"Behavioral finance: The role of psychological factors in investment decisions"

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Abstract

Human psychology contributes an important part in how individuals make investment decisions. Many investors are their own biggest enemy. The risk of some people making investment decisions is often more important than the risks of the investment itself. In the past few decades, research in behavioral finance has grown significantly. Human psychology plays a significant role in how individuals make investment decisions. Financial theory suggests that investor do not like taking excess risk. They will avoid taking on excess risk and continue buying or selling investments to reduce risk. This is theoretically great, but not true in practical world. In Behavioral finance has observed that psychology of human beings plays a big role while taking any investment decisions, hence many people in market end up taking wrong decisions. In the real world, investors facing potential losses often take on additional risks and hope they can make up for this loss. Even if the best strategy is to sell, they still hold the investment. The opposite is also true in case of investors earning good profit. This paper is the effort to study the role of such behavioral factors and their contribution in investment decisions.

KEYWORDS: Behavioral Finance, Investment Decisions, Human psychology, Stock Market, Behavioral Theory.

INTRODUCTION

"Investors are 'normal, 'but not rational," by Meir Statman.

Behavioral finance is a subfield of behavioral economics. It discusses psychological theories to explain stock market inconsistency, such as a sharp rise or fall in stock prices. The goal is to identify and understand why people make certain financial choices. In behavioral finance, it is expected that the information available and the features of market participants systematically influence individual investment decisions and market outcomes.

Behavioral finance is a one of the modern field seeking to combine behavioral and cognition Theory of Mind with Economics and finance which gives various reasons for why investors make unreasonable financial decisions. This is very famous in capital markets around the world for making Investment decisions.

Forbes (2009) defines behavioral finance a subject of science about psychological factors influencing financial markets. This view suggests that there exists many personal influential Factors such as cognitive bias which plays important role in decision-making process, even more than reason and wealth maximization objective.

Therefore, behavioral finance is an application of various researches on psychology, social science and the emotional contribution to market participants and market trends. It also focuses on the Psychological and social factors which affect financial decision making process of individual, groups and entities.

Tversky and Kahneman are known as the father of behavioral finance. Year 1981, they came up with the concept of a framing. Their research tells about a lot of psychological factors like people behave very overconfident and also too optimistic. The literature found Biased managers over-invest in their company Cash flow, start large number of mergers, start more companies and more new projects and also tend to stick to it Non-productive investment policies for longer. Corrective measures to reduce impact of this Manager's prejudice includes learning, bloating Discount rate and contract incentives but their effectiveness in suppressing this problem is restricted.

OBJECTIVES

To analyze the various emerging issues in financial market due to behavioral finance.

To study the relationship between economics and psychology which leads to behavioral finance.

To study the different causes of behavioral biases existing in financial market.

To examine various solution to avoid these behavioral differences.

Most common causes of Behavioral Biases

Over confidence

Overconfidence is one of the most obvious behavioral financial concepts. This is because investors are overconfident about the ability to predict the outcome of an investment decision. Overconfident investors are often not sufficiently diversified and therefore more susceptible to volatility.

Anchoring

Anchoring is also related to being overconfident. E.g. we have made an initial investment decision depending on the information which was available at the time of making investment. We later on receive news that has a huge impact on any forecasts we originally made. However, you only modify the old analysis instead of the making a new one. Since you are anchored, the revised analysis will not fully reflect the new information.

Representativeness

A company may announce a series of huge quarterly earnings. Therefore, you think the next announcement about the earnings may also be good. This mistake belongs to the broad concept of behavioral finance, called representation: you mistakenly believe that one thing means something else.

Another example of representativeness is to assume that a good company is a good stock.

Loss Aversion

Losing disgust or unwillingness to accept losses can be fatal. For example, one of your investments may fall by 25% due to some cause. The best decision in this situation may be just accepting the loss and moving on. However, you can't help but think that the stock may come back. The latter idea is dangerous because it usually leads you to increase the position of a loss-making investment. This attitude is like to a gambler who takes a series of big risks in order to breaking even the loss.

Regret minimization

Your future trading method is usually affected by your previous trading results. For example, you might sell a stock with a 20% increase just to watch the stock continue to rise after you sell it. Think about it, "As long as I wait." Or maybe your investment value drops, and you have to spend time selling it when you spend money. These will lead to unpleasant regrets.

When you completely avoid investing or investing conservatively, because you don't want to regret it, you will minimize the regret.

Framework dependence

The strength to withstand risks depends on your personal financial situation, investment horizons, and the size of your portfolio. Frame dependence is an idea that defines the tendency to fluctuate risk tolerance based on market direction. For example, when the market falls, you are willing to take risks and may fall. Or, as the market goes up, your tolerance of risk may increase. This usually leads investors to buy high prices and sell low prices.

Defense mechanism

Sometimes your investment will lose money. And the investor tends to feel that this is not his fault, The defense mechanism in the form of excuses is connected to overconfidence.

'if-only': If only that happened, then I am right.

"Almost right": But sometimes, proximity is not good enough.

"It hasn't happened yet": Unfortunately, "the market may be longer than you are unreasonable, and I can still maintain solvency."

'Single forecast': Just because you are wrong is not that you are going wrong with everything else.

Overcoming Behavioral Bias

Understanding behavioral finance helps investors choose better investment instruments, they can avoid repetition of a costly mistake in the future. They can improve their choices by identifying their biases and achieve better performance. The main aim of using behavioral finance is to reduce or eliminate psychological prejudice of investor in making investment decisions. Investors with behavioral bias avoidance strategies are more likely to succeed in investing. The following are some of the methods to avoid behavioral bias.

Managing emotions- Studies have shown that investors are more painful about investment losses than satisfaction with investment returns. Investors affected by the 2000 technology bubble burst and the 2008 global financial crisis have reason to worry about investment losses. Emotions led to painful sales at several key moments in 2016, especially in January, which was related to China’s concerns, as well as the June Brexit vote and the earlier election of President Donald Trump in November. Investors who calmly assess the impact of an investment are more likely to benefit from the opportunities offered by each event.

Seeking contrary views- Investors are vulnerable to confirmation bias because too many investors seek to support the verification of the source of their investment theory while avoiding opposing views. The best investors seek a reverse view and then evaluate the advantages of the competition argument.

Become a “renter” and not the owner- Investors often have unhealthy attachments to stocks. Sometimes attachments are related to the company's personal contacts; in other cases, investors do not understand that a "great" company may not always be a "great" stock well-managed and profitable companies are left behind by devastating economic power.

Don't chase yesterday's winner- Investors often ignore legal disclosures, which means that past performance may not resemble future performance. “Chasing performance” is a natural mistake, with funds flowing into the nearest winners, away from the recent losers. Investors mistakenly expect that recent success will continue into the future. However, performance tends to come back to the long-term average, so chasing last year's winners often leads to a vicious circle of underperformance and high turnover.

Beware of crowded transactions- Success has spawned the imitation of the investment industry, and a group of imitators can end successful investment strategies. The quantitative investment strategy became popular in the early 21st century, but many “quanta” eventually became part of the herd that invested in the same stock. As the herd went to the export at the same time, the quagmire boom ended severely in the 2007 “quantum quake”. Investors triggered by the technology bubble, the BRIC craze and the currency “arbitrage” exchange have found that mass trading has become a way of becoming too popular. For those investors who finally enter the crowded trading, reversing wealth can be particularly painful! Following a bullish group may be a bad idea, and investors should do their homework before joining a crowded deal.

Paying more focus on detailed analysis than to stories- the liking of stories and often leads to creation of narratives that support their investment decisions. Being captured by a "story" is dangerous and important for completing the research necessary to determine any flaws in the narrative.

CONCLUSION

“Be greedy when others are fearful, fearful when others are greedy”. – Warren Buffett

Behavioral finance provides an explanation for the cause Investors make unreasonable financial decisions. It Demonstrate emotional and cognitive errors Influencing investors' decisions.

Various causes of Behavioral finance is anchoring, overconfidence, Group behavior, overreaction, under reaction and risk aversion. Behavioral Finance provides many useful insights for investing. Therefore, professionals provide a framework assess positive investment strategies investor.Understanding behavioral finance helps investors choose better investment instruments, they can avoid repetition of a costly mistake in the future. They can improve their choices by identifying their biases and achieve better performance. The main purpose of studying behavioral finance is to minimize or eliminate psychological prejudice of investor in making investment decisions. Investors with behavioral bias avoidance strategies are more likely to succeed in investing. The following are some of the methods to avoid behavioral bias.Behavioral finance research has many practical as well as academic applications. This research can help guide portfolio allocation decisions Help understand the various mistakes investors tend to make manage their portfolios and let us better understand how investment managers should assign their investments and find make full use of profit opportunities.

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