

Role of Behavioural Finance in the Financial Market

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Abstract: *There are mainly two disciplines of financial market study viz. Conventional Finance and the recent development known as Behavioural Finance. Conventional finance foundation is mainly based on efficient market concept, Investor rationality concept and the modern portfolio theory developed by Markowitz. But till 1990 the conventional finance theories were not so been challenged. But from mid 90's researchers have shows many shortcomings of the existing theory and particularly challenged the investor rationality concept. As a result a new paradigm known as behavioural finance has been developed. In this paper an attempt has been made to highlight the shortcomings of the traditional finance theories as pointed out by behavioural finance supporters and also a discussion on the significance of behavioural finance.*

Key words: *Traditional finance, Behavioural Finance, Rationality.*

I. Introduction

Financial Markets are the place where Financial Instruments or the Financial Assets are traded. Financial assets mainly directed towards the securities issued by companies or in other words they include mainly the shares or stocks, debentures, bonds etc. The study of financial markets has always been a centre of attraction of the researchers. Different stages or developments have resulted due to this curiosity of scholars. Different theories were also developed in this regard. Basically these developments are classified into three broad categories, viz. Traditional Finance theories, Modern Finance Theories and the latest addition is the Behavioural Finance theories. In this paper an attempt has been made to throw some light in the development of the Behavioural finance in spite of the presence of other theories and will also discuss a few behavioural finance principles and their significance in the financial market study.

II. Statement of the Problem

Finance is the life blood of any business and in this competitive world the company requires more capital to expand their activities. The growth of companies is also necessary for rapid industrialization and economic growth of the country and which ultimately depends on the public .Shares are the most important source of finance for a company. So to attract more and more investors towards securities market will not only boost the economy of the individual companies but also contribute to the national development as a whole. Therefore to study not only the ups and downs in the financial market but also the behaviour of its investors which causes such ups and downs seems very effective for the growth of the financial market. That is why in this paper an attempt has been made to describe the growth of latest finance discipline, i.e. behavioural finance.

III. Objectives of the Study

The main objective of the paper is to highlight the limitations of the traditional finance theories and the significance of the growth of behavioural finance discipline in the study of investors' behaviour in financial market. A bird eye view of a few behavioural finance principles is also tried to be presented as the next objective.

IV. Methodology of the Study:

The paper is mainly conceptual and descriptive in nature and it is based on the different research papers, journals, articles related to behavioural finance available over internet based sources. Various other related books and journals which are available in physical form are also accessed to develop the foundation of the paper.

V. Literature Review

A wide range of studies available over internet based sources and also a few books and journals are consulted to develop the foundation of the paper. The main development of the conventional finance is the "Efficient Market Concept". As rightly pointed out, the efficient market hypothesis became one of the most influential concepts of modern economics and a cornerstone of financial economics.

It was extended in many directions, and literally thousands of papers were written about it [Alajbeg Denis et al., 2012]. But in spite of being a central theory of finance it also has been criticized on many grounds. “The Efficient Market Hypothesis is considered as the backbone of contemporary financial theory and has been the dominant investing theory for more than 30 years (from the early 60s to the mid 90s). Needless to say, a generation ago, it was the most widely accepted approach by academic financial economists” [Konstantinidis et al., 2012].

The conventional or standard finance laid its foundation on two main models -- The efficient market concept and the Markowitz model. But the investor decision making cannot solely be based on these two models. M. Kannadhasan (2006) in his paper wrote that decision-making is a complex activity. Decisions can never be made in a vacuum by relying on the personal resources and complex models, which do not take into consideration the situation. The investor rationality concept has also been criticized by many scholars. Behavioural finance is a new approach to financial markets that has emerged, at least in part, in response to the difficulties faced by the traditional paradigm. In broad terms, it argues that some financial phenomena can be better understood using models in which some agents are not fully rational [Nicholas Barberis & Richard Thaler, 2003].

In an report to identify the common investment mistakes and to provide insights into how investors make the initial decision to invest and why some are reluctant to invest at all, **Seth L. Elan(2010)** stated that Active Trading, More Attention to the Past Returns, Familiarity Bias, Momentum Investing, Under diversification, etc are some of the common mistakes made by the investors and Financial illiteracy and the lack of trust in financial markets play important roles in curbing participation in retirement plans.

Abhijeet Chandra and **Ravinder Kumar** in a study attempting to investigate the factors influencing individual investor behaviour in Indian Stock Market found that there are five underlying psychological axes that appear to be driving the Indian individual investor behaviour. These five pertinent axes on the basis of the underlying variables are named as prudence and precautionous attitude, conservatism, under confidence, informational asymmetry, and financial addiction. The results reveal some psychological axes, such as conservatism and under confidence, which are consistent with the prior literature to some extent; but there are some contrary behavioural axes reported by the multivariate analysis such as prudence and precautionous attitude and informational asymmetry which are not yet considered in prior literature in growing economies, particularly in Indian context. Thus there are many studies available some of which support the traditional finance and some are against the theory. Those critics have given birth to the new discipline named behavioural finance.

VI. Limitations of Conventional Finance

Many limitations of conventional finance are shown by different researchers. Some of them are specifically tabulated below:

Concept of Rationality: Conventional finance lays its base first on the concept that investors are completely rational. But this has been proved to be the main shortcoming of the theory by different empirical researches. Rationality means the investors always make the best and proper use of the information they possess and analyses them in an objective manner. But many studies [Paul Gerrans et al (2012); Ganesan Balaji (2013); Pal. Mukul (2009) ; Ricciardi Victor et al (2000)] have shown that in most of the times the investors being the social beings, with a brain and a heart full of emotions, behave in an irrational way, in spite of having different important information. They just overlook the rationality attitude and become biased in many cases.

Role of Emotions in Investment: Conventional finance completely ignores the role of emotions in investment decision making. But the investors are also normal human beings with emotions and we cannot ignore the role of emotion in any decision making including the field of investment.

Informational Accuracy: Conventional Finance always believes that the investors have access to all information and stock prices reflect that information instantly. But in practice, this may not be possible always because all the investors may not have access to all information at the same time. —In the world of investing, there is nearly an infinite amount to know and learn; and even the most successful investors don’t master all disciplines [Michael Pompian, 2006]

Role of Experience: According to conventional finance all investors are equally knowledgeable and expert. As such no distinction has been made between an experienced and novice investor,. But in real it cannot be so. As experience definitely makes the investors wiser and affects their decision making.

Demographic factors: Age, income, sex, family background, etc. are the demographic characteristics of investors are not considered by conventional finance, but they are also having effects on investment decision making abilities.

These are the main limitations of the traditional finance theories and which are proved to be true at different situations under the purview of behavioural finance. Thus the behavioural finance discipline seems to be a good development in the field of financial market study.

VII. Growth of Behavioural Finance

To know the meaning of behavioural finance the famous quotation of Albert Einstein i.e. "Only two things are infinite, the universe and human stupidity, and I'm not sure about the former" seems to be much more relevant. Really the human mind is the greatest and it is also the worst in some cases.¹ History of the behavioural finance goes back to Herbert A Simon, the Nobel lieutenant of 1978, for his paper in 1955 "A behavioural model of rational choice" may be regarded as the first thought that endeavored to state about a new concept called behavioural finance [Simon, 1955].

However the systematic study of behavioural finance started actually from the work of Daniel Kahneman & Amos Tversky (1973) where they for the first time discussed about the different heuristics affecting investment decisions. They also founded the very famous Prospect Theory in Tversky & Kahneman (1979) where they found that individuals will respond differently to equivalent situations depending on whether it is presented in the context of losses or gains and found that individuals are much more distressed by prospective losses than they are happy by equivalent gains. Statman Meir (2009), a professor from Santa Clara University wrote in an article published in the Wall Street Journal that most investors were intelligent people, neither irrational nor insane. But behavioural finance tells us we are also normal, with brains that are often full and emotions that are often overflowing and that means we are normal smart at times, and normal stupid at others.

The late **Peter L. Bernstein** wrote in **Against The Gods** that the evidence "reveals repeated patterns of irrationality, inconsistency, and incompetence in the ways human beings arrive at decisions and choices when faced with uncertainty."²

Behavioural Finance is the field which studies the investors' behaviour not only from the point of view of rationality but also incorporating different other irrational psychological investment biases which are overlooked by the conventional finance completely. This new field incorporated the theories of psychology, sociology and also neurology in the study of investor behaviour.

It may be noted that the behavioural finance is itself is not a pure and original development. It is due to the shortcomings of the efficient market hypothesis and other conventional finance developments that the growth of behavioural finance is accelerated. As Subash Rahul (2012) pointed out in his thesis — "The science does not try to label traditional financial theories as obsolete, but seeks to supplement the theories by relaxing on its assumptions on rationality and taking into consideration the premise that human behaviour can be understood better if the effects of cognitive and psychological biases could be studied in context where decisions are made.

VIII. Implications of Behavioural Finance principles

As stated under the traditional financial theory, the decisions makers are assumed to be rational. In contrast, behavioural finance suggests that Investors financial decision-making are not driven only by the equilibrium models and they often prove to be irrational while making investment decisions. In other words as per the principles of behavioural finance human decisions are subject to several cognitive and emotional illusions. Some of those illusions can be grouped as follows:

1. **Cognitive Dissonance:** It implies the mental discomfort felt by an investor while taking any decision against his belief or attitude. "Cognitive dissonance is nothing but a feeling of discomfort or disharmony resulting from the contradiction with the set beliefs or attitudes." [Sharma A.J.,2014 (1)] In such a situation he tries to relieve his tension by following different irrational heuristics.
2. **Herd Behaviour:** Herd means a group and in financial market context it implies to follow a group in respect of decision making. Many times investors knowingly or unknowingly reveals this type of behaviour which is completely against the rationality concept. "It is often seen that in many cases a particular group forms and it goes in a particular direction. And when a new investor comes by his own nature of being a human just follows the trend of the group without any consideration of his own values or beliefs or analysis. He takes it for granted that when so many people are there in that direction, they all must have something which is profitable as an investor." [Sharma, A.J. ,2014 (2)].
3. **Loss Aversion:** Aversion means the feeling of dislike or disinclination and loss aversion means disliking or feeling uncomfortable about a loss. This psychological feeling was first proposed by Kahneman and Tversky (1979) in their famous prospect theory. Tversky (1991) further used this concept in his study about making decisions under certainty. To date many scholars have studied the effect of loss aversion on decision making under different situations.

¹ Karz. Gary, CFA, "Psychology & Behavioral Finance" available at www.investorhome.com

² Ibid.

4. **Mental Accounting:** Mental Accounting; a concept first named by Richard Thaler in an attempt to describe the way in which a person subjectively frames a transaction in their mind the utility they receive or expect. People weigh the money value on the basis of the source from which that income has been generated. This is also a bias in investment decisions. Although having the same value, investors place different weights on an income earned as interest and income from lottery. There are many other such theories available in the field of behavioural finance which challenges the conventional finance theories of rational choice.

IX. Does Behavioural Finance help Raising Finance in Securities Market?

Behavioural finance discipline has come to an existence as a result of the shortcomings researched out of the efficient market theory. This development has highlighted different anomalies of securities market behaviour which are overlooked by the traditional finance theories. But it is to be noted that both efficient market theory and behavioural finance are related to investor behaviour, i.e. how the investors make decisions regarding investment in securities market. These disciplines have never tried to show the ways of raising finance in financial market. Rather we can say that if the biases put forwarded by the behavioural finance are given due consideration by the investors while making investment decisions then their decisions would be more efficient and this in turn will build their confidence about investment. This efficiency in investment decisions would also reduce the bubbles and crisis situations in financial market as seen every now and then in the stock market. Such bubbles and crisis vulnerabilities discourage the new investors to come out and invest. So if such situations are controlled, which is possible by following the behavioural finance principles would definitely bring more investors to the securities market. So although not directly but indirectly behavioural finance would definitely help to raise finance in the financial market.

X. Conclusion

To conclude we can say that we must recognize the shortcomings of conventional finance put forwarded by the empirical findings, and at the same time an objective analysis is necessitated to arrive at a conclusion. The growth of behavioural finance in this regard is definitely a positive aspect to better study the investor behaviour. However the behavioural finance alone cannot be said to be a perfect one because the discipline is not too old to accept as a theory. And the behavioural finance is only a collection of ideas and thoughts which are descriptive and advisory in nature but they are not exhaustive. More discussions and studies are required to point the limitations of behavioural finance itself so as to refine it to be a good theory. Till then we must admit that it is a theoretical framework, which is definitely a modest attempt and it has many positive sides in the context of stock market study but it needs more refinement and more rigorous analysis to replace a far impacted theory like EMH.[Sharma A.J., 2015(3)].

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