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A Study of Behavioral Biases and Its Impact on the Investment

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Abstract – The traditional financial theories such as modern portfolio theory, efficient market hypothesis dominated the financial world for almost two decades. The emerging field of behavioral finance investigated the sociological and psychological issues and their impact on the financial decision making of individual and institutional investors. In this paper, we highlighted some of the prevalent common behavioral biases among the investors and their impact on individual investors, institutional investors, market and regulators. A checklist of behavioral biases must be prepared by the investors before making an investment decision in the stock market.

Keywords: Behavioral Finance, Efficient Market Hypothesis, Behavioral Biases

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INTRODUCTION

The Efficient Market hypothesis dominated the financial world for almost two decades. There are two important implications of efficient market hypothesis. First, it states that security prices fully reflect all the available information whether private or public and the market price of the securities is always equal to its intrinsic value. The second and the most important implication is that no investor can beat the market by undertaking fundamental or technical analysis. Hence, it is impossible to outperform the market. However, it is difficult to devise a tool through which a true intrinsic value of a security can be determined and further difficult to test whether market price always matches with the intrinsic value.

Therefore, all the test of market efficiency focused on the performance of active trading strategies adopted by the investors. Neither class of tests has proven conclusive on it. The behavioral school of thought argues that it is difficult to find whether security prices are correct or wrong. Hence, failure of the traders following fundamental analysis or technical analysis cannot be taken as a proof of market efficiency. The assumption of behavioral finance is that traditional financial theories fail to include behavioral aspect of the investors in their financial model. But in the real world there are large numbers of behavioral biases which affect the investors at the time of investment. The field of behavioral finance is based on the notion that investors are not rational rather normal human beings.

There are large numbers of economist all over the world who interpret that financial anomalies are consistent with several “irrationalities” in the behavior of the investors which makes their behavior complicated. It is also argued that investors do not always analyzed information correctly and therefore assign incorrect probability distribution to the future rate of return. However, if such irrationalities affect the prices and become the reason for stock market anomalies, then sharp eyed arbitrageurs who are supposed to take advantage of such profit opportunities are expected to push back the prices of the stock to its proper values. But behaviorist argues that the actions of such arbitrageurs are limited and insufficient to force prices to match with its intrinsic (true) value. Such argument of behaviorist is worth noting. If this argument of behaviorist is correct that there is a limit to arbitrage, then the absence of profit opportunities does not make the market the market efficient. It was also noticed that most of the test on efficient market hypothesis focused on the existence of profit opportunities. But the failure of the investors to outperform the market does not imply that markets are efficient.

NEED OF THE STUDY:

The traditional financial theories such as modern portfolio theory and the efficient market hypothesis, assumes that investors are rational. However, the emerging field of behavioral finance states that there are psychological and social factors which affect the decision making process of investors. The purpose of our study is to examine the behavioral irrationalities not discovered by traditional financial theories.

OBJECTIVE OF THE STUDY:

There are two main objectives of the study:

a) To identify the most common behavioral biases prevalent among the investors in the stock market.

b) To study the impact of behavioral biases on different segments of the society.

MAJOR BEHAVIORAL BIASES

(a) Representativeness Bias: Representativeness is a mental shortcut which is very common among the human beings. We always judge a situation on the basis of our past experiences. In the stock market, investors judge the stock or the company in which they are going to invest on the basis of its immediate past results. It saves their time and effort but the risk of making wrong decision increases many times. For example we prefer to invest in the company which is familiar to us and avoid investing in new ventures. All the players of the stock market i.e. an individual investor, brokers, and sub-brokers suffer from this bias. It is also to be observed that investors prefer to invest in the stocks of those companies which are big in size, high rate of growth etc.

(b) Overconfidence:- The overconfident investors always overestimate their abilities, knowledge and skills, which becomes the reason of loss for them in the stock market. Overconfident investors always believe that they pick better stocks than others in the stock market and also prefer to invest in risky stocks to have more returns in the short run. They also keep stock of few reputed companies in their portfolio and expect that their portfolio perform better than market. Overconfident investors always rely on their skills to predict the future share and the direction of the stock market.

(c) Availability bias:- It is the human tendency to always search for options which are easily available to them. We the human beings rely on mental shortcuts to take quick decision making. The underlying principle is that "if you can easily recollect something, then it must be comfortable for you". The investors always give more weight age to those experiences which they can easily recollect. For example, when investors take an investment decision in the stock market they rely on recommendations given by financial analyst which clearly shows the existence of availability bias among the investors.

(d) Anchoring and Adjustment:- The term anchor means a central point which is taken as a base point and all adjustments are made keeping in mind the focal point also called anchor point. In the stock market, investors take some specific price or a particular piece of information as a base point and evaluate the stock or company on the basis of it. Once an anchor is set all further decisions revolve around it which results into biasness in interpretation of other information about the company or stock. For example, when the price of stock increases investor note it down and when its price falls they take it as an opportunity to buy it at a lower price.

(e) Disposition effect: It is a common practice among the human beings to hold on decisions which involve loss of money. The same attitude is also very common among the investors. They tend to hold on securities on which they are incurring losses, but to sell the securities which are in profit. They treat profits and losses in different frame of mind.

(f) Herd Behavior: It is the most common characteristic of a normal human being. In our day to day activities we prefer to follow others rather than using our own skills and experience. Such behavior of investors in the stock market becomes the reason for stock market crashes and bubbles. There are so many investors who invest in the stock market by following their friends and relatives and create bubble and crashes. It is also justified for investors to follow the crowd in the light of limited knowledge in the investment activities. Herd behavior among the investors reduces their uncertainty and creates a sense of confidence among them.

(g) Mood:- Mood is a variable which keeps on changing from time to time. It is temporary in nature which changes with the passage of time. We experience both the types of mood in our life i.e. good as well as bad mood. Our mood gets influenced by several variables like climatic conditions (humidity, Cloud cover), results of sports event, etc. It has been observed that the negative result of big sports event makes us pessimistic and we avoid making investment during that time. There are various mood variables like weather condition; results of sporting contests, cycle of the moon etc which affect the returns in the stock market.

(h) Cognitive dissonance:- Cognitive dissonance is a disability of the mind to hold two or more conflicting views simultaneously. In our day to day life we experience different situations where we hold two or more conflicting views. The common characteristics of investors suffer from cognitive dissonance are that they stick to their belief after making an investment, show unwillingness to sell the stock/share at a loss, mostly concentrate on positive side of the stock/company after making an investment. Such attitude towards investment results in irrational decision making and challenges the assumptions of traditional financial theories.

(i) **Culture:-** Culture is nothing but the transfer of traditions and beliefs from one generation to another. Culture not only affect the individuals but it also leave an everlasting impact on the generations. The growth and development of the country also get affected by the culture. Culture gets influenced by the religion which differs from country to country. Culture also plays an important role in financial decision making. For example: In Muslim religion, they consider interest income as a sin and avoid lending their money which adversely affects the stock market. In the same way, in Hindu religion some days of the year are considered as inauspicious and investors avoid making new investment in the stock market during this period.

(j) **Confirmation Bias:-** It is a cognitive bias in which an individual look for those options which satisfies his beliefs and ignore those which are against his belief. It is nothing but the selective thinking of a human being. In the stock market, the investors make use of message boards to seek and confirm information with their prior belief. Such behavior adversely affects their investment performance.

(k) **Mental Accounting:-** There is a strong relationship between the framing and mental accounting. Frames and mental accounting are an integral part of prospect theory. The mental accounting depends on how the problem has been framed. The mental accounting is nothing but the interpretation of situation/information. The interpretation of situation/information depends on our frame of mind. The one aspect of mental accounting is that people treat the same amount of money in different ways depending upon its source of earning For example; people tend to spend more if the source of earning is gift, lottery, bonus, tax returns etc as compared to the normal expected earnings. In the stock market investors treat stock differently depending on whether the stock is framed as contemplated gains or as losses.

(l) **Regret Aversion:** Regret aversion also known as loss Aversion is present in normal human beings to take decision under the situation of uncertainty. In other words, we are more sensitive towards losses rather than gains. We become distressed in case of losses and experience joy in case of gains. In the stock market, investors take more risk to avoid losses and give more weight age to the losses rather than gains. It also plays an important role in the prospect theory also. Regret aversion also describes the optimism bias which states that we are less willing to lose money.

APPLICATION OF BEHAVIORAL FINANCE

(a) **Individual Investors:** The basic assumption of traditional financial theories is that those who trade without following fundamental analysis do not impact the stock or the market. The argument given by behavioral analyst is opposite of it. They state that the noise traders can build up the stock price and also move it far away from the fundamental value of the stock. Such movement in price may not be supported by the investors following fundamental analysis in the beginning but carries the potential to change the belief of the investors and consequently they change their subsequent decisions.

(b) **Institutional Investors:** The traditional financial theories are based on the assumption that arbitrage plays an important role in correcting the mistakes made by noise traders. The arbitrageurs trade away the investor's mistake and as a result if it such errors will not affect the market price. But limits to arbitrage raised the question on the ability of the arbitrageurs to correct the mispricing of the stock or the market. However, the argument of arbitrage by traditional financial theories may not be compelling in a corporate setting. In a corporate setting, few people make decisions involving millions of rupees. Hence their biases not only affect the stock market but also have a direct bearing on the behavior of the corporate culture. Therefore, the study of behavioral finance is likely to be even more important for corporate setting.

(c) **Markets:** It is very important to understand the manner in which the market participants get affected by the behavioral biases. Stock market plays an important role in the development of an economy. The stock market mobilizes the savings from the households and channelizing them into the profitable ventures. Therefore, it is important to keep the good health of the stock market i.e. free from all types of behavioral biases. If the market makers or the future floor traders suffer from behavioral biases, then the prices generated in the derivative market would get affected by excess noise. Hence, it is to conclude that behavioral finance also impact the markets.

(d) **Regulators:** Behavioral finance not only impacts the individual investors and institutional investors but it also leaves an everlasting impact on the regulators also. The behavioral biases that impact investors and managers also influence the politicians who make rules and regulations for the capital market in the country.

CONCLUSION

We all are concerned for profit making investment opportunities. The behavioral finance criticizes the traditional financial theories particularly efficient market hypothesis on the ground of irrationality. The question which is still unanswered by the investors is that whether there is any scope of making money from the mispricing of the stocks. The behaviorists are silent on this point. There is an ever ending debate among the financial economists on the points raised by the behavioral analyst. Researchers believe that the behavioral approach is not structured. Behavioral finance is a new field of study, however its criticism of full rationality in investor decision making is acceptable, but the extent to which irrationality affects the stock pricing is still controversial. However, the investors who are aware of their inability to process the information can avoid such errors. It is also advisable to prepare a checklist of the various behavioral biases before making any investment decision in the stock market.

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