



Investment Decision Using Behavioural Finance

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ABSTRACT

This article provides brief introduction to behavioural finance. It has often been said that people spend too much time studying investment behaviour and not enough time focusing on investor behaviour. Regardless of what an investment does, it is the decision of the investor to buy or sell that ultimately determines success or failure. This fact is the underlying premise in behavioural finance.

Behavioural finance is about the odd behaviours that we exhibit when it comes to money. It took a very logical premise about the trade off between risk and return and added psychology.

Keywords: Behavioural finance, investment behaviour, psychology, risk and return

INTRODUCTION:

Behavioural finance is the paradigm where financial markets are studied using models that are less narrow than those based on Von Neumann-Morgenstern expected utility theory and arbitrage assumptions. Specifically behavioural finance has two building blocks: cognitive psychology and the limits to arbitrage. Cognitive refers to how people think. There is a huge psychology literature documenting that people make systematic errors in the way that they think; they are over confident, they put too much weight on recent experience, etc. Their preferences may also create distortions. Behavioural finance uses this body of knowledge, rather than taking the arrogant approach that it should be ignored. Limits to arbitrage refer to predicting in what circumstances arbitrage forces will be effective, and when they won't be.

Behavioural finance uses models in which some agents are not fully rational, either because of preferences or because of mistaken beliefs. Mistaken beliefs arise because people are bad Bayesians. Modern finance has as a building block the Efficient Market Hypothesis (EMH), introduced by Markowitz in 1952 and subsequently named by Fama in 1970 assumes that financial markets incorporate all public information and asserts that share prices reflect all relevant information. The EMH argues that competition between investors seeking abnormal profits drives prices to their "correct" value. 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. In contrast, behavioural finance assumes that in some circumstances, financial markets are informational inefficient.

IS PSYCHOLOGY REALLY IMPORTANT TO INVESTING?

To understand the answer to this question is to ask yourself how you feel about the markets today? If you are not feeling the emotions of concern, fear, frustration, desperation, panic and depression, than you would be considered either a very logical investor or one that has no clue about what is going on in the world today.

The fact of the matter is markets go in cycles, just everything else. The reality is that every bear market is the beginning of a new bull market. It is also a historical fact that every bull market has lasted about 3 to 4 times longer than bear markets. Yet, despite these logical facts, emotion often gets the best of us.

Why is it we all tend to rush out and buy equities at the height of the market? Why is it that we tend to sell at the bottom of the markets when they are at their cheapest prices? When do we tend to buy the best performing investments?

Here are few common examples of in the world of behavioural finance. If you can recognise these patterns of behaviour, than you may have the fortitude to prevent emotions from getting in the way of investing.

1. Innumeracy: this term refers to the inability of our minds to process problem solving easily. As a result, we tend to underestimate the frequency of randomness. Instead we label them as coincidence. If you flip a coin 20 times, what is the probability of flipping four heads in a row or four tails in a row? Most people think the odds are pretty low because they do not have a good sense of how easy it is for coincidences to occur. The answer is 50%. The key problem to innumeracy is we always try to develop patterns to investments, guessing as to when they will go up or down. The reality is there is a certain amount of randomness that occurs particularly in the short term.
2. Mental short cuts: our brain naturally develops mental short cuts otherwise known as rules of thumb. This helps our brain to organise and process information more quickly. For example we tend to say we flipped a coin five times and the first four times we flipped a head. What is the probability that the fifth flip will be another head? Most people would say pretty slim but the answer is 50/50. The last flip is an event of its own. We tend to over interpret random events. A good example of this is when someone says "i will never buy a mutual fund again". This tends to be an over generalization that all mutual funds are bad or risky. The reality is there are good funds and bad ones.
3. Availability: You can't make an informed decision without proper information an research. Unfortunately investors who make uninformed decisions are more susceptible to making poor decision fuelled by emotion. The information that is more readily available tends to shape your behaviour. The media is a good example of this. Which is more common, suicides or murders? Most people (around 70%) would answer murder buy there are three suicides for every two murders in north America. What shapes our misconception is that the media reports way more murders than suicides. In the investment world media continues to play a huge role in shaping the availability of

information. When times are good, headlines and news reports tend to be optimistic causing us to have an overly optimistic view of the future. The opposite is true when times are tough like today. The one thing to keep in mind is the media is a business and they are there to heighten our interest and our emotions.

COGNITIVE BIASES :

Cognitive psychologists have documented many patterns regarding how people behave.

Some of these patterns are as follows:

Heuristics

Heuristics, or rules of thumb, make decision-making easier. But they can sometimes lead to biases, especially when things change. These can lead to suboptimal investment decisions. When faced with N choices for how to invest retirement money, many people allocate using the 1/N rule.

Overconfidence

People are overconfident about their abilities. Entrepreneurs are especially likely to be overconfident. Overconfidence manifests itself in a number of ways. One example is too little diversification, because of a tendency to invest too much in what one is familiar with. Thus, people invest in local companies, even though this is bad from a diversification viewpoint because their real estate (the house they own) is tied to the company's fortunes. Men tend to be more overconfident than women.

Mental Accounting

People sometimes separate decisions that should, in principle, be combined. For example, many people have a household budget for food, and a household budget for entertainment.

Framing

Framing is the notion that how a concept is presented to individuals matters. For example, restaurants may advertise "early-bird" specials or "after-theatre" discounts, but they never use peak-period "surcharges." They get more business if people feel they are getting a discount at off-peak times rather than paying a surcharge at peak periods, even if the prices are identical. Cognitive psychologists have documented that doctors make different recommendations if they see evidence that is presented as "survival probabilities" rather than "mortality rates," even though survival probabilities plus mortality rates add up to 100%.

Representativeness

People underweight long-term averages. People tend to put too much weight on recent experience. This is sometimes known as the "law of small numbers."

Conservatism

When things change, people tend to be slow to pick up on the changes. In other words, they anchor on the ways things have normally been. The conservatism bias is at war with the representativeness bias.

Disposition effect

The disposition effect refers to the pattern that people avoid realizing paper losses and seek to realize paper gains. The disposition effect shows up in aggregate stock trading volume. During a bull market, trading volume tends to grow. If the market then turns south, trading volume tends to fall.

One of the major criticisms of behavioural finance is that by choosing which bias to emphasize, one can predict either under reaction or overreaction. This criticism of behavioural finance might be called "model dredging." In other words, one can find a story to fit the facts to ex post explain some puzzling phenomenon. Barberis and Thaler (2002) and Hirshleifer (2001) emphasize that there is a tendency for people to excessively rely on the strength of information signals and under-rely on the weight of information signals. This is sometimes described as the salience effect.

CONCLUSION:

This paper has pointed out that the actual financial markets tend to deviate from the three basic assumptions underlying the traditional efficient market hypothesis. The behavioural finance has contributed to our better understanding of actual investors' behaviour and real market practices over the past 25 years and is expected to make significant further progress. All these theories have contributed to help investors make better investment decisions in the very complex and complicated financial market places.

The emergence of the field of the behavioural finance has led to a profound deepening of our knowledge of financial markets. The rapid new development in this field is expected to improve the efficiency and predictive power of investors' behaviour and the entire financial markets in the future but, since behavioural finance is at its infant stage of development, much more theoretical analysis and empirical testing are needed. This is the direction of our future research. In particular, the literature could shed specific light on which agents are biased and whose biases affect prices. There is also room to analyse the fast-growing field of market microstructure and behavioural finance. For example, a central role played by financial markets is that of price discovery. What is the effect of cognitive biases of market makers on price formation? The impact of well-documented biases such as overconfidence and the disposition effect on market makers and the concomitant implications for transaction costs would seem to be a valuable topic for research.

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