



Behavioral Finance: A Better way to Understand Financial Market

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ABSTRACT *Can we think of the stock market as a person? It has moods, it can be ornery or lively, and it can overreact one day and under react on next day, and so on. There is growing field of Behavioral finance which involves study of moods of market. It assumes that investors are not as rational as traditional theory has assumed, but their psychology and biases in their decision-making impact stock prices. Behavioral finance studies psychological theory with conventional economics and finance and provides explanations about why people make irrational financial decisions. At times people behave irrationally and their behavior could not be understood by traditional theories of CAPM and EMH. While these theories could explain certain "idealized" events. The fact is people frequently behave irrationally. These anomalies prompted academics to look to cognitive psychology to account for the irrational and illogical behaviors that modern finance had failed to explain.*

Can we think of the stock market as a person? It has moods, it can be ornery or lively, and it can overreact one day and under react on next day, and so on. This does not sound practically possible, but psychology help us to understand the financial markets better.

There is one growing field named as Behavioral finance and many academics of the field had studies the moods of market. The idea behind this field is simple: Investors are not as rational as traditional theory has assumed, but their psychology and biases in their decision-making impact stock prices.

Conventional or Traditional Finance

"Conventional" or "Traditional" finance, is based on rational and logical theories, such as the capital asset pricing model (CAPM) and the efficient market hypothesis (EMH). Considering people are rational and there are no frictions, a security's price equals its "fundamental value". Here "fundamental value" is the discounted sum of expected future cash flows. The hypothesis that actual prices reflect fundamental values is the Efficient Markets Hypothesis (EMH).

The EMH does not assume that all investors are rational, but it does assume that markets are rational. The EMH does not assume that markets can foresee the future, but it does assume that markets make unbiased forecasts of the future.

Efficient Market Hypothesis

A generation ago, the efficient market hypothesis was widely accepted by academic financial economists were developed by Eugene Fama's in 1970. It was generally believed that securities markets were extremely efficient in reflecting information about individual stocks and about the stock market as a whole.

The efficient markets hypothesis (EMH) popularly known as the Random Walk Theory, is the proposition that current stock prices fully reflect available information about the value of the firm, and there is no way to earn excess profits, (more than the market over all), by using this information.

The efficient markets hypothesis (EMH) suggests that profiting from predicting price movements is very difficult and unlikely. The main engine behind price changes is the arrival of new information. A market is said to be "efficient" if prices adjust quickly and, on average, without bias, to new information. As a result, the current prices of securities reflect all available information at any given point in time.

Consequently, financial researchers distinguish among three versions of the Efficient Markets Hypothesis, depending on what is meant by the term "all available information".

The weak form of the efficient markets hypothesis asserts that the current price fully incorporates information contained in the past history of prices only. The weak form of the hypothesis implies with a reason – security prices are arguably the most public as well as the most easily available pieces of information.

The semi-strong-form of market efficiency hypothesis suggests that the current price fully incorporates all publicly available information. Public information includes not only past prices, but also data reported in a company's financial statements, earnings and dividend announcements, announced merger plans, the financial situation of company's competitors, expectations regarding macroeconomic factors (such as inflation, unemployment), etc. In fact, the public information does not even have to be of a strictly financial nature.

The strong form of market efficiency hypothesis states that the current price fully incorporates all existing information, both public and private (sometimes called inside information). The main difference between the semi-strong and strong efficiency hypotheses is that in the latter case, nobody should be able to systematically generate profits even if trading on information not publicly known at the time. In other words, the strong form of EMH states that a company's management (insiders) are not be able to systematically gain from inside information by buying company's shares ten minutes after they decided (but did not publicly announce) to pursue what they perceive to be a very profitable acquisition

If the strong-form efficiency hypothesis is correct, then insiders should not be able to profit by trading on their private information.

The EMH became controversial especially after the detection of certain anomalies in the capital markets. The presence of anomalies in conventional economic theory was a big contributor to the formation of behavioral finance.

The Effect of Efficiency: Non-Predictability

According to EMH, as prices respond only to information available in the market no one will have the ability to out-profit anyone else. This "random walk" of prices, commonly spoken about in the EMH school of thought, results in the failure of any investment strategy that aims to beat the market consistently. In the real world of investment, however, there are obvious arguments against the EMH. There are investors who have beaten the market - Warren Buffett, whose investment strategy focuses on undervalued stocks, made millions and set an example for numerous followers. There are portfolio managers who have better track records than others, and there are investment houses with more renowned

research analysis than others. So how can performance be random when people are clearly profiting from and beating the market?

Anomalies

The presence of regularly occurring anomalies in conventional economic theory was a big contributor to the formation of behavioral finance. These so-called anomalies, and their continued existence, directly violate modern financial and economic theories, which assume rational and logical behavior. The following is a quick summary of some of the anomalies found in the financial literature.

January Effect

The first anomaly is the January Effect: "blue Monday on Wall Street" is a saying that discourages buying on Friday afternoon and Monday morning because of the weekend effect, the tendency for prices to be higher on the day before and after the weekend than during the rest of the week.

The January effect is a pattern that shows higher returns tend to be earned in the first month of the year. The average monthly return for small firms is consistently higher in January than any other month of the year. This is at odds with the efficient market hypothesis, which predicts that stocks should move at a "random walk".

However, 2004 a study by I M Pandey, Professor at IIM, Ahmedabad, studied about this seasonal or so called January effect on Indian stock price for the 11 years (from April 1991 to March 2002). The author used monthly returns data for the same period.

The results of the study imply that the stock market in India is inefficient, and hence, investors can time their share investments to improve returns. The existence of the seasonal effect negates the weak form of the EMH and implies market inefficiency.

The analysis of descriptive statistics showed that the maximum average return (positive) occurred in the month of February and lowest (negative) in the month of March. The results of the study indicate that stock returns in India are not entirely random. This implies that the Indian stock market may not be informational efficient. As a consequence, perhaps investors can improve their returns by timing their investments. Therefore, some unconventional factor (other than the random-walk process) must be creating this regular pattern.

Equity Premium Puzzle

Equity premium is another big anomaly which contradicts to the CAPM model. According to the capital asset pricing model (CAPM), investors that hold riskier financial assets should be compensated with higher rates of returns. In a paper written by Professor, Rajnish Mehra, the average returns on equity has far exceeded the average return on short-term virtually default-free debt. He observed that average real annual yield on S & P 500 for ninety-year period 1889-1978 was seven (7) %, while the average yield on short-term debt was less than one percent (1) %. The question is why such large difference is there. The most probable answer is higher the risk higher the return.

The equity premium is the return earned by a risky security, such as a stock, in excess of that earned by a risk free security, such as a Treasury Bill. The average annual real return (that is, the inflation-adjusted return) on the U.S. stock market for the past 115 years has been about 7.5 percent. In the same period, the real return on a relatively riskless security was a paltry 1.0 percent. The difference between these two returns, 6.5 percentage points, is the equity premium.

However, academics believe that an equity premium of 6-7% is extremely large and would imply that stocks are considerably risky to hold over bonds. Conventional economic models have determined that this premium should be much lower.

Behavioral finance's answer to the equity premium puzzle revolves around the tendency for people to have "myopic loss aversion", a situation in which investors - overly preoccupied by the negative effects of losses in comparison to an equivalent amount of gains - take a very short-term view on an investment. While it is not uncommon for an average stock to fluctuate a few percentage points in a very short period of time, a myopic (i.e., shortsighted) investor may not react too favorably to the downside changes. Therefore, it is believed that equities must yield a high-enough premiums to compensate for the investor's considerable aversion to loss. Thus, the premium is seen as an incentive for market participants to invest in stocks instead of marginally safer government bonds.

Conventional financial theory does not account for all situations that happen in the real world. This is not to say that conventional theory is not valuable, but rather that the addition of behavioral finance can further clarify how the financial markets work.

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