The Impact of Behavioral Finance on Stock Markets

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"The economist may attempt to ignore psychology, but it is sheer impossibility for him to ignore human nature. … If the economist borrows his conception of man from the psychologist, his constructive work may have some chance of remaining purely economic in character. But if he does not, he will not thereby avoid psychology. Rather, he will force himself to make his own, and it will be bad psychology."

John Maurice Clark Economics and modern psychology

Abstract : Behavioral finance is part of finance that seeks understand and explain the systematic financial market implications of psychological decision processes. It utilizes knowledge of cognitive psychology, social sciences and anthropology to explain irrational investor behavioral that is not being captured by the traditional rational based models. Behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets. Behavioral finance is of interest because it helps to explain why and how markets might be inefficient. Behavioral finance is a new field in economics that has recently become a subject of significant interest to investors. 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. According to conventional financial theory, the world and its participants are, for the most part, rational "wealth maximizes". However, there are many instances where emotion and psychology influence our decisions, causing us to behave in unpredictable or irrational ways. This paper provides a general discussion of behavioral Finance .In this paper survey is made between two different groups of investors. This paper shows how we behave or the psychology when we make decisions involving risk, or in the possibility of loss and also throw some light on economists who stress psychological and behavioral elements of stock-price determination challenge Efficient market theory. Investor behave irrationally during risk decisions such asLosing Money :- Individuals typically measure risk by money that has been lost. These losses are measured against the original cost of the stock or bond. Individuals sometimes feel money has been lost only when the security is sold.Unfamiliar Instruments :- Unknown or complex securities may seem riskier Previous Losses in Familiar Instruments- a stock that has lost money for the individual in the past is considered unattractive. Contrary Investing :- Not "following the crowd" may appear risky to an individual Historical v Potential Levels of Risk - Many individuals regard past levels of volatility as more important than projected levels of risk.

Key words: Behavioral finance, Capital market, Classical finance, Rational behavior ,Market efficiency, Investment decision, Psychological factors,

I. 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. Most of the financial market anomalies cannot be explained using traditional models. Behavioral finance easy explains why the individual has taken a specific decision, but did not find as easily an explanation about how future decisions will be. Classical finance has as a cornerstone the Efficient Markets Hypothesis, according to whom, since everyone has access to the same information, It is not possible to change the market position, because that stock prices are, in fact, efficient, reflecting everything we know as investors. A market in which prices always "fully reflect" available information is called efficient. Synthesizing, Efficient Markets Hypothesis assume that capital market are information ally efficient. Eugene Fame, the father of efficient market hypothesis reveals, "Market efficiency survives the challenge from the literature on long-term return anomalies. Consistent with the market efficiency hypothesis that the anomalies are chance results, apparent overreaction to information is about as common as under reaction, and post event continuation of pre-event abnormal returns is about as frequent as post-event reversal. Most important, consistent with the market efficiency prediction that apparent anomalies can be due to methodology, most on-term return anomalies tend to disappear with reasonable changes in technique In contrast, behavioral finance assumes that, in some circumstances, financial markets are information ally inefficient. The main purpose of this article is to have an insight into how the influence of psychology on the behavior of the investors can explain capital markets imperfections. 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.

De Bondt and Thaler (1985) published article: "Does the Stock Market Over-react?" in a Journal of Finance. They propounded that the people are systematically over-reacting to unexpected and dramatic news results in substantially weak form inefficiencies in the stock market. Mental accounting is a set of cognitive operations used by individuals and households to organize evaluate and keep track of financial activities. Thus, behavioral finance is the application of scientific research on the psychological, social and emotional contributions to market participants and market price trends. It also studies the psychological and sociological factors that influence the financial decision making process of individual groups and entities.In this paper, a large body of psychological literature finds that the people tend to be over-confident and overly optimistic. This literature find that the biased managers over-invest their firms cash flows, initiate too many mergers, start more firms and more naval projects and tend to stick with unproductive investment policies longer. Corrective measures to reduce the effect of manager biases include learning, inflated discount rate and contractual incentives but their effectiveness in curbing over investment appears to be limited

II. OBJECTIVES.

- To study the concept of behavioral finance and various theories associated with it
- To identify the major factors responsible for determining the attitudes and trading behavior of stock market investors.
- . To measure the confidence the investors have regarding their investment in stock market.

III. RESEARCH METHODOLOGY

Primary data is collected from the individual investors with the help of structured questionnaire.

Secondary data is collected from the published source and through internet.

sample size is 50 respondents

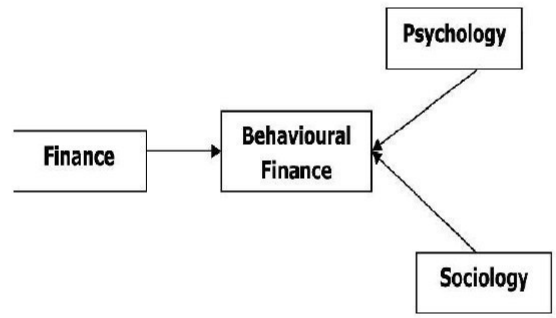
sample method convenient sampling is used

Tool :ANOVA

IV. BEHAVIORAL FINANCE

Meaning

Behavioral finance is a relatively new field that seeks to combine behavioral and cognitive psychological theory with conventional economic and finance to provide explanations for why people make irrational financial decisions. 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 Forbes (2009) has defined behavioral inance as a science regarding how psychology influences financial market. This view emphasizes that the individuals are affected by psychological factors like cognitive biases in their decision-making, rather than being rational and wealth maximizing.

V. TRADITIONAL FINANCE VS BEHAVIORAL FINANCE:

Based on efficient market hypotheses, traditional financial theories assume that investors are rational and risk averse, and hold diversified, optimal portfolios. This assumes how investors should act based on mathematical models and theories. However, this does not always play out in practice.

In contrast, behavioural finance is based on understanding how people actually make financial decisions in practice. Behavioral finance suggests cognitive errors and emotional biases can impact financial decisions, often in a detrimental way. Cognitive errors are based on faulty reasoning (belief perseverance), or due to memory errors (information processing errors). Emotional biases stem from reasoning that is influenced by feelings or emotions, not fundamental facts.

Behavioural finance challenges the assumptions of the traditional finance theory, recognizing that many investors do not make decisions in a rational manner. Investors are generally loss averse, and because their fears can get in the way, they do not necessarily hold optimal portfolios

VI. LITERATURE REVIEW

Schiller (2000) strongly advocated that the stock market is strongly governed by the market information which directly affects the investment behaviour of the investors.

Hong et al., (2001) conducted a study wherein they proposed that stock – market articipation is influenced by social interaction. According to them any given "social" investor finds the market more attractive when more of his peers participate. They tested this theory and found that social households – those who interact with Their their neighbours, or attend church – are substantially more likely to invest in the market than non social households, controlling for wealth, race, education and risk tolerance

Meng Chen Gong et al. (2004) tested how investor experience influence investing behaviour and trading performance. The study shoes that experienced investors are more inclined toward making trading mistakes and suffering from the representative bias. **Chandra (2008)** explored the impact of behavioral factors and investor's psychology on their decision-making. The research was based on the secondary data. The study concluded that retail investors do not always take rational decision. The decision of investment is influenced by many behavioral factors such as greed and fear, cognitive dissonance, mental accounting, heuristics and anchoring etc. The study focuses that these behavioral factors must be considered while taking the investment decision

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.

Another study conducted by Barberis and Huang (2001) suggests that loss aversion – the tendency to be more sensitive to losses than to gains – and narrow framing – the tendency to focus on narrowly defined gains and losses –play an important role in determining how people evaluate risky gambles.

VARIOUS BEHAVIORAL FACTORS WHICH AFFECTS THE DECISION OF INVESTORS IN STOCK MARKET:

Some of the behavioral factors which affect the investment decision of investors in stock market are as mentioned below.

1. Representativeness: The investors' recent success; tend to continue into the future also. The tendency of decisions of the investors to make based on past experiences is known as stereotype. Debont (1998)8 concluded that analyses are biased in the direction of recent success or failure in their earnings forecasts, the characteristic of stereotype decisions.

2 Overconfidence: There are several dimensions to confidence. It can give more courage, and is often viewed as a key to success. Although confidence is often encouraged and celebrated, it is not the only factor to success. The investors who are cautious and analytical can achieve success and others have to withdraw. Yet, confidence, especially self-confidence, is often viewed as a positive trait. Sometimes, the investors overestimate their predictive skills or assuming more knowledge then they have. Many times it leads excessive trading.

3 Anchoring: It describes the common human tendency to rely too heavily, or 'anchor' on one trait or piece of information when making decisions. When presented with new information, the investors tend to be slow to change or the value scale is fixed or anchored by recent observations. They are expecting the trend of earning is to remain with historical trend, which may lead to possible under reactions to trend changes.

4. Gamblers fallacy: It arises when the investors inappropriately predict that tend will reverse. It may result in anticipation of good or poor end.

5. Availability bias: The investors place undue weight for making decisions on the most available information. This happens quite commonly. It leads less return and sometimes poor results also.

6 Market Psychology The overall sentiment or feeling that the market is experiencing at any particular time. Greed, fear, expectations and circumstances are all factors that contribute to the group's overall investing mentality or sentiment.

7 Market Sentiment The feeling or tone of a market (i.e. crowd psychology). It is shown by the activity and price movement of securities.

8 Media Effect

A theory that relates how stories published in the media influence or amplify current trends. Borrowers or investors will read an article and be influenced to act quickly on the news. The media effect is often seen in the mortgage market, when prepayment rates can sharply increase following specific news stories.

11 Reflexivity The idea that a person's thoughts and ideas tend to be inherently biased. In other words, the values and thoughts of a person will be represented in their work. In the context of finance, the theory of reflexivity states that investors' and traders' biases can change the fundamentals that assist in determining market price

Prospect theory

This theory is developed by Kahneman and Tversky9. The second groups of illusions which may impact the decision process are grouped in prospect theory. He discussed several states of mind which may influence an investors decision making process. The key concepts which he discussed are as follows:

1. Loss aversion: Loss aversion is an important psychological concept which receives increasing attention in economic analysis. The investor is a risk-seeker when faced with the prospect of losses, but is risk-averse when faced with the prospects of enjoying gains. This phenomenon is called loss aversion10. Ulrich Schmidta, and Horst Zankb11 discussed the loss aversion theory with risk aversion and he aceepted the Kahneman and Tversky views.

2. Regret Aversion: It arises from the investors' desire to avoid pain of regret arising from a poor investment decision. This aversion encourages investors to hold poorly performing shares as avoiding their sale also avoids the recognition of the associated loss and bad investment decision. Regret aversion creates a tax inefficient investment strategy because investors can reduce their taxable income by realizing capital losses.

3. Mental Accounting: Mental accounting is the set of cognitive operations used by the investors to organise, evaluate and keep track of investment activities. Three components of mental accounting receive the most attention. This first captures how outcomes are perceived and experienced, and how decisions are made and subsequently evaluated. A second component of mental accounting involves the assignment of activities to specific accounts. Both the sources and uses of funds are labelled in real as well as in mental accounting systems.

4 Self Control: It requires for all the investors to avoid the losses and protect the investments. As noted by Thaler and shefrin13 investros are subject to temptation and they look for tools to improve self control. By mentally separating their financial resources into capital and 'available for expenditure' pools, investors can control their urge to over consume.

The third component of mental accounting concerns the frequency with which accounts are evaluated and 'choice bracketing'. Accounts can be balanced daily, weekly, yearly, and so on, and can be defined narrowly or broadly. Each of the components of mental accounting violates the economic principle of fungibility.

BEHAVIORAL FINANCE AND INVESTMENT DECISIONS

Behavioral finance seeks to find how investor's emotions and psychology affect investment decisions. It is the study of how people in general and investors in particular make common errors in their financial decision due to their emotions. It is nothing but the study of why otherwise rational people take some really thumb investment decisions. Decision making is a process of choosing best alternatives among a number of alternatives. This decision has come out after a proper evaluation of all the alternatives. Decision making is the most complex and challenging activity of investors. Every investor differs from the others in all aspects due to various factors like demographic factor, socioeconomic background, educational level, sex, age and race. An optimum investment decision plays an active role and is a significant consideration. Investor is a rational being who will always act to maximize his financial gain. Yet we are not rational being; we are human being; an integral part of this humanness is the emotion within us. Indeed, we make most of our life decisions on purely emotional considerations

In the financial world, investor's sometimes base their decisions on irrelevant figures and statistics, e.g., some investor may invest in the stock that have witnessed considerable fall after a continuous growth in recent past. They believe that price has fallen which is only due to short term market movements, creating an opportunity to buy the stock cheap. However, in reality, stocks do quite often also decline in value due to changes in their underlying fundamentals.

Cognitive dissonance is the perception of incompatibility between two cognitions, which can be defined as any element of knowledge including attitude, emotion, belief or behavior. The theory of cognitive dissonance holds that contradicting cognition serve as a driving force that compels the mind to acquire or invent new thoughts or beliefs or to modify existing beliefs, so as to reduce the amount of dissonance (conflict) between cognition. Festinger theory of cognitive dissonance states that individual attempts to reduce inner conflict in one of the two ways: (i) he changes his past values, feelings or options; and (ii) he attempts to justify or rationalize his choice. This theory may apply to investors and traders in the stock market who attempt to rationalize contradictory behaviors, so that they seem to follow naturally from personal values or view point.In "Financial Cognitive Dissonance", we change our investment styles or beliefs to support our financial decisions. For instance, investors who followed a traditional investment style (fundamental analysis) by evaluating companies using financial criteria such as, profitability measures, especially, profit/earning ratios, started to change their investment beliefs. Many individual investors purchased retail internet companies in which these financial measures could not be applied. Since these companies has no financial track record, very little revenues and no net losses. These traditional investors rationalized the change in their investment style (past beliefs) in two ways: the first argument by many investor is the belief (argument) that we are now in a "new economy" in which the traditional financial rules no longer apply. This is usually the point and the economic cycle in which the stock market reaches its peak. The second action that displays cognitive dissonance is ignoring traditional form of investing and buying these internet stock simply based on price momentum.

Regret theory states that an individual evaluates his or her expected reactions to a future event or situations. Psychologists have found that individuals who make decision that turn out badly have more regret when that decision was more unconventional. This theory can also be applied to the area of investor psychology within the stock market, whether an investor has contemplated purchasing a stock or mutual fund which has declined or not, actually purchasing the intended security will cause the investor to experience an emotional reaction.

- Most of the stock market investors are middle age and middle income group investors
- Income plays an important role in decision making
- confidence level of investors vary from their investment experience.

VII. CONCLUSION

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. The various causes that led to behavioral finance are anchoring, overconfidence, herd behavior, over and under reaction and loss aversions. In ssence, behavioral finance approach investigates the behavioral patterns of investors and tries to understand how these patterns guide investment decision. Behavioral finance offers many useful insights for investment professionals and thus, provides a framework for evaluating active investment strategies for the investor From this study it is clearly found out that demographics like age, gender, income, experience and education plays a major role in the risk appetite of individual investors and in their confidence level also. This study identified the major factors responsible for determining the attitudes and trading behavior of stock market investors. The most important factors that affects the attitude and trading behavior of stock market investors as obtained from factor analysis is as below: confidence level that an investors has in himself/herself as compared to formal sources, risk taking ability, more expectation and return oriented and conservative mentality.

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