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BEHAVIORAL FINANCE: DEVELOPMENT AND EMERGENCE TRENDS IN INDIA

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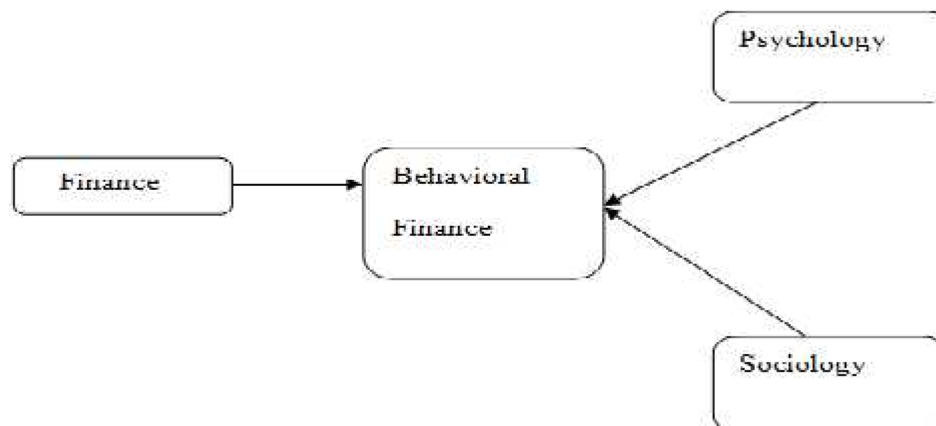
Abstract
Financial markets are influenced by many factors: The economic process which takes place in the world and the country, political constraint and institutional, information dissemination and accessibility. However, one of the most important factors in the people's perception and reaction. Behavioral finance integrates psychology and economic is finance theory. It is new paradigms of finance which seek to supplement the modern theories of finance by introducing behavioral aspect to provide explain for why investors make irrational decision. For each investor regardless of financial investments, business is a constant decision-making process.

Keywords: Behavioral Finance, Investor's Decision Making, Psychological Factor, Rational Behavior.

Introduction

Behavioral finance is the study of the influence of the psychological factors on the development of financial markets. In other words, financial markets inefficiency is analyzed in the light of the psychological theories and perspectives. Behavioral finance is a relatively recent and high impact paradigm which provides an interesting alternative to classical finance. It is very popular in stock market across the world for investment decisions.



Behavioral finance is the study of psychology and sociology on the behavior of the financial practitioners and the subsequent effect on the security market. It helps to understand why people buy or sell stock without doing fundamental analysis and behave irrationally in investment decisions.

Behavioral finance is the result of the structure of various sciences (Ricciardi & Simon, 2000):

Psychology - a science that analyses processes of behavior and mind, how processes are influenced by physical, psychical, and external environment of human being.

Finances - a system of formation, distribution and use of resources.

Sociology - systematic science about socio- behavior of human being or a group, emphasizing the influence of social relations on people's attitude and behavior.

In traditional theories of finance investment decisions are based on the assumption that investors act in a rational manner. This means that they behave rationally so they earn returns for the money they put in financial markets. To become successful in the financial market it is essential for investors to have rational behavior patterns. Rational behavior is also required to overcome tendencies.

Human nature is perfectible, but it is not perfect. Investors are people with many deviations from rational behavior, which often make illogical decisions. In the existing global financial perspective, the major influence of psychological factors in investment decision-making is undeniable.

Objective
To understand the influence of heuristic rule of thumb factors in decisions making.
To identify various behavioral factors influencing the decision of investor in financial market.

Literature Review
Luu (2014) examined the behavior patterns of individual investors in Ho Chi Minh stock market. It was found that overconfidence; anchoring, herding, loss aversion and regret aversion have moderate impacts on the investors while market factors have the highest impact among all on the investors' decision making.

Atif Kafayat (2014) examined investors in Islamabad Stock Market were affected from self-attribution bias, overconfidence and over-optimism bias in making rational decisions. The study concluded that all the factors mentioned are negatively correlated with investors' decision making.

Qadri & Shabbir (2014) conducted an empirical study to investigate the impact of overconfidence and illusion of control on investors' decision making in the Islamabad Stock Exchange. Their findings showed that overconfidence and illusion of control have positive significant impact on investors' decisions.

Tripathy (2014) examined the role of psychological biases on the cognitive decision making process of individual investors. The findings suggested that investors of Bhubaneswar Stock Exchange are victims of psychological biases namely: overconfidence, anchoring, regret and loss aversion and hence their decision making are affected.

Chaudhary (2013) studied how behavioral finance provides explanations for why investors make irrational financial decisions. The study demonstrates how emotions and cognitive errors influence investors in the decision making process. The study shows that various causes that led to behavioral finance are anchoring, overconfidence, herd behavior, over and under reaction and loss aversions.

Wamae (2013) had investigated the behavioral factors influencing investment decisions in Kenyan stock market focusing on investment banks. The behavioral factors investigated were herding, prospecting, risk aversion and anchoring. She found out that all the factors affect investment decision, with herding having the most impact, followed by prospecting, anchoring and finally the risk aversion factor has the least impact.

Bashir et al. (2013) studied behavioral biases including overconfidence, confirmation, and illusion of control, loss aversion, mental accounting, status quo and excessive optimism on investors' financial decision making. The study found out that there is a positive significant relationship and impact of overconfidence, illusion of control, confirmation biases and excessive optimism on investors' decision making. It was also found out that status quo, loss aversion and mental accounting biases have significant relationships but have no impact on investors' decision making.

Hon-Snir et al. (2012) in their study found out that more proficient investors are less affected by the behavior biases. The authors examined five behavioral biases in decision-making process in the stock market and differences of possible individual solutions due to these behavioral deviations: disposition effect, herd behavior, availability heuristic, gambler's fallacy and hot hand fallacy.

Lim (2012) had examined the relationship between psychological biases, namely the overconfidence bias, Conservatism bias, herding and regret and the decision making of investors in the Malaysian share market. He found out that overconfidence, conservatism bias and regret have positive significant impacts on investors' decision making. However, herding behavior was found to have no impact on investors' decision making. Most of the results in the study were consistent with the previous researches done in other countries.

Luong & Thu Ha (2011) had explored on the behavioral factors influencing individual investors' decision-making and performance at the Ho Chi Minh stock exchange. The factors explored were overconfidence, availability bias, herding, and market, prospecting and anchoring. The study concluded that all the factors have moderate impacts on decision making with the market factor having the highest impact.

Finding and Observations

To understand the influence of heuristic rule of thumb factors in Decision making

The crucial observations is listed as follows

1. Investors make judgment based on approximate rule of thumb, not sternly on balanced analysis.
2. Investors are not necessarily are careful to the equivalent choices if the choices are presented in significantly different contents, which referred to framing-effect.
3. There are explanations for observed market outcomes that are contrary to national expectations and market efficiency, which include mispricing, non-rational decision making and return anomalies.

From the above observations, it is clear that judgments can be systematically wrong in various Ways. Systematic errors of judgment are called biases. Financial decisions are made in situations of high Complexity and high uncertainty that preclude reliance on fixed rules and compel the decision-maker to rely on intuition.

Various Behavioral Factors Affect the Decision of Investors in Financial Market

(I) Representativeness

The tendency of investors to associate new event with a purpose of knowing the event and through which only they make investment. If a company makes some announcement, the investor will correlate that announcement with the past announcements and makes decision on the basis of that past announcement without considering the fact that past announcement may not represent the present one so far.

(II) Herding

The common mistake where investors tend to follow the investment decisions that taken by the majority. As a result of this investor will not buy or sell a stock even if that decision is supported by technical or fundamental analysis. Investor is pressurized by the influence by the peers. They are more concerned about what others think of their investment decision. As a result of herding behavior, investors lose their own individuality in the decision making process.

(III)Cognitive dissonance

Cognitive Dissonance can be defined as the mental conflict that people experience when they are presented with evidence that their beliefs or assumptions are wrong. As a result of this conflict, the investor ignores new information that contradicts known beliefs and decision. This behavior of investors leads to reduction in their ability to make rational and fair investments.

(IV)Overconfidence

Psychologists are of the opinion that overconfidence causes people are overconfident their knowledge and ability, underestimate risks and exaggerate their ability to control events. A common trait among investors is a general overconfidence of their own ability when it comes to picking stocks and to decide when to enter or exit a position. An overconfident investor makes too many trades and takes too much risk.

(V) Availability bias

The availability bias suggests that the recent memory i.e., the available example influences more on investor's decision of investment i.e., if investors have recently seen huge loss in one investment avenue then he will not invest in that avenue. Investors are more likely to be fearful of stock market if they have recently seen any stock market crisis.

(VI) Anchoring

People have a tendency to attach or 'anchor' their thought to a reference point even thought that may hardly have any logical association with the decision at hand. Anchoring is a psychological situation exists when investors give unnecessary importance to statistically random and psychologically determined 'anchors' which leads them to investment decisions that are not essentially 'rational'. After considering the estimation of good price for buying the share the investor will begin such process by using initial value called 'Anchor'.

(VII)Hindsight

Hindsight bias can be defined as the tendency to think that one would have known actual events that were coming before they happened. As a result of hindsight bias investors usually take wrong decision or pretend that the outcome of their decisions was known by them very earlier. If investor have loss on particular finance then too they will pretend as if they knew it earlier that they will loss, as a result of this they don't learn lessons from their wrong decisions and such decisions may be taken again in future also.

(VIII) Mental accounting

Mental Accounting is the set of cognitive operations used by households and individuals to organize evaluate and keep record of financial activities resulting in a tendency for people to separate their money into separate accounts based on a variety of subjective reasons. Individuals tend to assign different functions to each asset group, which has often irrational and negative effect on their consumption decisions and other behaviors.

(IX)Conservatism

Conservatism represents that the investor takes decision on the basis of his past information although faced with the new information or investor only partially adjust their view in the light of new information.

The field of Investors Behavioral Finance

Behavioural finances are more related to analysis of non-professional investor’s decision making. But it is impossible to separate market influence and personal psychological factors analyzing conditioning individual’s treatment in financial markets. Increased interest in the profits gained via financial transactions in recent decade stimulates the inquiries in this field.

Barber & Odean (2001) raise the question why people tend to overestimate their skills and knowledge. The results showed that men traded 45% more often rather than women. However, the study revealed the fact that active trading reduces investors' net returns. For active trading men typically reduce annual return 2.65% and 1.72% for women (Barber & Odean, 2001). The authors also support previous assertions that the market is not efficient due to excessive investor confidence (Daniel et al., 1998; Barber & Odean, 2001).

Hirshleifer et al. (2001) analyze masses’ effect on investor. To take in to account the opinions of others may be rational, but investors are usually blamed for their decisions and beliefs being irrational because they obey the "herd instinct" or react too emotionally in stressful situations. The proof of that research is radical market changes taking place in the absence of significant news. Such irrational behavior of stock market prices is determined by an incorrect value and at the same time market inefficiencies. But at the same Hirshleifer et al. state that some of the decisions which at first sight may seem irrational can actually be rational. For example, an investor by his decision correct previous errors or delay in the decision making and bring it over time, when the situation can be changed. As a result, it may seem that there is no rational investor behaviour appeared in point of popped up information. So Hirshleider et al. take an intermediate position between the rational and the irrational market (Hirshleifer et al., 2001). One of the main goals of Hirshleifer et al. was to figure out how dogging masses’ steps can lead to stock price changes. The authors compare the rational and partly rational behavior theory and conclude that investors can follow the masses and ignore conflicting signals of the personal information. This is somewhat contrary to the De Bondt’s theory, which predicts that investors are more likely to rely on their own internal information and are more sensitive to changes in the personal information comparing to publicly available. In the process of studying investor’s behavior, Hirshleifer et al. propose to consider the actions of investors rather than the stock prices changes (Hirshleifer et al., 2001; De Bondt 1998).

Daniel (2002), along with Hirshleifer et al. made more additional findings and stated that: Excessive self-confidence has a significant impact on investor’ perception of investment strategies, in other words, investors often tend to rely on the masses, or on more experienced market players’ decisions; investors are prone to systematic errors; The government’s role is particularly important in the investment process. The government needs to raise the degree of market efficiency by strengthening the investment rules to increase market efficiency and improve the quality of financial reporting. Nevertheless, the authors acknowledge that the emotions and psychological factors have a significant influence on public discourse and political processes, and the governments themselves face difficulties to dissociate from the subjective and make rational and right decisions. In this case, to improve the efficiency of the market is proposed to limit statutory inexperienced investor, thereby helping to prevent irrational decisions.

Conclusion

The conclusion can be drawn that investors not always act in a rational manner due to the cognitive and psychological errors they have to deal with. The behavioral factors are important in financial markets because they influence the investors who make the financial decisions. 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. Behavioral finance is based on research of human and social recognition and emotional tolerance studies to identify and understanding incoming economic decisions.

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