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Role of Behavioural Finance in Investors Decision Making

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ABSTRACT:

Individual's investment choices and decisions that lead to these choices are highly influenced by an individual cerebral level of understanding. Often these decisions are based on the available information which make it easy to interpret the statistics and lead to decisions which makes an individual optimistic about his/her choices. But reality talks different. What you seek is not always true. Investor's emotional intelligence, heuristics, risk tolerance, regret aversion etc. form the basis of individual's choices. These decisions come from psychological and sociological behaviour that leads to irrational choices. Behavioural finance is a psychological concept and irrational decision choices of the investors is the basic idea of the whole concept. The research surveyed 110 respondents that form the sample size of the particular research. Respondents are asked questions to check their cerebral knowledge and behavioural approach in various cases of selecting their investments and their decision making for the same. The research analyses the attribute of emotional intelligence (EQ/EI), the heuristics and its biases involving quick decisions under pressure or need to make accurate judgements and the behavioural finance impacting decision of portfolio selection of an individual.

KEYWORDS: behavioural finance, portfolio, investors, decision making.

INTRODUCTION:

This research paper is focusing on behavioural finance and the heuristics and emotions involved in the financial decision making resulting into portfolio management. Behaviour finance is a branch of psychology which studies the influence of behaviour of investors or financial analysts on market outcomes. This subject focuses on the fact that investors are not always rational and that they can take financial decisions based on their emotions. They tend to ignore logic and statistics while taking these decisions and let their personal biases take control instead. Traditional finance on the contrary, assumes that an investor is a rational person who can process information leaving out his personal biases. Behaviour finance is a more real-world experience which takes investors emotions and biases into consideration.

The first part of the research paper is focusing on the heuristics that influence financial decisions of investors and analysts. This research is exploratory and is open for conclusion. The first part mainly includes the explanation of heuristics and its impact on financial investors while making decisions. Although, heuristics are useful for making quick judgements in complex situations and helps in solving problems quickly and efficiently with incomplete information, they may not be helpful in making financial decisions. Statistics and analysis are comparatively more helpful and reliable while taking decisions related to stock market. Researchers have studied about risk taking ability and risk palatability in financial investors and how it affects their decisions related to the stock market. Risk taking and risk palatability leads to irrational decisions and adverse investment planning and portfolio management. Finally, the researchers have also studied about the impact of heuristics and emotions and risk-taking factor on portfolio management. Portfolio management is a very important thing in today's world. Therefore, these decisions should be unbiased and based on statistics and analysis which can yield expected rates of return from investments.

METHDOLOGY:

This research is an exploratory research, in the sense that no conclusions are made and the analyses under hypothesis is for sole purpose to study the attributes of behavioural finance and its impact on the decision making of the investors. The survey conducted by the researchers is for the better understanding of investor's mind-set when he/she makes decisions regarding financial assets. The research begins with emotional intelligence playing a role in such decisions, then heuristics method that come along the way under pressure to make better decisions and later the impact of behavioural biases on portfolio selection.

STATEMENT OF PROBLEM:

The problem explored by the researchers in the research paper is broadly based on behavioural finance and its attributes affecting the decision making of investors. The fear of losing their savings, lack of knowledge about market prospects, lack of risk tolerance, quick decisions, influence of other investors etc. form basic problems of the individual investor's that they don't even try to invest. The researchers explore all the answers obtained from the respondents and explores the behavioural finance theory.

OBJECTIVES:

1. To understand Heuristics and its implications for Decision Making.
2. To detect the factors which have an impact on the investor's decision.
3. To understand the emotions of investors which lead to adverse decision making.
4. To analyse the factors and timeline of investors emotions.
5. To study the investors decision making attributes while selecting financial asset for their

portfolio.

6. Whether behavioural finance theory has role in the portfolio selection.

HYPOTHESIS:

Decisions related to finance are not influenced by heuristics.

Emotional patterns affect investors decisions.

Portfolios are highly influenced by particular human heuristics.

ANALYSIS:

Hypothesis 1:

When decisions related to risk and uncertainty are to be made, one often relies on heuristics. A heuristic is a mental shortcut that helps people in taking tough decisions, solving problems and making judgements quickly and efficiently. These shortcuts often simplify complex problems and situations with incomplete information and help us make decisions under pressure.

1. Representativeness Heuristic-

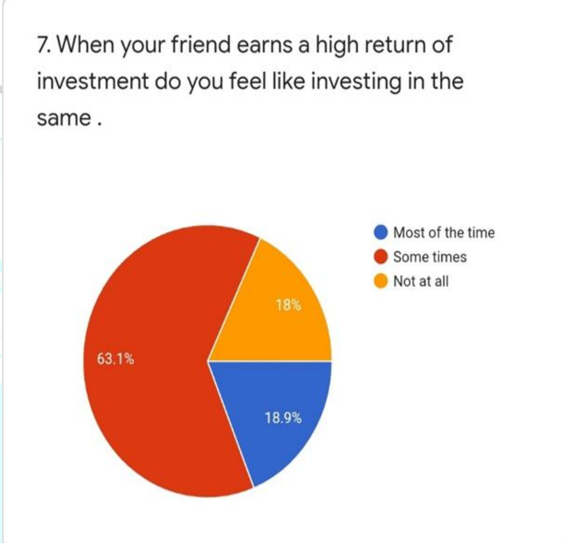
Representativeness Heuristic occurs when one's thinking process is influenced by similarity of events or objects regarding the possibility of an outcome. People often wrongly believe that two similar things have a close correlation than they actually have. This results in confusion and creates a bias in the decision-making process. One of the important things from this heuristic is to judge a problem, based entirely on statistical data or logic instead of correlation. While making financial decisions one should often match the reasoning to the outcomes, whether good or bad. For example, forecasting future outcome on the basis of historical performance. People often assume that a stock that has shown a significant growth in its outcome in the last five years will continue to do so indefinitely in the future.

2. Overconfidence Heuristic-

Overconfidence heuristic is a tendency in which people overestimate the assessment of their skills, talents and intelligence. This heuristic creates a mirage in which people falsely believe that past success was the result of their skills and not just dumb luck. Most investors consider themselves to be above average in their analytical skill. Correctly predicting an outcome of a stock leads to investors believing that they have mastered the knowledge of financial market. Such investors don't often rely on statistics while making financial decisions and they might even overconcentrate their portfolios. When investing in stocks, one should remember that portfolios should be diversified as price movements are very unpredictable. This heuristic influences an investor in believing his investments are less risky than they actually are and leads to the downfall of portfolios. People believe that they are in control of a situation but they are actually not is a result of Illusion of Control. All these types of overconfidence heuristics create bias in financial planning of investors.

3. Herd Mentality Heuristic-

Herd mentality bias is a tendency of financial investors to follow and copy other investors in their investing patterns and stocks. These investment decisions are influenced by emotion and instinct and not by logical or statistical analysis. People are hard-wired to herd. Investors often herd with financial analysts' recommendations without even doing our own independent analysis. It is emotionally or psychologically painful to go against the crowd.



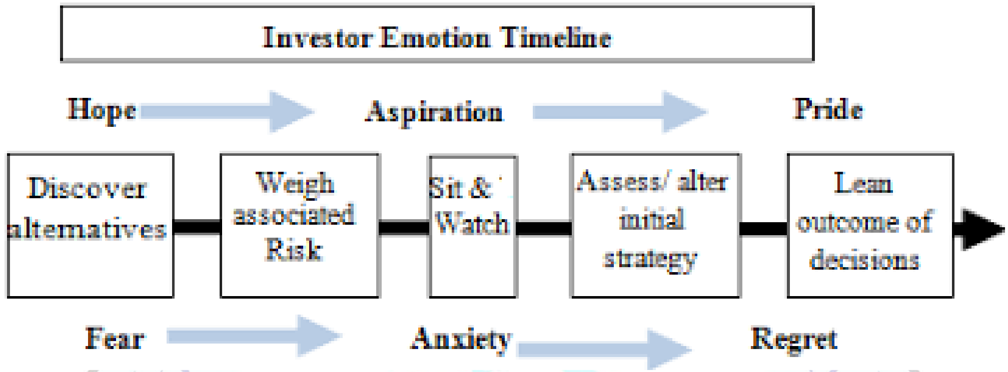
This statistics prove that herd mentality bias forms a part of decision making process of financial investors. When a friend earns a high return of investment, 63.1% investors feel like doing the same sometimes while 18% investors feel like doing the same most of the times. Therefore, majority of-investors let herd behaviour bias in their financial decision-making process.

Hypothesis 2:

Most of the public today invests in some or the other financial tool and seem to be aware of the financial gains from their respective investments. In this process the common trend seen is that most of these investors consult to various financial consulting firms or advisory firms. The decisions taken thereof are majorly depended on the investors emotional and behavioural patterns. As the above heuristics prove the various forms of behaviours that investors go through, it is important to see how these behaviours shape the decision making of the investors. In most financial decisions a major aspect to notice is the risk-taking ability and the risk palatability.

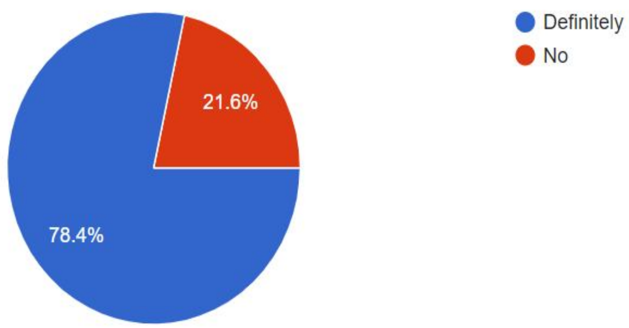
These forces act as the major driving forces that influence investment decisions. There is a set of process the investors go through internally which finally leads them taking these adverse financial decisions. To understand them in depth we first had a look at the major heuristics that cause the human behaviour to think and act in certain way. After the play of heuristic the investors go through a psychological process which the researcher names as Timeline of affecting factors.

Irrational behaviour of investor builds the foundation for behavioural finance. According to (Shefrin 2009) "hope and fear" are two factors which lead people to behave irrationally. The following diagram is with the exact reference of how the emotions of investors influence him to take particular decisions in certain adverse ways.



Here as per the author Fear and Hope are the two emotions that trigger the investors. The fear ultimately leads to regret, hope ultimately leads to pride. These are the emotions that make investors irrational. Many a times various investors do paper trading to check the accuracy of their predictions. This habit of paper trading gives them a sense of belonging and assures them that their decisions are right. This leads to higher aspirations in the coming time and finally causes the investor to develop emotions of pride for his predictions and stocks. The same is the case with the fear of investing. The fear that creeps from the past losses occupies a major part of the investors bias towards a particular investment opportunity. The fear of making losses is so pertinent in the mind of the investor that he/she doesn't take the trade.

The diagram below shows a particular data from the survey collected by the researcher. The data shows that 78.4% of the investors believe in paper trading. This phenomenon simply builds the confidence of the investor to predict stocks without actually trading them.



These are the attributes thus analysed by the timeline of affecting factors which show the adverse decisions of investors.

1. Overconfident investor overestimate their ability toevaluate the investment avenues.

2. Overconfidence of investorsmakes them trade excessively based ontheir intuitive reasoning and by overestimatingknowledge.

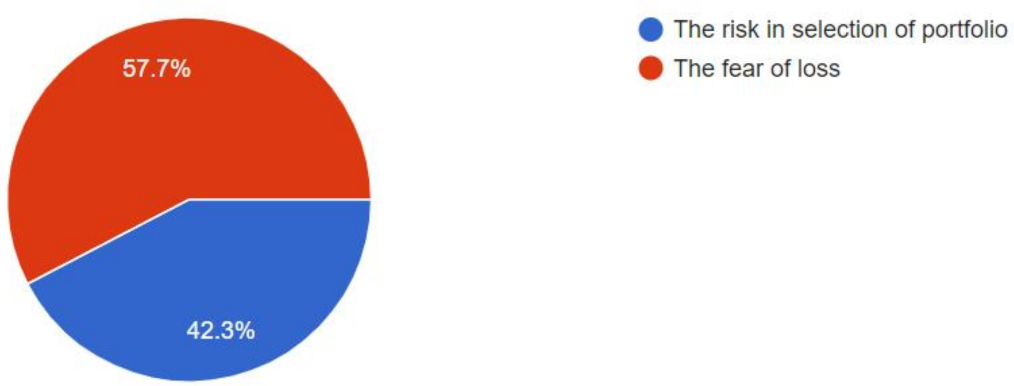
3. By overestimating the abilities,overconfident investor may underestimate theirdownside risks.

4. Most overconfident investors hold less diversifiedportfolios.

The following conclusion is reached by analysing the emotions and the process of development of these emotions. Thus it is coined by Samuelson and Zeckhauser, Status Quo Bias, is an emotional bias in which people do nothing instead of making a change. People are generally more comfortable keeping things the same than with change and thus do not necessarily look for opportunities where change is beneficial. Given no apparent problem requiring a decision, the status quo is maintained.

Emotions, such as fear, hope, anger, regret, pride, worry, excitement, guilt and mood may also influence investment decision making. These emotions determine the risk tolerance level of an investor. The risk tolerance of investors is directly related to the investments they choose and the financial decisions they make. The risk tolerance of a rational economic man as defined by the standard economics differs from the level of risk tolerance of the irrational man that goes through these emotions. These levels of risk tolerance decide the decisions of the investors.

Decision making is the process of choosing a specific investment alternative from the basket of alternatives. The process of choosing is done after the evaluation of all the alternatives. Thusbehavioural finance assumes the investors are irrational in the process of "choosing and selecting" their investments. They will react according to the new information which is perceived to them by their emotions.The same leads to irrational decisions and adverse investment and financial planning.



Hypothesis 3:

Portfolio selection is a process of selection of financial assets for attaining maximum profit at varied level of risk. Investor's portfolio selection is based on different factors every selection is taken for maximum optimisation, keeping in mind risk tolerance long term needs, short term needs extra income etc.

Investor's portfolio selection decision is heavily influenced by market behaviour and psychological behaviour. Researchers have found these two attributes aiding two theories namely Market portfolio theory (MPT) and behavioural finance theory. Before MPT, Eugene Fama of Chicago University had done the market hypothesis which suggested that investors are rational and only have available information on basis of which the investors mark their decisions. Their conventional theory suggests that the financial market will return an average extra income of at least 9 % per year which suggests their income would double in 10 years. Obviously looking at the prospects this sounds as an amazing offer.

Market portfolio theory was developed by Harry Markowitz came around the same time that suggested how a rational investor can mix different criteria assets to attain maximum output from the market at various risk tolerance levels. This theory was called "efficient frontier".

Even after all of this, it is not as simple as it looks on papers. Reality states different. Behavioural Finance Theory suggests the irrational behaviour of investors while making decisions regarding asset selection. This psychological behaviour is caused by observational, emotional, present conditions of the investors. It affects the emotional quotient (EQ) and the investor tends to make heuristics approach when selecting his/her financial asset. Investor tend to exhibit various behavioural biases while making decisions. Holding investment for long to avoid losses, overconfidence, high risk, etc. are few of the biases.

Overconfidence bias

Overconfidence biases is actually when the person thinks his judgement accurate than it actually is. It makes less than correct decision for investment. Surveys taken earlier suggest that 70% believed that they were affirmative and above average in their judgements and the remaining 30% said that they were average. No one said that they were below average which is clearly not possible statistically.

Herding bias

Herding as the name suggest moving where the herd moves. It basically means getting influenced by the action and moves of the other investors. In behaviour finance, it is very common tendency.

Mental accounting Bias

Mental accounting bias is a cognitive bias which leads the investor to give subject name to the money. Let's say, investor puts the money into two different blocks and assigning them their purpose, intent or use. For example, one portion was for education of kids and other for retirement purpose.

The above graph has been taken from the survey conducted by the researcher. The date shows safe 65 % investors believe that they get influenced by the decisions of other investors or if those investors are getting profits from their trade or not and their wish to go for safer investment and less risk. These 65% investor make their decision of financial asset based better profit less risk. The above statistics clearly indicates the researcher about the influence on investors and their irrational decisions.

The factors/biases that can be witnessed from the graph are:

- Herding bias
- Over optimism that they would attain the same level of profit at others.
- Heuristic decision (quick decisions) for better result
- To earn maximum return from the market

The analysis thus concludes the psychological and behavioural impact of investors on their decisions. However, it still debatable that whether which one the modern theory or behavioural theory is more responsible while making decisions of portfolio selection.

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