Behavioral Finance in Investment Decisions: A Literature Review and Related Issues

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ABSTRACT

Behavioural finance is a stimulating new field as it presents numeral normative propositions for both individual investment decisions and corporate financial decisions. While traditional financial theories such as portfolio optimization theory, the capital asset pricing model and the efficient markets hypothesis emphasizes on rationality in decision making, the emerging field of behavioural finance investigates the more well-known psychological concerns that impact the decision-making process of individuals, groups, and organizations. The field of behavioural finance has endeavoured to describe a number of biases, heuristics, and inefficiencies present in financial markets since its origin. This paper is prepared as a systematic literature review of behavioural finance, and includes both the shaping works as well as more recent papers. This paper will discuss behavioural finance theories like overconfidence, loss aversion, the problem of inertia, the theory of regret, and the prospect theory, corporate finance, and momentum investing. Finally, this paper will draw unique conclusions across behavioural finance and put forward some topics within behavioural finance, which are likely to yield the most appealing research in the near future.

Keywords: behavioural finance, efficient markets hypothesis, overconfidence, and corporate finance.

Introduction

Traditional finance has been the leading concept for decades, which was followed, in the early part of during the year 1920 to 1950. This approach is based on the past occurrence and the traditionally accepted technique. This concept has been looking for understanding the financial decisions by making a few normative assumptions about individual behaviour. One of these assumptions is that investors or individuals, institutions, and even markets behave rationally. According to traditional finance theory, rational decision makers evaluate all available information and possible outcomes, and make rational choices that lead to maximizing expected utility. That is, they act in an unbiased fashion and make decisions that maximize their self-interests. Those who make suboptimal decisions would be punished through poor outcomes. The basis of this concept is classical decision theory.

The rationality of market participants nourishes into a further leading theory in finance – the efficient markets hypothesis (EMH), which states that financial markets are rational and where all the information is efficient. The EMH was developed by Professor Eugene Fama who argued that stocks always trade at their fair value, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices.

The traditional finance paradigm attempts to understand financial decisions by building on the notion that rational investors and other market forces correct mispricing. Despite the appeal of the traditional finance paradigm, it places an unrealistic burden on human behavior. Although traditional asset pricing theory has rigor, evidence shows that many of its assumptions are unrealistic from a behavioral standpoint and some of its associated findings are invalid. Based on the traditional finance theories of human rationality and efficient markets, conventional wisdom suggests that success emerges from accurate quantitative analyses. Yet, behavioral research in perception, judgment, and decision-making under uncertainty combined with qualitative evidence reveals a different story. Consequently, behavioral finance researchers turned to observed behaviors to develop models that describe how investors actually reach their decisions.

Research Objectives

- To study the origin of Behavioral finance and what path it has taken to acquire where it is today?
- To analyze the present state of Behavioural Finance
- To state the future scope and to find out the area for further research.
Behavioural finance: 

Behavioural finance came forward in the 1980s as a new conception that seeks to combine behavioural aspects in economic and financial decision-making process to provide explanations for why people make irrational financial decisions. Behavioural finance confronts the efficient market theory and assists to understand the investor’s behaviour in financial decision making. Behavioural finance suggests that the investment decision-making process is influenced by various behavioural biases that encourage investors to deviate from rationality and make irrational investment decisions. Meaning of behavioural finance assumes two key aspects: individual investors and entire market. In other words behavioural finance in a wide sense is divided to macro behavioural finance and micro behavioural finance (Pompian, 2006). Macro behavioural finance discloses and describes anomalies of efficient market hypothesis that could be explained by models of people behaviour. Micro behavioural finance analyses behavior of individual investors.

Olsen (1998): “Behavioral finance seeks to understand and predict systematic financial market implications of psychological decision process. Swell (2005) asserts that behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets. Further in 2007, he has stated that behavioral finance challenges the theory of market efficiency by providing insights into why and how market can be inefficient due to irrationality in human behavior.

Fathers of Behavioral Finance

Daniel Kahneman and Amos Tversky, renowned as the Fathers of Behavioral Finance and this part is presenting some of the key literary works of these two. Tversky’s mathematical work on the normative theory and Kahneman’s ‘psychophysical emphasis on the difference between objective stimulus and subjective sensation’ blended perfectly to serve the purpose (Heukelom, 2007).

The first paper authored by these two-, “Belief in the Law of Small Numbers” was published in 1971, in which they state that “People have erroneous intuitions about the laws of chance. In particular, they regard a sample randomly drawn from a population as highly representative”(Kahneman and Tversky, 1971). In their 1972 publication titled “Subjective probability: A judgment of Representativeness”, they study the Representativeness bias and followed it up with a 1973 publication titled “On the psychology of prediction” which says that Representativeness play a key role in intuitive predictions made by individuals (Kahneman and Tversky, 1972, 1973). In 1974 “Judgment under Uncertainty: Heuristics and Biases”, one of their prominent works, was published. They described three heuristics – Representativeness, Availability and Anchoring. They said that “a better understanding of these heuristics and of the biases to which they lead could improve judgment and decisions in situations of uncertainty”.

In 1979 their most important work titled “Prospect Theory: An analysis of decision under risk” appeared in Econometrica, which was ‘a critique of expected utility theory as a descriptive model of decision making under risk’ and the alternative model developed was called Prospect Theory. Kahneman was awarded the Nobel Prize in Economics in 2002, for his work in Prospect Theory. Tversky and Kahneman (1981) introduced the effect famous as Framing in his paper. It was shown that when the same problem was framed in different ways, the psychological principles that governed the perception of decision problems and evaluation of probabilities and outcomes produced predicated shifts of preference.

Overconfidence

In general, you are overconfident when you overestimate your ability to make the correct choice or decision. People are generally overconfident regarding their ability and knowledge. They tend to underestimate the imprecision of their beliefs or forecasts, and they tend to overestimate their ability. Thus, overconfidence can cause investors to under-react to new information and that leads to earn significantly lower yields than the market. The belief that you can forecast the future with precision is a common form of overconfidence. According to Shefrin (2000), Overconfidence “pertain to how well people understand their own abilities and the limits of their knowledge” 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. These tendencies were researched.
Prospect Theory

The Prospect theory was envisaged by Kahneman and Tversky (1979) and later on Daniel Kahneman being awarded the Nobel Prize for Economics for his work. The theory discriminates two phases in the choice process: the early phase of framing and the subsequent phase of evaluation. Tversky and Kahneman, by developing the Prospect Theory, demonstrated how people manage risk and uncertainty. The theory clarifies the evident irregularity in human behavior when evaluating risk under uncertainty. It says that human beings are not constantly risk-averse; rather they are risk-averse in gains but risk-takers in losses.

“certainty effect” is as people place much more weight on the outcomes that are perceived more certain than that are considered mere probable. Kahneman and Tversky, 1979. “Framing” refers to the way in which the same problem is worded in different ways and presented to decision makers and the effect deals with how framing can influence the decisions in a way that the classical axioms of rational choice do not hold. It was also demonstrated systematic reversals of preference when the same problem was presented in different ways (Tversky and Kahneman, 1981).

The value maximization function in the Prospect Theory is different from that in Modern Portfolio Theory. In the modern portfolio theory, the wealth maximization is based on the final wealth position whereas the prospect theory takes gains and losses into account. This is on the ground that people may make different choices in situations with identical final wealth levels. An important aspect of the framing process is that people tend to perceive outcomes as gains and losses, rather than as final states of wealth. Gains and losses are defined relative to some neutral reference point and changes are measured against it in relative terms, rather than in absolute terms (Kahneman and Tversky, 1979). Another element of the prospect theory is the weighting function: The value of each outcome is multiplied by a decision weight. Decision weights measure the impact of events on the desirability of an investment. They are not probabilities and typically do not add up to unity. Kahneman and Tversky (1979) call this property sub-certainty. Prospect theory describes several states of mind that can be expected to influence an individual’s decision-making processes.

Corporate Finance and Behavioural Finance

One part of behavioral finance that is overlooked at times is its effect on corporate finance. Heaton (2002) looks at managerial optimism and how free cash flow can both help and hurt companies with overly optimistic managers. In the article, Heaton finds that managers who are overly optimistic over-estimate the Net Present Value of company’s projects and also believe that a firm’s risky securities are undervalued. This premise has two results. The first is that the manager will tend to take projects that are actually Net Present Value negative, because they are overly optimistic about the project’s true worth. In this sense free cash flow is a bad thing because it makes it easier to accept bad projects. On the other hand, if a manager views a company’s securities as undervalued, then he will be less likely to want to issue new securities to fund NPV positive projects. This combination leads to significant loss for the company.

Another application of behavioral finance to corporations is through prospect theory. Kliger and Tsur (2011) take prospect theory a step further by applying it to troubled corporations. Firms that had suffered bad performance were less loss averse and
more willing to take risks. Grinblatt et al. (1984), and Desai and Jain (1997) find evidence of drift following stock splits. Furthermore, after seasoned equity offerings individual stock returns are poor, and continue to be mediocre for more than a year following the offering (Loughran and Ritter, 1995; Spiess and Affleck-Graves, 1995). Baker and Wurgler (2000) show that return predictability from aggregate security issuances obtains at the market level as well. Further, Loughran and Ritter (1995) find similar negative flow after IPOs. Finally, dividend initiations lead to positive drift and dividend cuts to the opposite (Michaely et al., 1995). Apart from episodic events such as stock splits and mergers, there also is a question about how managers make more mundane decisions such as capital budgeting, the choice of capital structure, and the initiation/maintenance of dividends.

Future Scope
There are probably a number of different areas of behavioral finance with regard to above study that will excel in the coming years. Behavioral finance needs to move towards the study of particular biases and the grouping of biases for research. This is similar to the point made above about the formulation of na analysis for biases. The other area of further research is wealth and investment management. While financial researchers have to look forward to behavioral finance in corporate finance will also promote.

References