# INFLUENCE OF BEHAVIORAL FINANCE IN THE FINANCIAL MARKET

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ABSTRACT

Financial Market is considered as the life blood of any economic activity. There are different approaches while dealing with financial market. They are conventional finance, modern finance and a recent approach called behavioral finance. Conventional finance is based on the assumption that investors act rationally and the markets are perfect. They are of the opinion that they collect all the information from the market itself and their decisions are based on that data. Till 1990s, no challenges come across the line of conventional finance. But there was many shortcomings of the existing theory and from mid 1990's researchers have challenged the investor rationality concept. As a result a new paradigm known as behavioral finance has been developed. Behavioral finance concept provides importance to the aspect of investors psychology. In this research paper, the researcher had attempted to highlight the shortcomings of traditional finance and suggest the significance of behavioral finance and also suggest the role of behavioral finance in financial market.

Keywords : Traditional finance, Behavioral Finance, Rationality, Efficient Market Hypothesis.

## INTRODUCTION

Financial Markets are the place where Financial Instruments or the Financial Assets are traded or marketed. A Financial asset is an asset which is used for production or consumption or for further creation of assets and they include mainly the shares or stocks, debentures, bonds etc. Financial instruments are those instruments or documents used for the transfer of funds. They may either money market financial instruments or capital market financial instruments. Financial Market is considered as the life blood of any economic activity. The study of financial markets has always been a center of attention and attraction of the researchers. Different stages or developments have resulted due to the shortcomings of the existing system. Different theories were also developed in this regard. Basically these developments are classified into three broad categories, viz. Traditional Finance theories, Modern Finance Theories and the latest one is the Behavioral Finance theories.

Behavioral finance is the study of psychological biases which influences investment activity or the decision making process of investors. Most of the theories of finance and economics are based on two common assumptions; viz. human is rational and is involved in informed decision making. Contrary to this, the behavioral finance focuses more on the irrationality of human behavior. The investors as human beings have varied number of emotions which divert them from rational decision making and create market anomalies. The classical finance assumes investors as a rational agent while behavioral finance called them irrational. As a result a new paradigm known as behavioral finance has been developed. In this paper an attempt is made to highlight the shortcomings of the traditional finance theories as pointed out by behavioral finance supporters and also a discussion on the significance of behavioral finance. This paper discusses new approach, i.e. behavioral finance in the world of financial markets.

There are mainly two disciplines of financial market study viz. Conventional Finance and the recent development known as Behavioral Finance. Conventional finance foundation is mainly based on efficient market concept, Investor rationality concept and the modern portfolio theory developed by Markowitz. But till 1990 the conventional finance theories were not so been challenged. But from mid 90's researchers have shows many shortcomings of the existing theory and particularly challenged the investor rationality concept. As a result a new paradigm known as behavioral finance has been developed. In this paper an attempt has been made to highlight the shortcomings of the traditional finance theories as pointed out by behavioral finance supporters and also a discussion on the significance of behavioral finance.

Behavioral finance is the branch of finance which is concerned with the application of psychology for financial behavior. Behavioral finance studies the influence of psychology on the behavior of investors or financial analysts and the subsequent effect on the market. It studies the effect of psychological, cognitive, emotional, cultural and social factors on the decisions of individuals and institutions.

**BIASES IN THE INVESTMENT DECISIONS**

Investment biases simply refers to the error of thinking while making an investment decisions. The biases which influence the investors while taking investment decisions are classified into two:

1. Cognitive Biases

Cognitive Biases: Cognitive biases are a type of error in thinking that occurs when people are processing and interpreting in the world around them. The following are the different types of cognitive biases are as follows :

- Confirmation Biases: It means seeking information that confirms positive information and ignoring the information that opposes them.
- b. Self Serving Biases : The tendency of the people to attribute the positive outcomes as skills and negative outcomes as bad luck.
- c. Herd Mentality: Investors may follow things what the other investors are doing on the assumption that what the majority does is right.
- d. Framing Biases : Making an investment decision based on the way the information is presented and not on the merit of the information.
- e. Bandwagon Effect: The bandwagon effect is a psychological phenomenon in which the individual had a tendancy to acquire a particular style, attitude or behavior because everyone else is practicing it.

2.Emotional Biases

Emotional biases are those biases which arise may due to the emotions of investors. Emotional biases are deeply in-built in the psychology of the investors and are generally much harder to control. The following are the different types of emotional biases.

- Loss Aversion Biases: People may feel more strongly about the pain from the loss than the pleasure from the equal gain. It may be due to the psychological disposition of human being.
- b. Over Confidence Biases: When an investor feels he is superior to others in knowledge and skills, this biases arises.
- c. Endowment Biases: The feeling that we do own is more valuable than what we do not.

**LIMITATIONS OF CONVENTIONAL FINANCE**

There are many limitations for conventional finance which are shown by different researchers. Following are some of them :

- Concept of Rationality: Conventional finance is purely based on the assumption that all the investors are completely rational. But later found unreal and different empirical researches had proved that it was main shortcoming of the theory . Rationality means the investors always make the best decision and properly use all the relevant and available information they possess and analyses them in an objective manner But many studies namely Paul Gerrans et al (2012); Ganesan Balaji (2013); Pal. Mukul (2009) ; Ricciardi Victor et al (2000) ] have shown that it was a wrong assumption as in most of the times the investors being the social beings, with a brain and a heart full of emotions, behave in an irrational way, in spite of having different important information. They just overlook the rationality attitude and become biased in different cases.

- Role of Emotions in Investment: Another important disadvantage of Conventional finance is that they had completely ignored the role of emotions in investment decision making. As investors are also normal human beings, they have emotions. So in real sense we cannot ignore the role of emotion in any decision making including the field of investment.
- Informational Accuracy: Conventional Finance always believes that the investors have access to all information and stock prices reflect that information instantly. But in practice, this may not be possible always because all the investors may not have access to all information at the same time. ―In the world of investing, there is nearly an infinite amount to know and learn; and even the most successful investors don't master all disciplines‖ [Michael Pompian, 2006]
- Role of Experience: As per the assumptions of conventional finance all investors are equally knowledgeable and expert. As such no distinction has been made between an experienced and learned investor,. But in real it cannot be so. As experience definitely makes the investors wiser and had influence in their decision making.
- Demographic factors: Age, income, culture, sex, family background, etc. are the demographic characteristics of investors which are not considered by conventional finance, but in real sense they have also having an effect on investment decision making abilities.

These are the main limitations of the traditional finance theories and which are proved to be true at different situations under the purview of behavioural finance. Thus the behavioural finance discipline seems to be a good development in the field of financial market study.

## EMERGENCE OF BEHAVIOURAL FINANCE

To know the meaning of behavioral finance the famous quotation of Albert Einstein i.e."Only two things are infinite, the universe and human stupidity, and I'm not sure about the former" seems to be much more relevant. History of the behavioral finance goes back to Herbert A Simon, the Nobel lieutenant of 1978, for his paper in 1955 ―A behavioral model of rational choice may be regarded as the first thought that endeavored to state about a new concept called behavioral finance [Simon, 1955].Global financial markets is based on by many factors like the economic processes which take place in the country and the world, institutional and political constraints, information dissemination and accessibility, and so on. However, it is also influenced by another important factor ie., the people's reaction, beliefs and perception. Behavioral Finance is the field which studies the investors' behavior not only from the point of view of rationality concept but also it incorporates different irrational psychological investment biases which are overlooked by the conventional finance completely. This new field incorporated the theories of psychology, sociology, philosophy and also neurology in the study of investor behavior. Behavioral finance is not a pure and original development. It is due to the shortcomings of the efficient market hypothesis and other conventional finance theories had led to the growth of behavioral finance

## BEHAVIORAL FINANCE CONCEPT

Behavioral finance typically encompasses six main concepts.

1. Mental Accounting: Mental accounting refers to the propensity for people to allocate money for specific purposes.
2. Herd Behavior: Herd behavior states that people tend to imitate the financial behaviors of the majority of the herd. Herd behavior is sometimes referred to as information cascades.
3. Emotional Gap. Emotional gap refers to decision making based on extreme emotions or emotional strains such as anxiety, anger, fear, excitement etc.

4.Anchoring: Anchoring means to attach or prefix a spending level to a certain reference. Ex: spending based on a budget level.

5.Self Attribution: Self attribution refers act of making choices based on a confidence in self based knowledge.

6. Gambler's Fallacy : When it comes to probability, misleading knowledge or lack of awareness can lead to wrong assumptions and predictions about the onset of events. One of these wrong assumptions is called the gambler's fallacy.

## DOES BEHAVIORAL FINANCE HELPS RAISING FINANCE IN SECURITIES MARKET?

Behavioral finance discipline has come to an existence as a result of the shortcomings researched out of the efficient market theory. This development has highlighted different anomalies of securities market behavior which are overlooked by the traditional finance theories. But it is to be noted that both efficient market theory and behavioral finance are related to investor behavior, i.e. how the investors make decisions regarding investment in securities market. These disciplines have never tried to show the ways of raising finance in financial market. Rather we can say that if the biases put forwarded by the behavioral finance are given due consideration by the investors while making investment decisions then their decisions would be more efficient and this in turn will build their confidence about investment. This efficiency in investment decisions would also reduce the bubbles and crisis situations in financial market as seen every now and then in the stock market. Such bubbles and crisis vulnerabilities discourage the new investors to come out and invest. So if such situations are controlled or removed, which is possible by properly following the behavioral finance principles and it would definitely bring more and more investors to the securities market. So although not directly but indirectly behavioral finance would definitely help to raise finance in the financial market.

## CONCLUSION

While recognizing the shortcomings of conventional finance put forwarded by the empirical findings, we can undoubtedfully emphasize the importance of behavioral finance. The growth of behavioral finance in this regard is definitely a positive aspect to better study the investor behavior and it is important to consider the human element or psychological aspect while making investment. However the behavioral finance alone cannot be said to be a perfect one because the discipline is not too old to accept as a theory and also the discipline is still developing. Behavioral finance is a developing concept that combines the field of psychology, economics and other social sciences to identify and understand why people make certain choices . And also behavioral finance is only a collection of ideas and thoughts which are descriptive and advisory in nature but they are not exhaustive. More discussions and studies are required to point the limitations of behavioral finance itself so as to refine it to be a good theory. Behavioral finance is theoretical framework, and also it is definitely a modest attempt and has many positive sides in the context of stock market study but it needs more refinement and more rigorous analysis to replace a far impacted theory like Efficient Market Hypothesis.

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