



The Influence of Behavioral Finance on Investment Decision Making

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ABSTRACT

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Traditional finance theories propose that individuals make rational investment decisions by carefully weighing risk and return factors to maximize gains while minimizing losses. However, behavioral finance challenges this notion by suggesting that various biases influence individual investment decisions. These biases include heuristic biases like anchoring, representativeness, and the gambler's fallacy, as well as psychological phenomena such as regret aversion, framing, and the disposition effect, as outlined in prospect theory. This research paper seeks to examine the impact of these biases on the investment decision-making process and explore strategies that individual investors can employ to make more rational decisions. By analyzing how practical considerations constrain individual decision-making, the paper concludes that investors must diligently gather and analyze data while considering external factors before making investment decisions.

Key words: prospect theory, heuristic biases, behavioral finance, traditional finance theories, investment.

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1. INTRODUCTION

Early investment theories propose that investors act rationally, aiming to maximize returns while minimizing risks. However, recent theories challenge these assumptions, recognizing that human behavior is not always rational, and markets are not always efficient. Psychological factors such as greed and fear can significantly influence investment decisions. For example, while conventional wisdom might suggest that investing in the stock market is advantageous for a certain type of investor, the fear of loss—especially after witnessing others lose money in the market—can sway their decision-making process. This recognition led to the emergence of behavioral finance as a crucial field of study.

Behavioral finance explores how psychological and emotional factors heavily influence investment decisions. Olsen (1998) asserts that behavioral finance not only incorporates traditional finance principles related to rational decision-making and maximizing returns but also acknowledges individual behavior as a key determinant of investment outcomes. Shefrin (1988) observes that behavioral finance examines how psychology shapes financial decisionmaking and affects financial markets. Traditional finance theory assumes rationality among individuals and efficiency within economic models. However, as research on financial decision-making deepens, it becomes evident that human emotions, intentions, intuitions, and habits significantly influence financial choices.

Slovic (1972) underscores in his research that traditional financial theories fall short and those various psychological processes drive individuals' investment decisions. Belsky and Gilovich (1999) liken behavioral finance to behavioral economics, which integrates psychology and economics to elucidate why individuals make irrational decisions regarding investing, saving, earning, and spending. Chaudhary (2013) argues that human behavior is susceptible to various anomalies, leading individuals to make decisions that contradict fundamental principles of wealth maximization.

2. BEHAVIORAL BIASES

(Agrawal, 2012) observes that behavioral biases have a significant impact on investors' judgment, and while it's not feasible to entirely eliminate them, it's crucial to mitigate specific biases in certain situations. (Rayenda Khresna Brahmana, 2012) reinforces the notion that psychological factors influence stock price anomalies and financial decision-making, outlining the factors contributing to irregularities in such decisions. Numerous cognitive biases identified by psychologists shed light on human behavior and decision-making processes. Some of these biases include:

Heuristics

(Kahneman D., 2003) defines heuristics as mental shortcuts or rules of thumb that aid decision-making by simplifying complex questions. Individuals often make rapid judgments based on personal experience, trial and error, or simple experimentation. While heuristics may facilitate decision-making in some cases, they often overlook or inadequately consider crucial factors affecting investments. Heuristic decision-making processes are influenced by various behavioral biases, including:

Representativeness

Investors tend to categorize and generalize based on past successes, influencing their future decisions. They may perceive patterns where none exist, disregarding the law of averages or long-term trends. Short-term trends, such as recent stock price increases or outperformance of certain industries, receive undue emphasis. According to (Bondt, 1998), investor analyses often rely on recent successes and failures, biasing their judgment toward future investments.

Anchoring

Investors often fixate on a single piece of information when making decisions, neglecting other relevant data. This anchoring bias can lead to significant underestimation or missed opportunities. (G. Hoguet, 2005) found that investors tend to anchor their expectations to specific information, leading to under-reaction to new information.

Overconfidence

While confidence in one's ability to achieve above-average returns is beneficial, excessive confidence can distort investment decisions. Overconfidence bias arises when investors overestimate their ability to evaluate stocks or industries, potentially leading to excessive trading and skewed results. Without considering past trends or future expectations, overconfident investors rely excessively on their judgment.

Gambler's Fallacy

Investors may mistakenly believe that trends will reverse, similar to the fallacy observed in gambling. This bias leads investors to anticipate a reversal in underperforming stocks, akin to expecting a change in roulette outcomes after a series of black numbers. According to (Cai, 2016), this bias stems from an individual's misconception of probable outcomes based on past events.

Availability Bias

Investors often base decisions on readily available information, such as recent news or peer recommendations. This bias leads to reliance on easily recalled information, potentially resulting in flawed decision-making. (Qawi, 2010) notes that the more salient and recent an event, the greater its influence on decision-making.

Conservatism

Conservatism bias entails insufficiently revising beliefs when presented with new information, leading individuals to under-react to changing trends. Investors may anchor themselves to existing situations, resisting

adjustment even in the face of significant changes. (Singh S., 2012) explains that conservatism bias contradicts representativeness bias, as investors may be slow to react to changes but may over-react to long-term patterns.

2.1. Prospect Theory

According to economists, utility refers to the usefulness an individual derives from a particular object or service. Traditional finance theories posit that the net benefit from any investment is the sum of gains and losses experienced by the individual over the long term. However, individuals often deviate from rational behavior, as demonstrated by the theory developed by (Kahneman & Tversky, Prospect Theory: An Analysis of Decision under Risk, 1979). Prospect theory suggests that people evaluate potential gains and losses differently, displaying a preference for potential gains over potential losses, even when the net outcome of both options is identical. Thus, options framed in terms of potential gains are typically favored over those framed in terms of potential losses. Several biases contribute to this behavior, including:

Framing

In behavioral finance, framing refers to the wording used to present a particular problem or solution. When investors are presented with various investment choices, they tend to prefer options framed in terms of potential gains over those framed in terms of potential losses. Individuals generally find potential losses more distressing than potential gains. For instance, a loss of Rs. 500 is perceived as twice as distressing as a gain of Rs. 500. (Levin & Schneider, 1998) describe framing in three forms: risky choice framing, attribute framing, and goal framing.

Loss Aversion

Loss aversion refers to individuals' tendency to prioritize avoiding losses over acquiring equivalent gains. Losses are perceived as being twice as impactful as gains of the same magnitude. For example, when faced with a 50-50 chance of gaining \$500 or losing \$450 in a gamble, individuals are often unwilling to accept the bet due to the perceived greater impact of the loss. This bias may lead investors to engage in counterproductive behavior, such as purchasing poorly performing stocks to recoup previous losses.

Regret Aversion

Regret aversion describes individuals' tendency to experience regret over unfavorable outcomes. Investors may regret making poor investment decisions more than the actual losses incurred. This aversion to regret can influence financial decisions, such as avoiding investments in poorly performing stocks or following herd behavior to avoid feeling left out.

Mental Accounting

Mental accounting bias involves individuals segregating their money and investments into separate mental accounts based on criteria such as income source and intended use. This practice may serve as a form of self-control, as individuals attempt to prevent overspending by compartmentalizing their finances. However, this approach may lead to missed opportunities for portfolio diversification.

Disposition Effect

The disposition effect suggests that individuals tend to realize paper gains while avoiding paper losses. Investors often hold onto losing investments in the hope of recouping losses, while selling winning investments too soon. This behavior may lead to suboptimal investment decisions, such as holding onto underperforming assets for extended periods while prematurely selling outperforming ones.

3. IMPLICATIONS FOR FINANCIAL MARKETS

Supporters of the Efficient Market Hypothesis (EMH) argue that market anomalies are automatically adjusted, driving stocks to their fundamental prices, and that behavioral biases do not significantly impact markets. They attribute market changes to various factors rather than individual behaviors, believing that thorough analysis of stocks and consideration of past trends and current news can reveal that market changes are merely chance occurrences, not influenced by biases.

However, the presence of anomalies in financial markets led to the emergence of behavioral finance. These anomalies challenge the assumption of rationality and logic in all investors, which is fundamental to traditional finance theories. Some notable anomalies include:

- January Effect: Small firm returns are consistently higher in January compared to other months, contradicting the EMH.
- Winner's Curse: Traders tend to pay more than the true value of assets in auctions, contrary to the EMH's expectation of investors paying according to asset value awareness.
- Equity Premium Puzzle: Traditional theories suggest that stock equity premiums should be lower, but behavioral finance proposes that loss aversion bias necessitates higher premiums to compensate for aversion to loss.

Proponents of behavioral finance argue that while not all biases affect all investors simultaneously, some biases are prevalent and impact the financial market overall. For instance, heuristic biases like representativeness and anchoring can lead to overoptimism about past-performing stocks and pessimism about underperforming ones, causing share prices to deviate from their fundamental values. These biases can result in several issues, including:

- Over or underreactions to price change news
- Ignoring fundamental stock price information
- Extrapolating future trends from past trends
- Giving undue preference to "hot" stocks

4. SUGGESTIONS FOR INVESTORS

While it's impossible for investors to completely eliminate biases, recognizing their presence is crucial for making rational investment decisions that maximize returns and minimize losses. Here are some strategies to mitigate biases:

- Awareness: Informed investors who understand the biases affecting investment decisions are better equipped to address them.
- Seek Diverse Perspectives: Investors should seek out sources with different viewpoints and compare data and reasoning to make more informed decisions.
- Diversification: Spreading investments across various industries and sectors reduces the risk of losing the entire investment while potentially increasing returns.
- Set Investment Goals: Clarifying and quantifying investment goals helps investors avoid behavioral biases when making short-term decisions to achieve long-term objectives.
- Analyze Trends: While past winners may seem appealing, it's important to recognize that previous performance doesn't guarantee future success. Investors should avoid placing excessive emphasis on past performance and expecting continued success.
- Learn from Mistakes: Mistakes are inevitable, but it's crucial to learn from them and apply those lessons to avoid repeating them in the future. Traders and investors should track their mistakes and use them as learning opportunities to improve their decisionmaking process.

5. CONCLUSIONS

Traditional finance theorists and behavioral finance economists often find themselves in disagreement. While extensive research has been conducted on behavioral finance, there hasn't been a definitive study that conclusively attributes stock market anomalies solely to behavioral biases. However, numerous significant studies have contributed to this field, such as the groundbreaking work by Kahneman and Tversky on Prospect Theory in 1979, and by Kahneman, Knetsch, and Thaler on Endowment Theory in 1991.

The field of behavioral finance has witnessed significant growth in recent years. Despite this, it doesn't completely invalidate the efficient market hypothesis. Instead, it offers several explanations for why anomalies may occur in an efficient market and why stock prices may deviate from their fundamental values. Behavioral finance theories hold particular relevance for individual investors, as behavioral biases and psychological differences significantly influence the investment decision-making process.

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