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Inclusion Of Psychological Factors In Financial Theories: Transformation From Traditional Finance To Behavioral Finance

Ms. Sarita Choudhary[1] , Dr. Hem Ahuja[2]

[1]Research Scholar, Rajasthan Technical University, Kota, Rajasthan, India - 324010

[2]Assistant Professor, Department of Management Studies, University College of Engineering and Technology, Bikaner, Rajasthan, India - 334004

Abstract:

A rational investor and rationality are basic models to provide understanding of financial market in traditional financial theories. In the traditional finance theory, rationality means well known about the ideas and information of market and act according to the standardized act on the basis of this market information. Market crises, anomalies of the financial markets are some of those incidents which was not explained by traditional financial theories. Traditional finance foundation is mainly based on efficientmarket concept(EMH), investor rationality concept and the modern portfolio theory (MPT)developed by Markowitz. But till1990 the traditional finance theories were not so been challenged. Market anomalies discard the concept of rationality of investors and questioned the traditional financial theories since mid-1990s.this resulted in the emergence and development of a new paradigm that is behavioural finance. In this paper an attempt has beenmade to highlight the criticism of the traditional finance theories as pointed out by behavioural financesupportersandalsoadiscussiononthe significanceofbehaviouralfinance.

Keywords: Traditionalfinance,BehaviouralFinance,Rationality.

Introduction

Investment is referred to as the sacrifice of present consumption and investing that saved money in some financial product with an expectation of earning higher returns in the future. But the accessibility to large amount of information creates a lot of confusion among the individuals, moreover it is very time consuming as well since the investors are many a times not capable of processing the available information. In addition to that, it is also necessary to have a sound knowledge of the existing investment options so as to arrive at good investment decision.

Traditional Theory of Finance assumes that (a) Investors are impeccably rational i.e. they deduce the accessible information correctly and homogenously, and (b) Markets are perfect i.e. all the important facts and figures are mirrored in share prices instantly and completely. The assumption of perfect markets has originated from "Efficient Market Hypothesis"

Academic and experimental work of two researchers Daniel Kahneman and Amos Tversky who provides their rich work to psychology in 1970s acted as a base and gave birth to a new concept known as Behavioral Finance in 1980s, which examines how investors are affected by their emotions like greed and fear while taking financial decisions.

Literature Review

Traditional finance is built on the notion of "homo economics", which states that humans always make perfectly rational choices to maximize their wealth and minimize risk (Pompian, 2012). This implies that traditional finance has concern about how investors should behave rather than how investors are actually behaving (Baker and Nofsinger, 2002). The one of the important traditional finance theory is Efficient Market Hypothesis. It states that in an efficient market, all the available information is incorporated while estimating the prices of financial assets. The basic assumption of EMH is that the investors of financial markets are rational in making their decisions. However, research studies on judgement and decision making have revealed that an individual's behaviour is inconsistent with rationality (Tourani-Rad and Kirkby, 2005; Baker and Nofsinger, 2010; Barberis and Thaler, 2003; Fama, 1998; Miller, 1986;Neumann and Morgenstern, 1944,Shefrin, 2000; Statman, 1995; Statman, 1999; Shiller, 2003;). In the 1980s, behavioural finance emerged as a new concept that combined behavioural and psychological aspects in economic and financial decision making. Behavioural finance challenges the efficient market perspective and helps to understand why investors behave in a specific manner while investing in financial assets (Ackert and Deaves, 2009; Baker and Nofsinger, 2010; Hirshleifer, 2001; Pompian, 2011; Statman, 1999).

Thaler (1993) suggested that behavioural finance "entertains the possibility that some of the agents in the economy behave less than fully rationally some of the time" (p. 17). EMH with its three basic assumptions ruled the financial markets over 30 years. The three basic assumptions are: rational investors in financial markets, investors access all the available information and make decisions accordingly, and decisions are made to maximize the wealth. Whereas, in reality when the experts analyzed the market crises and anomalies thoroughly they identified that in uncertainty investors don't make rational decisions generally. They are biased and make errors due to effect of their emotions, feelings and cognitive thoughts in their decisions. Dehnad, 2011 explained the importance of awareness

about market sentiments, resistance and support while investing in the financial markets. Under difficult and risky situations investors make predictable, non-optimal choices because of heuristic simplifications. Thus, behavioural biases abstractly are defined in the same way as systematic errors are in judgment (Chen et al, 2004). Shahzad et al. 2013 emphasized that heir is a relation between psychological characteristics and behavioural aspects with the decision making of investors.Hassan et al., 2013 stated that fear of loss make investors more precautious at the time of decision making but, heuristics and anger can negatively affect the decision making of these investors. Throughout the past five decades researchers have distinguished specific biases in their studies and behavioural finance research relies on a broad collection of evidence pointing to the ineffectiveness of human decision making in various economic decision circumstances (Pompian, 2006).

Some researchers refer to biases as heuristics (Brabazon, 2000; Parikh, 2011) while classifying biases along cognitive or emotional lines (Shane, 2005; Kristensen and Garling, 1997; Montier, 2002). However, experts of behavioural finance believe that investors are more affected by cognitive errors than behavioural biases (Jureviciene&Jermakova, 2012). Behavioural finance researchers have made significant contributions to understanding the factors that influence individual investors (Johnson and Tversky, 1983; Barberis and Thaler, 2003; Fama, 1998; Shefrin and Statman, 1985; Thaler, 1999). A brief description of some of the research work reported in the behavioural finance literature is given below. Initially, Tversky and Kahneman (1974) identified the presence of three heuristics (representativeness, availability and anchoring) in decision making under uncertainty and risk, whereas Kahneman and Tversky (1979) developed the prospect theory for decision making under uncertainty. Further, Tversky and Kahneman (1981) explained the concept of framing and Kahneman et al. (1982) also analysed the concepts of heuristics and biases. In addition, Tversky and Kahneman (1986) analysed the issues of framing and prospect theory. Furthermore, Tversky and Kahneman (1991) documented evidence of loss aversion theory and endowment effect. Banerjee (1992) developed a model on investors' herding behaviour. Later, Jegadeesh and Titman (1993) created an investment strategy based on the idea that stocks exhibit momentum in the market to see whether one could make profits based on momentum. Lakonishok et al. (1994) researched the opposite side of the spectrum on contrarian investing.

Olsen (2008) analysed how cognitive dissonance is the biggest problem that arises between behavioural finance and traditional financial theory. Vasiliou et al. (2008) documented how behavioural finance can be used to predict future prices. Ekholm and Pasternack (2008) documented that large investors react more positively to good news and vice versa than do small investors. Anagol and Gamble (2013) examined the effect that presentation of results has on equity allocation. Doviak (2015) explained that behavioural finance is important to consider by a financial planner for understanding the investors'

thought process to guide them for decisions..Asnesset al. (2015) discussed value investing.

Objectivesof theStudy

The main objective of the paper is:

1. To highlight the limitations of the traditional finance theories
2. Todescribethegrowthofbehavioural financetheorywhich study the investors' behaviour in financialmarket.

MethodologyoftheStudy:

The paper is conceptual and descriptive in nature and it is grounded on thedifferent researchpapers, articles, journals related to behavioural finance available over different sources i.e. internet, libraries.

LimitationsofTraditionalFinance

Rationality: The base of the traditional finance theory is that the investors are rational and the markets also have all the information which is available to all the investors. But this has been criticized by different empirical researches. In traditional finance theory, investors are expected to make the best use of available information and properly utilize and analyze this information in an objective manner. Earlier researches by Paul Gerrans et al (2012); GanesanBalaji (2013); Pal.Mukul (2009) ; Ricciardi Victor et al (2000) explained that generally investors being a human with brain, emotions and feelings acts in a irrational pattern instead of acting rational as they have important information.The concept of rationality is ignored in effect of behavioural biases by the investors at the time of decision making.

Decisions based on Emotions in Investment: Traditional finance completely ignores the role of emotions in investmentdecisionmaking.But the decision making in the area of investment is influenced by emotions and feelings as investors are normal human beings with emotions.

InformationalAccuracy:Traditional financial theories are based on the assumption that the investors have access to all information and the information is accurate enough which is reflected by the share prices.MichaelPompian, 2006 stated that there is infinite number of information in the field of investment and it is difficult for investors to possess all the available information to know about the market. Even many successful investors are also unable to master all the disciplines.

Equally knowledgeable investors: According to conventional finance all investors are equally knowledgeable and expert. Traditional financial theory stated that there if no difference between an experienced investors' decision making and a new investors' decision making. But, in reality experience matters when an investor make decisions as the investor learn through experiences and acts wisely

while making decisions.

Demographicfactors: Age,income,sex,familybackground,etc.arethedemographiccharacteristicsofinvestors are not considered by traditional finance, but they are also having effects on investment decisionmakingabilities.

Traditional finance theories have these limitations which are indicated by many market crises and anomalies and are explained by the theory of behavioural finance. So, this new field of behavioural finance is a development over the traditional financial theories.

Explorationof BehaviouralFinance

Behavioral finance is a relatively new concept of finance, which combines traditional finance theory and various behavioral aspects to the decision making process. In other words, behavioral finance studies how the investor's behavior in the share market is shaped by psychological factors and how it affect their decision making process. It paves a way to explain why it is justifiable to think that markets are inefficient. Since past few decades, many studies on investor's psychology are done and found that the discomfort of losing money is almost double than the pleasure of earning money. Behavioral Finance tries to analyse why and how emotional and psychological errors impact the decision making of investors leading to stock market crashes. It is also seen from the past few events that even small adjustment in markets results in crashes due to investor's overreaction who tend to make imprudent decisions to refrain losing money rather than focusing on fundamentals of the company. Therefore, it is not necessary that whatever decision an investor takes is in his full conscious. Rather, emotions such as greed and anxiety play an important role in decision making process. The basis behind behavioral finance is that behavioral biases, influence investors, lead to misinterpretation of information and faculty conclusions even if the information is accurate. These behavioral biases gave birth to various investment strategies that take advantage of irrational behavior of investors. Although investment strategies encashing emotions have existed from past few decades, behavioral finance concentrates on finding psychological errors repeatedly made by investors.

Prospect Theory

Prospect theory, a behavioral model (formulated by Amos Tversky and Daniel Kanheman in 1979), presumes that losses and gains are admired differently, and thus investors take decisions based on anticipated gains rather than anticipated losses. In other words, it shows how investors choose between alternatives that includes risk and uncertainty. It exhibits that investor's judge their decisions in terms of expected utility corresponding to a reference point as compared to real outcomes. Prospect

theory was evolved by giving risky options, and it reveals that investors are lossaverse, and if two choices are given to them, both equal, with one given in terms of probable gains and the other in terms of probable losses, the former option will be preferred. As investors hate losses more than the equal amount of gain and they are more inclined to take risks, so as to avoid losses.

Behavioral Biases

Investors are prone to numerous behavioral biases that results in psychological errors and faulty decision making. Investors make probable, non-efficient choices when they came across with problematic and ambiguous decisions by using rules of thumb. Behavioral biases, theoretically, are characterized in the same way as systematized errors in forming judgment. Researchers, over a period of time, extricate an extended list of explicit biases; applied these biases to individual investor behavior to check how it changes their decisions. These biases are often referred as heuristics, thinking, judgments, cognitive and psychological errors by various researchers. Although this type of bias classification is useful-but the fundamental theory about why investors are prone to these biases has not been formed. Various behavioral biases are following:

Cognitive Errors	**Overconfidence bias**	Tendency to believe they are better than others
	Disposition Effect	Tendency to hold loss making assets
	Familiarity bias	Prefer to invest in familiar securities
	Framing effect	Tendency to make investment by looking at the framing of the outcome
	Anchoring bias	Tendency to rely on reference point
	Availability bias	Tendency to invest based on information easilyavailable
	Self- Attribution bias	Rely on their own skills
	Representativeness	Tendency to buy rising stocks with the expectation that this rise will continue. Follows past trend of stocks
	Mental Accounting	Tendency to divide their money in to different accounts/ assets
	Hindsight bias	Tendency to believe that past events were predictable
Emotional	**Regret Aversion**	Tendency to feel regret for past decisions

	Loss Aversion	Tendency to have more sensitivity towards losses thanGain
Social Interaction	**Herding bias/Media bias**	Tendency to rely on other sources of information

Conclusion

It can be concluded that the investors acts irrationally as they are affected by the psychological errors and behavioural biases. The investors of financial markets are influenced by these behavioural biases and they make financial decisions with the impact of these behavioural biases. In an uncertain environment, rational and comprehensive decision making is not possible due to these heuristics. In contrary to Efficient Market Hypothesis, behavioural finance explains the impact of psychological and emotional factors on investment decision making. It explains that a person take decisions according to the personality traits, cognitive skills and emotional skills he possess. It is a remarkable progressive field of financial management as it combines social sciences with finance and represents the development of financial theories.

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