



Analysis of Investor's Decision Making Patterns by Applying Behavioral Finance Factors: Overconfidence & Herd Behavior Bias

KEYWORDS

Behavioral Finance, Overconfidence, Herd Behavior

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ABSTRACT Decision-making can be defined as the process of choosing a particular alternative from a number of alternatives. It is an activity that follows proper evaluation of all the alternatives and select best alternative. Behavioral finance is a relatively new field that seeks to combine behavioral and cognitive psychological theory with conventional economics and finance to provide explanations for why people make irrational financial decisions. In this research paper we will discuss some of the underlying reasons and biases that cause some people to behave irrationally. Human beings are susceptible to numerous behavior biases which became counterproductive to the wealth maximization principles leading to irrational behavior. This research examines the meaning and importance of behavioral finance and its application in investment decisions of investors in Kanpur.

Introduction:

Behavioral finance studies the psychology of financial decision-making. Most people know that emotions affect investment decisions. People in the industry commonly talk about the role greed and fear play in driving stock markets. Behavioral finance extends this analysis to the role of biases in decision making, such as the use of simple rules of thumb for making complex investment decisions. In other words, behavioral finance takes the insights of psychological research and applies them to financial decision-making.

Behavioral finance has been growing over the last twenty years specifically because of the observation that investors rarely behave according to the assumptions made in traditional finance theory.

Behavioral researchers have taken the view that finance theory should take account of observed human behavior. They use research from psychology to develop an understanding of financial decision-making and create the discipline of behavioral finance. This guide summarizes the findings of these ground-breaking financial theorists and researchers.

BIASES IN FINANCIAL MARKET:

There are many biases (Overconfidence, Loss aversion, Framing, Mental Accounting, Availability, and Herd Behaviour) which affect investor's behavior in financial markets but here in this research paper we are only discussing about overconfidence bias and herd behavior bias in detail.

Herd Behavior Bias-

Herd behaviour, which is the tendency for individuals to mimic the actions (rational or irrational) of a larger group. Individually, however, most people would not necessarily make the same choice.

There are a couple of reasons why herd behavior happens. The first is the social pressure of conformity. You probably know from experience that this can be a powerful force. This is because most people are very social and have a natural desire to be accepted by a group, rather than be branded as an outcast. Therefore, following the group is an ideal way of becoming a member.

The second reason is the common rationale that it's unlikely that such a large group could be wrong. After all, even if you are convinced that a particular idea or course of action is irrational or incorrect, you might still follow the herd, believing they know something that you don't. This is especially prevalent in situations in which an individual has very little experience.

The Dotcom Herd-

Herd behaviour was exhibited in the late 1990s as venture capitalists and private investors were frantically investing huge amounts of money into internet-related companies, even though most of these dotcoms did not (at the time) have financially sound business models. The driving force that seemed to compel these investors to sink their money into such an uncertain venture was the reassurance they got from seeing so many others do the same thing.

A strong herd mentality can even affect financial professionals. The ultimate goal of a money manager is to follow an investment strategy to maximize a client's invested wealth. The problem lies in the amount of scrutiny that money managers receive from their clients whenever a new investment fad pops up. For example, a wealthy client may have heard about an investment gimmick that's gaining notoriety and inquires about whether the money manager employs a similar "strategy".

In many cases, it's tempting for a money manager to follow the herd of investment professionals. After all, if the aforementioned gimmick pans out, his clients will be happy. If it doesn't, that money manager can justify his poor decision by pointing out just how many others were led astray.

Overconfidence Bias-

People have a tendency to be overly confident about own capabilities and level of knowledge. Psychological research has discovered many ways how overconfidence affects human behavior in several fields. The effects of overconfidence are strongly present in difficult decisions that include uncertainty. Thus financial decision making is very likely affected by overconfidence. Overconfidence appears in several forms, such as 'better than average', 'optimism bias' and 'setting too narrow confidence limits'.

Studies of overconfidence have typically examined people's confidence in their ability to answer general knowledge questions, but similar results have also been found in financial settings. Results imply that people suffer from overconfidence also in financial decision making. The effects of overconfidence on financial decisions are serious and can be risky to financial well being. Overconfident investors trade more, believe returns to be highly predictable and expect higher returns than what less confident people do. In similar overconfident investors will overestimate the value of their private information, causing them to trade actively. However, active trading does not lead to better performance. Many behavioral financial analysts, who study trading behavior of households, find that households that trade frequently earn much lower net annualized geometric mean return than those that trade infrequently. Thus overconfidence can be hazardous to individual's wealth.

Research Methodology:

Research Design:

To check the applicability of Behavioral finance, it is essential to conduct a sample survey among the investors. This is to know the investing behavior of the investors. A questionnaire has been designed to get information.

RESEARCH TYPE:

Descriptive Research

SAMPLE DESIGN AND SIZE:

The sample size for the survey is 20 (10 investors having less than five years experience and other 10 investors having more than five years experience).

Tool for data collection: Questionnaire

Hypothesis Testing-

First Hypothesis-

Ho: There is no significant relation between confidence level of investors and experience of investors .

H1: There is significant relation between confidence level of investors and experience of investors.

For testing this hypothesis I have applied nonparametric 2 sample independent test that is Mann-Whitney test.

Mann-Whitney Test-

Ranks				
	trading experience	N	Mean Rank	Sum of Ranks
confidence score	less than five years	10	6.40	64.00
	more than five years	10	14.60	146.00
	Total	20		

Test Statistics ^a	
Mann-Whitney U	9.000
Wilcoxon W	64.000
Z	-3.149
Asymp. Sig. (2-tailed)	.002
Exact Sig. [2*(1-tailed Sig.)]	.001 ^b
a. Grouping Variable: trading experience	
b. Not corrected for ties.	

Result-

As significant level is (.002) that is less than (.05' level of significance), so null hypothesis rejected and alternate hypothesis accepted means there is significant relation between investor's trading experience and their confidence level.

Second Hypothesis-

Ho: There is no significant relation between Herd Behaviour of investors and experience of investors.

H1: There is significant relation between Herd Behaviour of investors and experience of investors.

Mann-Whitney Test

Ranks				
	trading experience	N	Mean Rank	Sum of Ranks
% of your trading strategies based on herd behaviour	less than five years	10	14.65	146.50
	more than five years	10	6.35	63.50
	Total	20		

Test Statistics ^a	
	% of your trading strategies based on herd behavior
Mann-Whitney U	8.500
Wilcoxon W	63.500
Z	-3.147
Asymp. Sig. (2-tailed)	.002
Exact Sig. [2*(1-tailed Sig.)]	.001 ^b
a. Grouping Variable: trading experience	
b. Not corrected for ties.	

Result-

As significant level is (.002) that is less than (.05' level of significance), so null hypothesis rejected and alternate hypothesis accepted means there is significant relation between investor's trading experience and their herd behaviour level.

Conclusion:

As it is clear from hypothesis testing that the investors having more than five years experience are more confident or overconfident about their trading strategies(mean rank is 14.60) and investors having less than five years experience are less confident about their trading strategies(mean rank is 6.40). So experience of investors and confidence level of investors is significantly related.

It is also clear from hypothesis testing that the investors having more than five years experience are showing less herd behaviour in their trading strategies(mean rank is 6.35) and investors having less than five years experience are showing more herd behaviour in their trading strategies(mean rank is 14.65). So experience of investors and herd behaviour of investors is significantly related.

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