Volume: 1 Issue: SP14 Pages: 100-103

International Journal of Research in Academic World

E-ISSN: 2583-1615
Impact Factor: 4.714

Received: 22/September/2022 Int. J Res. Acad. World. 2022; 1 (SP14):100-103 Accepted: 25/October/2022

# Behavioral Finance: How Behavioral Biases Affect Investment Behavior

*[1]Namrata Kalwani

*[1]Assistant Professor, Department of ABST, SPC Government College Ajmer, MDS University Ajmer, Rajasthan, India.

**Abstract**
Traditional financial theory attempts to explain the process of making financial decisions based on the rationality of the market and its participants. Traditional financial theory mentions that markets and investors are rational; investors have perfect self-control, and are not confused by cognitive errors or information processing errors. However, investors, especially veterans, behave irrationally because unintentional decisions are influenced by state of mind, emotions, trading theory, beliefs, and interpretation of information. Behavioral biases influence the actual process of decision making of investment decisions rationality is not often used in investment decisions. One of the key aspects of behavioral finance studies is the influence of psychological biases finance it can be analyzed to understand different outcomes across a variety of sectors and industries. Some common behavioral financial aspects include loss aversion, consensus bias, and familiarity tendencies. When most of the economic theories fail of explain the investment decision and the bubble in the US market then this theory comes into play to. Businesses using the combination of traditional and behavioral finance theories to generate effective client management strategies are increasing. This paper seeks to explore the influence of emotional, psychological, cognitive, and social factors on the financial decision-making of individuals and organizations.

**Keywords:** Behavioral finance, investment decisions, decision theory, investment bias, prospect theory, heuristic decision making

## Introduction

Behavioral finance emerged as a new paradigm in the field of financial economics as an alternative to traditional finance in the 1980s. It can be said that traditional finance or standard finance makes certain assumptions. One of the most important assumptions is rationality. Whenever people have to make a decision in an uncertain situation, they analyze the probabilistic results of various alternatives and choose the alternative that maximizes their utility, as suggested by expected utility theory. This means weighing the pros and cons of each possible alternative and choosing the one that works best for you. But the important question is, "Are we rational?" and "Are we making decisions according to expected utility theory?"

Behavioral finance deals with what comes to a person's mind whenever they make a financial decision. Therefore, it is very important to understand human behavior, psychology, attitudes, and prejudices. Behavioral finance is the intersection of finance and psychology. Behavioral finance economists have shown through experimental and empirical research that people's behavior that goes against economic logic is systematically and predictably irrational.

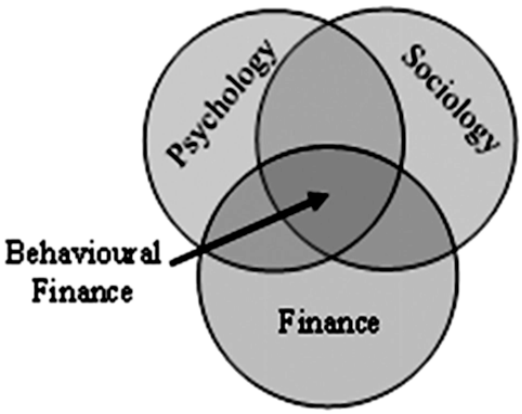


**Fig 1:** Components of Behavioral Finance

## Origin of Behavioral Finance

The origins of behavioral finance can be traced back to the 1980s. Daniel Kanhemann, known as the father of behavioral finance, co-founded one of the most important theories of behavioral finance, the Prospect Theory, with Amos Tversky in 1979. Kanhemann was awarded the Noble Prize in 1979 for

***Corresponding Author:** Namrata Kalwani

this achievement. In 2002, the two made a significant contribution to the field with an amazing collaboration. They have published about 200 articles, most of which cover psychological concepts related to behavioral finance.

Another important contribution to this field is Robert J. Shiller, who received the Nobel Prize in 2013. In his book Irrational Exuberance, he predicted and warned the world of the 2007 global financial crisis. Coincidentally, he shared the Nobel Prize with Eugene Fama, a prominent economist in the field of standard finance. As a result, the Honors Committee recognized the growing importance of the field of behavioral finance alongside traditional finance.

Although early psychological theories in this field were proposed by Kahneman and Tversky, the field was further developed by the important contribution of economist Richard Thaler. Important books he has authored/edited include Semi-rational Economics, The Winner's Curse: The Paradoxes and Anomalies of Economic Life, and Advances in Behavioral Finance (Editor), Volumes 1 and 2. He received the latest 2017 award in this field for his contributions to various important concepts in behavioral finance, such as mental accounting, nudge theory, donation bias, and more. Some of the other important names in this field are Dan Ariely,

Werner D. Bondt, Hersh Shefrin, Meir Statman *et al*.

Behavioral economists have studied and discovered many predictable mistakes that people make when assessing situations and risks. These errors are called biases.

**Different Behavioral Biases and Cognitive Distortions and their Impact on Financial Decision Making Process**

The several biases that influence decision-making incorporates loss aversion, regret avoidance, cognitive dissonance, herding behavior, overconfidence, familiarity bias, over and under reaction, framing, conservatism, disposition effect, availability bias, hindsight bias, randomness bias, endowment bias, mental accounting, Anchoring Bias, Bandwagon Bias, Pain of paying, Nudging.

Human decisions are subject to several cognitive illusions which can be classified as the illusions identified within the prospect theory and the illusions identified within the heuristic decision process.

**The Prospect Theory**

The prospect proposition describes how people choose between different options (or prospects) and how they estimate (numerous times in a prejudiced or incorrect way) the perceived liability of each of these options. The prospect proposition was proposed by psychologists Daniel Kahneman and Amos Tversky in 1979.

According to prospect proposition a group of visions may impact decision-making process of individualities. It deals with how individualities manage threat and query. According to Kahneman and Tversky (1979) individualities place much further weight on the issues that are perceived more certain than that are considered bare probable, a point known as the "certainty effect." Individual choices are also affected by "framing effect" which refers to the way a problem is posed to the decision-maker and their "internal account" of that problem.

Under the prospect proposition, an investor's decision-making process will be told by four different geste impulses grounded on the query and threat as depicted in Following Figure.

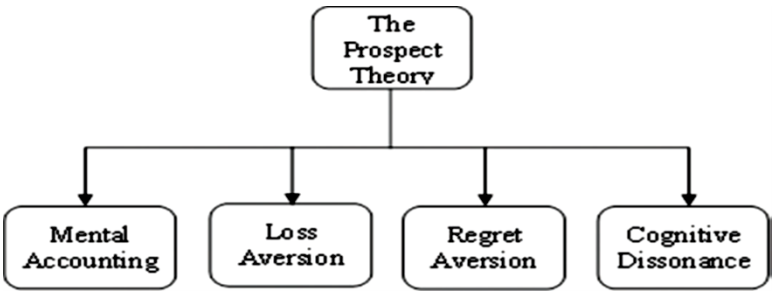


**Fig 2:** Components of Prospect Theory

These are dealt with in detail herein.

**Mental Accounting**

Thaler (1985) established the conception of 'internal account'; tallying to which individualities tend to mentally allow their current and unborn substance into non-transmittable separate chambers. Farther, nonidentical situations of mileage are assigned to each group which has an illogical jolt over their consumption and other opinions.

For illustration, tallying to the objective of the account, a special deposit is set aside for a holiday or a new house, while still having a huge credence card debt. The plutocrat in this special deposit is being treated else from the plutocrat that the same person is utilizing to pay down his or her debt, despite the fact that interest disbursements towards debt prepayment reduces the person's net worth. Hence, it's mischievous to have savings in this deposit earning little or no interest while the credence-card debt is outstanding at a veritably high rate of interest annually. Preferably than saving for a holiday, it's further logical to exercise the finances in the deposit to pay off the precious debt.

To beat this, one must understand plutocrat is commutable anyhow of its origin or intended use. One can slash down on gratuitous spending of redundant gained plutocrat, by realizing that redundant gained plutocrat is noway nonidentical than bones hard-bitten earned plutocrat. One should also realize that saving plutocrat in a low-or no-interest account is meaningless if one still has an outstanding debt carrying high rate of interest to repay. In utmost cases, the interest on your debt will corrode any interest that you can realize in utmost savings accounts, therefore, performing in an common drop in the substance

**Loss Aversion**

Most of the persons behave so as to minimize losses because losses attract higher than gains, even though the probability of those losses is very less. The pain of losing explains why, when gambling, winning Rs.200 and then losing Rs.160 feels like a net loss even though you are actually ahead by Rs.40. Person's reaction to loss is more extreme than their reaction to gain. (The order is also important were we to first lose Rs.160, then come back and win Rs.200, it would shift our reference point and make it feel like a net gain)

An information uploaded on websites can play in person's

bias in order to peruse him to purchase or some other decision. For Instance insurance websites frequently display a long list of unlikely, yet costly outcomes that we may encounter should we not buy insurance. This list encourages us to avoid such large losses and makes us forget the small but regular payments we will make indefinitely to secure coverage.

**Abhorrence of Regret**

When making decisions, all outcomes, the probabilities and consequences of each outcome are considered and selected based on them. What people actually do is often different. They think about the worst possible outcome and how they will feel about it (their level of regret). Then choose options that minimize regret, even if not optimal.

Yes. When choosing a stock, you need to consider the potential gains and losses as well as the losses and gains each stock can cause. What most people do is different. They think how bad it would be if stocks move as badly as you can imagine, and they try to minimize that feeling. This leads to the wrong hedging strategy.

**Cognitive Dissonance**

The tendency to adjust beliefs to justify past behavior is a psychological phenomenon called cognitive dissonance. Individuals are distressed by conflicting cognitive elements, such as a discrepancy between empirical evidence and past choice, and that they alter their beliefs to reduce this discomfort (Festinger, 1957). Individuals alter their beliefs to conform to their past actions is the key feature of dissonance. Cognitive dissonance can be considered a psychological conflict that individuals seek to reduce by adjusting their beliefs about the efficacy of past investment choices in the context of investment decision-making. There is a mental clash that individuals face when they find that their convictions and suspicions aren't right, which prompts them out of line and irrational investment decisions. They tend to disregard new data that negates known convictions and choices.

Example: Rohan is looking to buy a stock of an ABC limited because he believes that ABC limited will perform well in the future Limited ABC stock is currently trading at Rs.140 on the market, and Rohan is thinking of buying the stock once a few dollars drop to Rs.130. Three days later, the stock reached Rs.136 and Rohan thinks the stock will hit Rs.130 sooner. But three days later, the stock suddenly surged to Rs.150, driven by demand from other investors.

At this time, Rohan is more likely to experience cognitive dissonance. Now the question arises as to why Rohan suffers from cognitive dissonance, let's try to find the answer. Rohan here sees the price of ABC finite stock soaring, showing that he can buy it for Rs.136 and will feel uncomfortable because it is what the market is offering compared to the previous trading price. It is possible that Rohan will buy a portion of the stock for Rs.150 to overcome the discomfort he is experiencing. Rohan might still think it's good to buy a stock at a higher price because other investors are also buying at the same price, but Rohan is irrational in that it justifies the buy.

**Heuristic Decision-Making Process**

In general, heuristics are methods or techniques that people use to make decisions or solve problems more quickly. We often use the phrase rule of thumb in the same sense. Results using heuristics may not be perfect or optimal, but are usually "good enough". The

heuristics are efficient rules that people generally follow to make judgments and decisions that usually involve focusing on one aspect of a complex problem and ignoring others. While these rules work well in most situations, they can deviate from standard logic, probability, or traditional rational choice theory. In practice, investors collect relevant information that is reasonably valued when it involves mental and emotional factors that are difficult to separate. These factors include overconfidence, representativeness, anchoring, herd behavior, and hindsight bias.

Under the heuristic decision theory, an investor's decision-making process will be influenced by five different biases based on the uncertainty and risk as depicted in Following Figure:

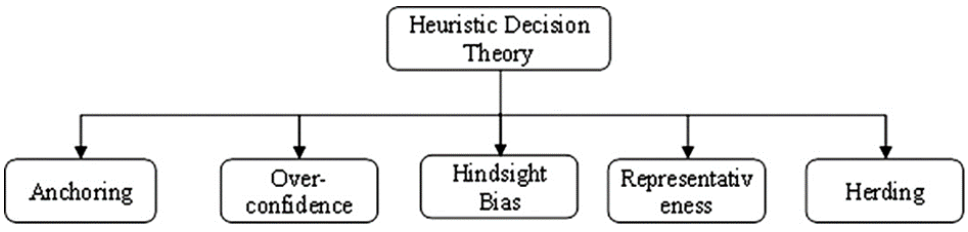


**Fig 3:** Parameters of Heuristics Decision Theory

These are dealt with in detail herein.

**Anchoring Bias**

The fixed heuristic, also known as focalism, describes the human tendency to accept and rely on first information given before making a decision. The first part of this information is the anchor and sets the tone for everything that follows.

Number pinning is a phenomenon in which initial exposure to a number serves as a starting point and influences subsequent value judgments. This process usually occurs without cognitive awareness. The credit card tip system used by NYC taxis is a smart anchor. In this system, the credit card system will automatically tip 30-35%. As a rule of thumb, a 25% tip seems low, so the passenger will end up getting 25% of the taxi fare as a tip. Prior to this system, the average tip was only 12-15%. During negotiations, most people tend to ask the other party for a price to start the negotiation. The buyer wants the seller to specify a price, and the seller wants the buyer to specify a price so that the anchor can be obtained. And they use this price as an anchor for negotiations. This is how the human mind works. Calculating "real value" is tricky. But the human mind is easier to circumvent the norm.

**Overconfidence Bias**

Confidence bias can be defined as a tendency to be more confident in one's own abilities and to overestimate the accuracy of information compared to others. As a result, confident investors and traders tend to believe that they have a special ability to pick stocks that always yield profits.

**Hindsight Bias**

Person often believe that they knew the outcome of the event before the actual event has taken place. Therefore it is though that they suffer Hindsight Bias in which after the event has happened, they claim that they already knew it all along even when the event has not happened. Hence, it is also called 'I-knew-it-all-along' phenomenon. The phenomenon is seen in a number of different conditions ranging from politics or sports or stock markets. There are many factors which contribute to hindsight bias according to scientist. First, people tend to recall information very selectively and recall information that confirms what they believe to be true. You then organize your stories to make the information more meaningful. When we tend to interpret the outcome as if it were predictable. Research also shows that people want to see a more predictable world because the world is complete. And a more predictable world contributes to a more positive view of ourselves.

**Representativeness bias**

Representativity bias heuristics arise when the similarity of an object or event confuses people's thinking about the likelihood of an outcome. People often make the mistake of believing that two similar objects or events are more closely related than they really are. This representative heuristic is the common information processing error in behavioral finance theory. One example of this representative bias in financial markets is when investors automatically assume that good companies make good investments. But not necessarily. A company can be great in business, but bad in other areas of the business**.**

**Herding Bias or Bandwagon Bias**

It refers to the tendency of investors to follow and copy what other investors are doing. Investors are mostly influenced by emotions and instincts, rather than by their own independent analysis. This guide provides examples of how investors can combat herd bias, within the framework of behavioral finance theory.

In financial markets, when the investor starts buying or selling stocks because everyone else is doing it, he is part of a group. This happens because if the investor faces a loss on an investment with a lot of other investors, the failure will not be as severe as if he lost alone. Herding behavior also leads to "abomination of remorse." Joining a band gives you a sense of security like a doctor, not better investor decision making. The strong herd mentality can even affect financial professionals in the industry.

**Conclusion**

The purpose of this study is to understand how investors' emotions and psychology influence their investment decisions. This is a study of how people in general, and investors in particular, make common mistakes in financial decisions because of emotions. This is nothing more than an exploration of why rational people rely on rules of thumb to make investment decisions. Decision making is the process of choosing the best alternative from a set of alternatives. This decision was made after careful consideration of all alternatives. Decision making is the most complex and complex activity of individual investors. Each investor differs from others in every way due to a variety of factors such as demographics, socioeconomic status, level of education, gender, age, ethnicity and religion. Optimal investment decisions play an active role and are an important factor. Investors are always rational beings who act to maximize their financial interests. However, individual investors are not rational. An integral part of humanity is the sentiment among investors. In fact, investors make most of their life decisions based purely on emotional considerations. In the financial world, investors sometimes make decisions based on unrelated figures and statistics. For example, some investors may invest in stocks that have recently declined significantly after a sustained rise.

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