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New Paradigms in Investment: A Behavioral Finance Perspective

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Abstract – Behavioral finance is the study of psychological biases which influences 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.

Key words: Traditional finance, Behavioral Finance, Rationality, Psychological biases, EMH.

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I. INTRODUCTION

The financial instruments or securities are traded in financial markets. The financial securities mainly directed towards the shares or stocks, debentures and bonds issued by the companies/entities. The study of investors' behavior has always been a centre of attraction of the researchers after great depression and financial crisis of 2008 in which 70% wealth of the investors eroded. Basically financial market theories are classified into three broad categories, viz. Traditional Finance theories, Modern Finance Theories and the latest addition is the Behavioral Finance theories. In this paper an attempt is made to throw some light on the development of the Behavioral finance in spite of the presence of other theories and will also discuss few behavioral finance principles and their significance in the study of financial market.

II. STATEMENT OF THE PROBLEM

Financial markets are the life blood of any economy and in this competitive world any country requires more capital to expand their business, economic and development activities. Shares are the most important source of finance for businesses. In recent we have also seen the irrational behavior of investors in crypto currency market which has bubbled the pricing and in fact no one knows the reliability of these virtual currency.

The traditional theories focus on a widely accepted approach of "fully rational agent" where decision making is based only on available data and mathematically proven concepts. In the early years, investment was based on performance, forecasting, market timing and so on. In an ideal scenario where this approach is applicable, the market is informally efficient, i.e. security prices would incorporate all the available information in the market and all the securities would be fairly priced. But there was a huge gap between available returns and actually received returns which forced experts to search for the reasons. In the examining process, they identified that it is caused by fundamental mistakes in the decision-making process. Behavioral experts argue that investors are led by their sentiments and are prone to make cognitive errors. They may lack self control, be overconfident about their abilities, overreact or follow the crowd without thinking so much (Statman 2012). These errors can lead to market inefficiencies in form of anomalies, like-speculative bubbles, January effect and aggressive selling etc. Some of the recent examples are like internet based dot com bubble, housing or real state bubble in USA, block chain based virtual currency bubble etc.

III. OBJECTIVES OF THE STUDY:

The main objective of the present research paper is to highlight the limitations of the classical finance theories and the significance of the growth of behavioral finance discipline in the study of investors' behavior in the financial market. A bird eye view of a few behavioral finance principles and biases is also tried to present as the next objective.

IV. METHODOLOGY OF THE STUDY:

The paper is mainly conceptual and descriptive in nature and it is based on the different research papers, journals, articles related to behavioral finance available over internet based sources. Some other related books and journals which are available in physical form are also accessed to develop the foundation of the paper.

V. LITERATURE REVIEW

In the past economics was closely attached to psychology, which was displayed in the study "The Crowd: A study of the popular Mind" by Le Bon. The study was the most influential books of social psychology written earlier.

But with the development of Neo-classical economics, it has been taught to us that

- People have rational choices among outcomes that can be associated with a value
- Individuals are prone to maximize utility and times maximize profits
- People have access to full and relevant information and they independently rely on that.

At this time psychology had largely disappeared from economic and finance discussions. The main development of the conventional finance is the “Efficient Market Concept”. The conventional or standard finance laid its foundation on two main models - The efficient market concept and the Markowitz model. But the investor decision making cannot solely be based on these two models. **M. Kannadhasan (2006)** in his paper discussed that decision-making is a complex activity. Decisions can never be made in a vacuum by relying on the personal resources and complex models, which do not consider the situations. Behavioural finance phenomena can be better understood using models in which some agents are not fully rational (**Nicholas Barberis & Richard Thaler, 2003**).

In a report to identify the common investment mistakes and to provide insights into how investors make the initial decision to invest and why some are reluctant to invest at all, **Elan (2010)** examined that active trading, more related to the past returns, familiarity biases, under diversification etc. are some of the common mistakes made by the investors and financial practitioners. **Chandra and Kumar** found that there are five underlying psychological axes that appear to influence the Indian retail investor's behavior. These five pertinent axes on the basis of the underlying variables are named as prudence and precautious attitude, conservatism, under/over confidence, informational asymmetry, and financial addiction. Thus, there are many studies available some of which support the traditional finance and some are against the theory. Those critics have given birth to the new discipline named behavioral finance.

VI. DISCUSSION:

A. Limitations of Conventional Finance: Alike every research Traditional finance also has its own limitations. Some of them are specifically tabulated below:

a. Concept of Rationality: Conventional finance emphasized on the concept rationality. Rationality means the investors always make the best and proper use of the information they possess and get maximum utility out of it. But many studies [Paul Gerrans et al (2012); Ganesan Balaji (2013); Pal. Mukul (2009); Ricciardi Victor et al (2000) have shown that investors as being the social man, behave in an irrational way because of their social beliefs and emotions. In spite of having important information they just overlook the rationality attitude and become biased in many cases.

b. Informational Accuracy: Conventional Finance focus that the investors have access to all information and stock prices reflect that information instantly. But in practice, this may not be possible because if all the investors may not have access to all information at the same time, the buyer and seller cannot exist same time for same asset class. 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)

c. Role of Experience: According to conventional finance all investors are equally knowledgeable and expert. As such no distinction has been made between an experienced and beginners. But in real experience definitely makes the investors wiser and affects their decision making.

d. **Demographic factors:** Age, income, sex, family background, etc. are the demographic characteristics of investors are not considered by conventional finance, but they influence a lot to decision making abilities.

B. **Growth of Behavioral Finance:** Behavioral finance is a study of the markets that draws on psychology, throwing more light on why people buy or sell, how they buy, and even why they do not buy financial assets at all. This research on investor behavior helps to explain the various 'market anomalies' that challenge standard theory. This is because this anomaly is persistent therefore this behavior exists. The two building blocks of behavioral finance are cognitive psychology and the limits to arbitrage (Ritter, 2003). Cognitive refers to how people think and the limit to arbitrage when markets are inefficient. There is a huge psychology literature documenting that people make systematic errors in the way they think: they always making decision easier (heuristics), overconfidence, put too much weight on recent experience (representativeness), separate decisions that should be combined (mental accounting), wrong presenting the individual matters (framing), tend to be slow to pick up the changes (conservatism), and their preferences may also create distortion when they avoid realizing paper losses and seek to realize paper gains (disposition effect).

C. **Implications of Behavioral Finance principles:** As behavioral finance suggests that Investors financial decision making is not driven only by the equilibrium models and they often prove to be irrational while making investment decisions. As per the principles of behavioral finance human decisions are subject to several cognitive and emotional illusions. Some of those illusions can be grouped as follows:

a. **Cognitive Dissonance:** It tells about the mental discomfort felt by an investor while taking any decision against his belief or attitude. It is a feeling of discomfort or disharmony resulting from the contradiction with the set beliefs or attitudes as stated by Sharma (2014).

b. **Herd Behavior:** Herd means information which has originated from a group and in financial market context an investor who follows a group in respect of his investment decision. Many times investors knowingly or unknowingly shows this type of behavior which is completely against the rationality concept. He takes it for granted that when so many people are there in that direction, they all must have something which is profitable as an investor.

c. **Loss Aversion:** Aversion means the feeling of dislike or disinclination and loss aversion means disliking or feeling uncomfortable about a loss. This psychological feeling was first examined by Kahneman and Tversky (1979) in their famous prospect theory. Tversky (1991) further used this concept in his study about making decisions under certainty. In one study, investors in a company retirement plan chose larger equity allocations after they were shown the actual results of investing in equities over many different 20-year periods. The research suggests that if investors focus on the distribution of outcomes for the whole period, they are more likely to make the correct decision.

d. **Mental Accounting:** Mental Accounting is a concept first named by Richard Thaler in an attempt to describe the way in which a person subjectively frames a transaction in his mind the utility he/she receive or expect. People weigh the money value on the basis of the source from which that income has been generated. Although having the same value investors place different weights on an income earned as interest and income from lottery.

There are many other such theories available in the field of behavioral finance which challenges the conventional finance theories of rational choice.

VII. CONCLUSION

The investors in the securities market they are more prone to herd information and results in high fluctuation of share prices. They give more emphasize to positive and negative information without keeping fundamentals in mind. The growth of behavioral finance in this regard is definitely a positive aspect to better study the investors' behavior. 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. The behavioral finance is a collection of ideas and thoughts which are descriptive and advisory in nature but they are not exhaustive. Behavioral finance is a rapidly growing area that deals with the influence of psychology on the behavior of financial practitioners. The above-mentioned arguments are provided for why movements towards greater psychological realism in finance will improve mainstream finance. Apart from these things this particular area also collectively predict some outcomes where the traditional models failed along with reaches, the same current predictions as the traditional models.

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