific. Paper mentions that people are not rational as modern financial economics believes. People are investing on the basis of overconfidence and regrets. In addition there is over and under reaction component to add value. The paper also tries to analyze and explain various concepts of behavior finance. The sole focus of this paper in Indian context is both its strength and weakness.

◆ **INVESTMENT BEHAVIOR & BIASES OF INVESTOR: AN EMPIRICAL RESEARCH AGENDA IN INDIAN PERSPECTIVE**

In their paper suggests that an individual or any investor is affected by psychological and sociological factors in concluding his investment decisions. Individuals decision making depends on the years of experience in the field of finance skills and knowledge the process in life and other financial factors. The main purpose of this paper was to build a conceptual understanding in the field of behaviour finance. It also examine the decision making process along with the variables affecting the process. Both the authors tried their best to use prevailing theories for explain the practical situations.
THE IMPACT OF PSYCHOLOGICAL FACTORS ON INVESTORS’ DECISION MAKING IN MALAYSIAN STOCK MARKET: A CASE OF KLANG VALLEY AND PAHANG

They started their research with a note that there is always a presence of sensitiveness among the individuals in making keen investment decisions. It shows a rational difference between individuals and economists this study shows us how the psychological factors affect the depositors, analyzers and executives of the company. The main objective of the research is to portray how overconfidence and herding differences affects individuals’ mentality and studies the human behavior in case of gain; he shows off his talent and in case of loss, simply blames his fate and moves on. In this paper they bring out a closure to the gap between the differences in decision making of other countries in comparison with the Malaysian stock.

BEHAVIORAL FINANCE

In his paper explains the theory of Von newmann-Morgenstern expected utility and arbitrage assumption which are too narrow to understand the cognitive behavior of people which leads to the development of model based paradigm known as Behavioral Finance. This new approach uses the body of information related to individual investor such as overconfidence on his/her recent experience which was previously ignored. Author is of opinion that not always biased due to psychological reasons but it is also the result of mismatch of demand and supply, Government interference, and International agencies, etc. According to author it is very important to divide events into high-frequency events and low-frequency events to analyse those events which affect market efficiency. The former supports market efficiency whereas the latter does not. The author has also explained the application of this subject on inflation & stock market and under-pricing of IPO i.e. how people are unable to identify that the increase in inflation decreases the nominal value of their debt which enables them to further increase the debt and stockholders frame of thinking(prior issue stockholders) on diluting their control.

Objectives of the study:-

- To determine and analyse the effect of education on financial decisions.
  - To observe the behavioral pattern among different sets of Investors.
  - To Critically study and explore possible ways to increase financial accuracy and better decision making methods.
  - To effectively use the outcome as a base for the further research in the field of neuro finance.
Research Methodology:

- Data Collection: Primary data is being collected by One to One interview method.
- This study is descriptive and Qualitative.
- The duration of the study is one and a half month.

Limitations of study:

This study is based on personal interviews of the focus groups under study. Hence, the chances of Biased answers cannot be eliminated. The study may be affected by various human mistakes as well.

Analysis & Interpretation:

- The first four question of the questionnaire revolves around the basic parameters of age, profession, experience and expertise in investments or markets. All four categories of respondents answered these question very effectively except then that fact the last two categories were more experience and expertise in comparison of the first two.

- The next three questions focused on the Instrument these respondents traded in, how they will define financial markets, how they collect information before taking a financial decision, tools they use to come to a conclusion and also if given choice what they will prefer to invest in among bank, Mutual funds, Debt Instruments and secondary markets. Category 1 never traded in any financial instruments and most of the financial decisions made by them was largely affected by the peers, family and relatives. The way financial markets was defined by them was very basic. For them its was nothing but a gambling market where Luck prevails. When asked to choose between various investment options majority of them choose Banks over other as there was easy to understand, every one around them does the same and most importantly bank savings involves less risk. Category 2 on the other hand also opt for banks but they was also aware of Mutual funds and eager to put some money in them too. Its was savings plus some investments. Category 2 also believed that secondary market is a gamble. Many of the respondents was also eager to try their hands on secondary markets but was not ready to absorb the risk involved .some of them who were in secondary market dealing only with equity.

- Respondents in category 3 was quite different from the first two categories. Majority of them traded in secondary markets. They usually collect their part of information from various online sites, forums but most importantly secondary market was not a gamble for them but a calculative risk. Whenever they have to make decision they was more open to take a expert
advice rather than asking their peers or relatives. When asked to choose between different investment opportunities they placed banks on number 3. just opposite of what the first two categorizes did. For them secondary markets was the first followed by debt instruments and mutual funds. The respondents in this category wanted to establish a balance between savings and investments. Many of the respondents agreed that they do use various analytical tools for market understanding but majority of it revolves around studying candle stick diagrams and some basic analysis.

✓ Category 4 was different from all. For them trading was a profession. The definitions given by them was really professional. For them its was a market of speculation and uncertainty, which yields huge returns.. Majority of them was not dependent on external sources of information but they preferred to do the analysis on their own. The tools used were consist of Analytical analysis, Fundamental Analysis, Management Analysis, ratio analysis and many more. Candle stick diagram was not the only thing they was looking on. When asked to choose between different investment opportunities . All of them ranked banks at last and also they was having a very different take on mutual funds as well. They believed that the mutual funds will collapse in upcoming future. Their emphasis was more on Investments then on savings. Along with this they were aware and open towards different other opportunity like derivatives, futures, short selling etc.

✓ When asked about what portion of their earning goes in saving or investments. Category 1 respondents agreed that what ever is left after their expenses goes for savings in banks. They were not very precise regarding the percentage. Coming on the category 2 they was also more keen on savings. For investment all they were looking forward was land, gold or Mutual funds but a very little investment in secondary market. Category 3 and 4 was bit different. Majority of the respondents said that they keep aside a fix percentage of amount from their earning for investments off course after adjusting their expenses. These two categorizes was very specific regarding the percentage of amount for investments. Its about 40% of their net savings. We also felt the these two categories were more aware regarding their money and expenditure pattern as such.

✓ In the next questions the respondents were asked regarding how they will maximize their gain if the index starts collapsing. The category 1 respondents were clueless regarding what Index actually means. When explained they were unable to figure out a way through a collapsing index. Category 2 did had some answers. Majority of them said they will quit the market which means pack up. These class of investors are first to quit and also act as a catalysis to increase the rate of collapse. Since, majority of them depends upon advice’s they go numb when index starts collapsing. The respondents from category 3 and 4 was having a different take on it. Category 3 said they would wait and will not make haste decisions. Long story short all they wanted to do is to go Bearish. They saw collapsing index as an opportunity for future. They agreed that they will target to purchase more shares in blue chips when the index collapses and also try their hands on short selling if opportunity exits. Category 4 was more
comfortable with Collapse of index cause as per them its nothing more than a “market adjustment”. They anomalously agreed to go for short sell, go bearish and also diversify their investment. Some of them also agreed that if such things happens its a high time to look for other investment opportunities as well.

✓ When asked about the active factor behind their investment decision i.e advice or instinct we observed two group on opposite extremes. Category 1 rely on advice only while category 4 rely on instinct only. Category 3 was more close to 1 and 3 was close to category 4 which according to us is nothing but a direct transformation of dependence into independence with increase in expertise and level of knowledge. Category 4 was open to advice but if there is any conflict between what they think and what they are being told. They was ready to follow their heart. While the remaining categories was ready to go with advice if any conflict as such arises.

✓ In the next questions the respondents were asked if tax evasion is the most important thing they consider while making investment decision. Category 1 to 3 was on the same side in this question. They answered it affirmative. But category 4 took a different stand. Respondents in first 3 categories agreed that whenever they thing about investments, tax evasion is a prime factor. This was a main reasons why people go for health insurances and various Mutual funds and Sips as such. But still there were many people in category 3 itself who disagreed with it. These people had one common thread i.e they were highly trained, seasoned and experienced from the other. These few people from category 3 and category 4 in majority said tax evasion is the last thing they look forward for. If they are making profits its totally fine with them to give some cramps of bread to the government too in from of taxes and other deductions. They further added that schemes with tax evasion actually is less profitable. Its simple the more risk the more profit! Usually government grants these tax schemes to persuade people to invest. Which in totality support the economy as whole.

✓ The second last question was a psychological question. Respondents were asked if they ever get a chance to meet Warren Buffet. Whats the one question they will ask? Till category 3 the replies were generic such as how he made so much wealth, how he takes investment decisions and tips he can give them for investment ( Many of the respondents from these categories were also unaware about Warren Buffet !) , But the replies from category 4 was really good . They wanted to know how he is so patience even though he deals in long term investments, there were many other question raised regarding various tools used for analysis and which is the best among them! But non of the respondent in this category asked for any tip regarding their investment. They were more keen to know the formula then the problems.

✓ The last question was a personal question regarding their sleeping and reading habits. The respondents in the first 2 categories were sleeping min 6-7 hours a day. They acknowledged that they read for 10-15 min regarding investments and news as well. Respondents in category said they sleep 5-6 hours and read about 1-2 hours a day for knowledge addition. But the
category 4 respondents were actually taking only 3-4 hours of sleep on working days. Many of the respondents use to trade in different indexes in different time zone cause of which their sleeping cycle is affected but for them its fine cause they make profits! They also agreed they give a lot of time to horn their skills and gather information or learn new techniques as well.

✓ The belief that Knowledge is power is evident in our study. Its quite visible in the outcome that the respondents with more educational qualification, experience and expertise are more seasoned in taking financial decisions. They are more capable of taking huge risk and usually take calculative risk. Respondents belongs to category 1 were not able to manage their expenses and also investments. All they were looking forward was saving and fixed deposits with min. Risk involved. While respondents from the category 2 was looking out for other ways but still they were not able to interpret and take huge risks. Category 3 and 4 respondents takes huge risk, are way much better to forecast future trends. They were more confident regarding their investments and way away from herd behaviour. These respondents were persuading self esteem rather than financial security. We as a study group are not saying that its all happen cause of their fancy qualification but they were more skill full then others.

✓ If a beginner really want to take decisions as accurate as professional. There are many things which should be kept in mind. The first among them is all these professionals were once a beginners. All they have is right skill set, right education and expertise and most important among all, experience and expertise. Education mo doubt played a vital role behind it but we should not confuse education with literacy. Here we are not talking about the professional degrees these professionals have but education as a whole package of skill, knowledge, degree, experience and expertise. In the course of this paper we have also found all these professionals learned a lot from their blunder mistakes of their lives. One among them lost INR. 12 Lakh in a day. But they never gave up on themselves. They took risk and succeeded, which was clearly lacking in categories 1-3. long story short “Being Millionaire is not about money but mindset”!
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