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Behavioral Finance in Investor Decision on Investment – A Study on Investor Perspective

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A B S T R A C T

This study is to analyze and understand the investment behavior and preferences of investors and their awareness about products and services provided by the company. Beings that are rational with focus on maximizing their returns but this assumption is flawed as we are here ignoring the biases, emotions, perceptions and other behavioral processes that affect the decisions of investors. Behaviour finance is still a new field of study in India whereas many studies are going on and have been done abroad. This article makes an attempt to compile the theoretical results of some Indian behavioral finance studies and throw light on the behaviour biases present in investors. The study attempts to analyze the behavior of investors towards investment pattern and to analyze the factors which an investor takes into consideration while taking Investment decision. The Study concludes that behavior matters a lot when it comes to making a wise investment decision on expected returns.

A R T I C L E I N F O

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Introduction:

Behaviour finance is a recent area of financial research as far as India is concerned. In the recent years many behaviour finance researches have been conducted in India which have thrown light on the biases and behavioural aspect affecting decision making of Indian investors. Most of the researches conducted

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have accepted that behaviour biases are present in investors and they are not all rational. Anchoring, overconfidence, regret aversion, herd behaviour are the behavioural factors present, affecting decisions of investors. Richard Thaler, a founding father of behavioural finance said "The difference between us is that you assume people are as smart as you are, while I assume people are as dumb as I am." Financial decisions are taken by people who are affected by emotions, biases and other psychological factors. behavioural finance can be define as the field of finance that makes use of social and psychological theories to explain the actions of individuals in trading and other financial decision making . It helps us in understanding why the behaviour of people differs from the traditional financial theories.

Key Elements

- Behavioral finance emergence is based on 3 aspects namely psychological origin, economic origin and financial origin.
- The pillars of behavioral finance are cognitive psychology and the limits to arbitrage.
- Behavioral finance biases can influence investor judgment about how we spend our money and invest.
- Behavioral finance is the study of the effect of psychology on investors and financial markets.

Review of early works

Though the literature of behavioral finance are very large, it is proposed to present some empirical and theoretical studies to focus light and insight to behavioral finance and its application in decision-making.

Chandra Shekhar, Shailesh Kumar Jain, Sunil Deshpande, Pallavi Rai (2018) This study is to analyze and understand the investment behavior and preferences of investors, their awareness about products and services provided by the company. The present changing economic environments have forced difficult decision for companies. In a different scenario understanding, how critical is the survival for the investors on an ongoing basis, however; the management desires current response from the investors, partners and employees in order to endure, innovate and grow.

Jyoti Bhoj (2019) in their study explains the Traditional finance consider humans to be homoeconomicus i.e., beings that are rational with focus on maximising their returns but this assumption is flawed as we are here ignoring the biases, emotions , perceptions and other behavioural processes that affect the decisions of investors. Behaviour finance is still a new field of study in India whereas many studies are going on and have been done abroad. This article makes an attempt to compile the results of some Indian behavioural finance studies and throw light on the behaviour biases present in investors.

Kanan Budhiraja, Dr. T.V. Raman and Dr. Gurendra Nath Bhardwaj (2018) in their study explain about Behavioral finance challenges the traditional financial theory and suggest that multiple biases impact individual investment decisions. The research paper aims to understand how these biases impact investment decision making process and what steps can be taken by individual investors to make rational decisions. Analyzing how practical considerations limit individual decision making, the paper concludes that individual investors need to carefully mine data and consider external factors before undertaking investments.

Charles and R. Kasilingam (2016) in their study is intended to find out the impact of behavioural bias

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factors on investment decision of equity investors. Retail investors who access the Indian equity market from the Tamil Nadu state are taken as respondents for this survey. By utilizing the broad critique of literature, six behavioural bias factors are identified to find out its impact on investors' investment decisions. They are mood, emotions, heuristics, frames, personality and gambling. This study also examines the relationship among these behavioural bias factors.

Prof. Devrshi Upadhyay and Dr. Paresh Shah (2019) This paper seeks to find out the major influence of certain behavioral finance concepts such as overconfidence, perception, Representative, anchoring cognitive Dissonance, Regret Aversion, narrow framing and mental accounting on the decision-making process of individual investors in stock market. The objective was to know effects of behavioral financing on investors and to study the impact and relevance of behavioral financing in investment decision of investors.

Objective of the study

- To the study explain the important relevance of behavioral financing in investment decision of investors.
- To study various behavioral factors influencing the investors while investment decisions.
- To analyze the behavior pattern and their psychology on investors
- To know the preference of people towards investing.

Behavioral finance:

"Behaviour" and "finance" are two different things. But the question is how they can be interlinked in the same phrase?

Behaviour is all about emotions, personalities, psychology, and sociology. And finance is all about numbers, equations, statistics, and balance sheets.

The importance of behavioral finance on investor's decision

The prevalence of behavioural finance in our society was very beautifully demonstrated by John Keynes who was a British economist. In 1936, he stated that market behaviour is analogous to the behaviour of the individuals who have to choose the winner at a "beauty contest". In a beauty contest, the judges select that person as the winner whom his/her peers are likely to select, i.e. the judges are not interested in picking the most beautiful face, but they rather concentrate on selecting the one who is likely to please the other judges. If you notice carefully, you will see the investors use a similar approach of "consensus" wherein they all combine their expectations and act in unison. On the other hand, there are investors who are likely to trade on stocks that are expected to beat the consensus and avoid those stocks whose market value is considerably less than the fundamental value as per the consensus. Therefore, the concept of behaviour is applicable from the moment investors attempt to spot the future behaviour of fellow investors.

Behavioral finance expects individuals to be more influenced by their emotions or reasonable biases rather than taking the rational approach. There are a large number of brains who are not quite willing to accept this discipline as it is often found to be more complex, instinctive, abstract etc. Further, the denial for the discipline is also because it can create doubt in the minds of many about the decisions of sophisticated investors and professional advisors.

Now that you have been familiarised with the basic concept of behavioural finance, let me introduce

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you to the four major themes of behavioural finance: over-confidence, financial cognitive dissonance, regret theory and prospect theory.

- **Over Confidence**

How often do we come across people who apparently over-estimate their own skills and predictions for success. The behaviour of such people is defined to be over-confidence which eventually results in over-estimation of the probable outcomes of an event. Now one such friend of mine is Tarun who is an active investor with long standing experience, but has suffered several losses in the past primarily due to his over-confidence. But what is more disturbing is that he refuses to learn from his previous failed investment decisions.

- **Financial Cognitive Dissonance:**

It is another theory which states that people often feel anxious when they are subjected to their own conflicting beliefs. Most of the individuals try to bring down their inner conflict in either of the two following ways: a) They alter their past values, feelings or opinions. b) They try to rationalize or justify their choice. This theory can be applicable to many of my friends who are traders in the stock market and are required to rationalize their conflicting behaviors in order to make it look as if it followed naturally from their personal values.

- **Regret theory:**

According to this theory an individual usually assesses his expected reactions to a future event or situation based on some regret of the past. The theory can be associated with the emotion instigated by comparison of a given outcome with the outcome of a foregone choice. For instance, Trevor had to decide between investing in an unknown stock and a well-known stock. As an investor he knew that the known stock would give lower return than the unknown one, but he decided to go with the known stock because he is more comfortable with the regret of finding that the unknown stock performed better than the known stock.

- **Prospect Theory:**

On the other hand, prospect theory states that people usually do not behave rationally. So you might come across people who hold onto persistent biases that are motivated by several psychological factors that are triggered under conditions of uncertainty. One such personality is Rishab who considers preferences as a function of "decision weights", but his decision weights tend to overweight small probabilities and underweight moderate and high probabilities which eventually does not quite help his case.

FEW DECISION MAKING BIASES AND ERRORS

Behavioural finance also covers various decision-making biases and errors and few of them are discussed below:

- **Self-deception:** We usually meet people who tend to limit their learning abilities due to self-deception. They are your those colleagues who think they know more than you and as such are not receptive to information that might be required to make an informed decision.
- **Heuristic simplification:** This bias is again associated with people who take into account incorrect and erroneous reasoning or adopt a wrong behaviour to arrive at a decision.

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- **Emotion:** How often do we make a decision out of anger, happiness, ecstasy etc. I am sure we all tend to have many such instances in our day-to-day life. But this is basically how our moods affect our decision making.
- **Social Influence:** As a social being, most of our decisions are largely impacted by our peers which may include investment in a stock because most of our friends invested in that.

The role of behavioral finance in investment decisions

- The field of behavioural finance attempts to better understand and explain how emotions and cognitive errors influence investors in their decision-making process. Behavioural finance is different in its view from the traditional belief in that investment decisions are not always made on the basis of full rationality.
- Behavioral finance is the study of the effects of psychology on investors and financial markets. It focuses on explaining why investors often appear to lack self-control, act against their own best interest, and make decisions based on personal biases instead of facts.
- Behavioral finance helps us understand how financial decisions around things like investments, payments, risk, and personal debt, are greatly influenced by human emotion, biases, and cognitive limitations of the mind in processing and responding to information.
- Human psychology plays an important role in how individuals make investment decisions. Many investors are their own worst enemy. The risk of how some people make investment decisions is often more significant than the risk of the investment itself. Many think that investing is the domain of economists and mathematicians. Those disciplines have their role, however, successful investing requires an understanding of human tendencies.
- Financial theory suggests investors are risk adverse. They will avoid taking on excess risk and buy or sell investments in order to lessen risk. In the real world investors who are facing a potential loss will often take on additional risk in the hope they will recover that loss. Even when the best strategy is to sell, they continue to hold the investment.
- The opposite is true when the investor has a gain. Those investors are risk adverse and are more likely to sell at a profit versus risk continuing to own that investment.
- Investment success is difficult. After tax, after investment fees, and after inflation, it is very difficult for most investors to achieve the amount of returns they had hoped for. Add to that difficulty, the fact that human behaviour is not always logical makes achieving long-term investment success even more difficult.
- My perception is to accept human tendencies as fact and try to develop strategies that will help you resist making poor investment choices based on normal human behaviour.
- The key is to accept the fact that you too share these human tendencies, versus being in denial and thinking you are different. You are different as an individual however financial research would suggest most humans make this mistake.
- Another human tendency is to overstate the amount of risk they can tolerate. This can be dangerous during periods of stock market volatility.
- Human behaviour will play an important role in your long-term investment success. I encourage you to consider these variables in order for you to make better investment decisions.

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Types of Behavioral finance

Behavioral finance biases can make or break your journey to building wealth. The truth at the heart of behavioral finance is the fact that we are not rational decision makers when it comes to our money. The following five psychological and emotional aspects of an investor's behavior have a huge impact on the investment decisions they make.

1. Overconfidence

- Results from good stock picking over a short time period.
- Can often lead to over trading.

2. Familiarity Bias

- Investing primarily in their country of residence because it is familiar.
- This also includes investing a large portion of your portfolio in the company that you work for. Having a high percentage of your assets as well as your income in your company heightens your risk and offers little diversification if your company experiences a time of financial difficulty.

3. Hindsight Bias

- Investor believes they predicted a particular past event, which in fact they did not
- This leads to overconfidence and the investor thinking they can predict future events.
- Picking a fund based on how it has performed lately or fear of missing out on future gains.

4. Naive Diversification

- Investing in every option available to the investor in their 401k plan.
- Using a large number of fund choices so you "feel" more diversified.

5. Belief Perseverance

- Avoiding changes to their belief in an investment, even if new information contradicts their original reason for investing
- Sticking to a flawed investment strategy.

Impact of behavioral finance on investment decision

Behavioral finance is the study of the influence of psychology on the behavior of investors. It also includes the subsequent effects on the markets. It focuses on the fact that investors are not always rational, have limits to their self-control, and are influenced by their own biases.

1. Traditional Financial Theory

In order to better understand behavioral finance, let's first look at traditional financial theory.

- Traditional finance includes the following beliefs:
- Both the market and investors are perfectly rational
- Investors truly care about utilitarian characteristics
- Investors have perfect self-control

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- They are not confused by cognitive errors or information processing errors.

2. Behavioral Finance Theory

Now let's compare traditional financial theory with behavioral finance.

Traits of behavioral finance are:

- Investors are treated as "normal" not "rational"
- They actually have limits to their self-control
- Investors are influenced by their own biases
- Investors make cognitive errors that can lead to wrong decisions

Financial biases

Behavioral finance seeks an understanding of the impact of personal biases on investors. Here is a list of common financial biases.

Common biases include:

- Overconfidence and illusion of control
- Self Attribution Bias
- Hindsight Bias
- Confirmation Bias
- The Narrative Fallacy
- Representative Bias
- Framing Bias
- Anchoring Bias
- Loss Aversion
- Herding Mentality

Overcoming Behavioral Finance Issues

There are ways to overcome negative behavioral tendencies in relation to investing. Here are some strategies you can use to guard against biases.

1. Focus on the Process

There are two approaches to decision-making:

- Reflexive – Going with your gut, which is effortless, automatic and, in fact, is our default option
- Reflective – Logical and methodical, but requires effort to engage in actively

Relying on reflexive decision-making makes us more prone to deceptive biases and emotional and social influences.

2. Prepare, Plan and Pre-Commit

Behavioral finance teaches us to invest by preparing, by planning, and by making sure we pre-commit.

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Let's finish with a quote from Warren Buffett.

"Investing success doesn't correlate with IQ after you're above a score of 25. Once you have ordinary intelligence, then what you need is the temperament to control urges that get others into trouble."

Conclusion

Investment decision in India is taken into consideration by perception, by word of mouth, by pass returns and honestly investment decision. India is not taking seriously and lack proper planning for the long term investment rather it is done quickly and no proper detail review regarding investment takes place. Behavioral finance provides explanations for why investors make irrational financial decisions. It demonstrates how emotions and cognitive errors influence investors in the decision making process. It offers many useful insights for investment professionals and thus provide framework for evaluating active investment strategies for investment.

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