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BEHAVIORAL FINANCE AN IMPACT OF INVESTORS UNPREDICTABLE BEHAVIOR ON STOCK MARKET

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Abstract : Behavioral finance is a part of finance that seeks to 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 behavior that is not being captured by the traditional rational based models. This article, namely behavioral finance, presents a new approach in the analysis of capital markets. Behavioral finance is the study of the influence of the psychological factors on financial markets evolution. Financial investors are people with a very varied number of deviations from rational behavior, which is the reason why there is a variety of effects, which explain market anomalies. Human beings are rational agents who attempt to maximize wealth while minimizing risk. These agents carefully assess the risk and return of all possible investment options to arrive at an investment portfolio that suits their level of risk aversion Classical finance assumes that investors are rational and they are focused to select an efficient portfolio, which means including a combination of asset classes chosen in such a manner as to achieve the greatest possible returns over the long term, under the terms of a tolerable level of risk. Behavioral finance paradigm suggests that investment decision is influenced in a large proportion by psychological and emotional factors.

Key words: behavioral finance, capital market, classical finance, investment decision, market efficiency, psychological factors, rational behavior

INTRODUCTION

Behavioral finance is the study of the influence of the psychological factors on financial markets evolution. Inother words, financial markets inefficiency is analyzed in the light of the psychological theories and perspectives. Behavioral finance is a relatively recent and high impact paradigm which provides an interesting alternative to classical finance. The classical finance assumes that capital markets are efficient, investors are rational and it is not possible to outperform the market over the longterm. Psychological principles of behavioral finance include among others heuristics and biases, overconfidence, emotion and social forces. A very important step for an investor is to understand his financial personality. In other words, in the posture of investor is vitally important to understand why you make certain financial decisions or how you are likely to react in common conditions of uncertainty. This form of analysis is useful in an attempt to understand how you can temper the irrational components of investment decisions while still satisfying your individual preferences and requirements. Behavioral finance provides a different perspective, very complex and unconventional. Behavioral financeparadigm suggests that investment decision is influenced in a large proportion by psychological and emotional factors Humanemotionalcomplexityincludesthefollowing primary feelings: fear, panic, anxiety, desire, joy, greediness, pleasure, spirit/egotism. Emotion thus play a vital role in financial markets.

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 efficiencyhypothesis 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.

Scope of the study:

The intended study is to be taken in the Capital markets in India. The study will be focusing onbehavioral pattern of individual investorsresiding in Bangalore. The study is Empirical researchbased on literature.

Objectives:

1.To understand how emotions and cognitive errors can affect financial affairs.
2.To understand the influence of heuristic (rule of thumb) factors in decision making

Literature review:

“Factors Influencing Investor Behaviour: An Emperical Study In Mumbai” pointedout the most impacting and the lowest affecting reasons influencing decision of an investor residing in Mumbai.the demographic factors were considered.The researcher had categorized investors as follows:-goodwill /self-image of the firm, financial details, unbiasedinfo, legal recommendations and personal fiscal needs. The author also attempt to identify the sector which was having higher value in the market in comparison to standard SENSEX for the period of 2005 to 2012. The result of the survey concluded that the behavior male and female investing in stock market in Mumbai have almost the same set of factor that influence their behavior.

Love Inness (2003) in this research the author hasacknowledged and categorizedsections of individual investors based on their shared investing approaches and behavior. The five main category that has impact on the behavior of the trader is investment prospect, self-confidence, control, attitude towards risk and possibility of loss. Majority of the respondentshad similar opinion and hence were categorized 1) risk irresistible traders; 2) confident investors; 3) Youth risk seeker; risk averselong-term investors. Each subdivision purchasediverse types of stocks, they have different source of information and has different levels of investing behavior.

Anovel approach to capital markets:-

The field of modern finance has registered remarkable progress in the last decades. Behavioral finance is a newapproach to capital markets, having an important role in financial decision making process. Decision making related with behavioral finance, can be defined as “the process of choosing a particular investment alternative from a number of alternatives”. It is an activity that follows after proper evaluation of all the alternatives.

In the 1960s cognitive psychology initiated to throw light on the brain as an information processing device in contrast to behaviorist models. Psychologists in this field, such as Ward Edwards, Amos Tversky and DanielKahneman began to compare their cognitive models of decision-making under

risk and uncertainty to economic models of rational behavior. Mathematical psychology has long-lasting impact on order of preference and what kind of measurement scale utility constitutes.

In 1979, Kahneman and Tversky was talking on the Prospect theory: An Analysis of Decision under Risk, paper has used cognitive psychology to clarify various differences of economic decision making from neoclassical theory. Agreeing to Sewell, behavioral finance is the study of the impact of psychology on the behavior of financial practitioners and the subsequent effect on markets. Barberries and Thaler consider that behavioral finance has two building blocks: limits to arbitrage, which debateson the fact that it can be difficult for rational investors to unwrap the disruptions caused by less rational investors and psychology, which lists the kinds of difference in investing

According to Fromlet, "Behavioral finance closely combines individual behavior and market phenomena It is the combination of both the psychological and finance. However, mainly, behavioral finance has not fully developed area, but has major repercussions for the manner in which the investment process is directed. In other words, behavioral finance is a far-reaching visions paradigm which is trying to understand and to forecast financial markets based on psychological and emotional implications. According to some researchers, behavioral finance states the features of interpretation and action based on the data for organized investing decisions by individuals. In Thaler opinion, behavioral finance defines that some of the economical factors which may not treat rationality based on the assumption. Thus this study is the psychological decision process in acknowledgmentof prediction of financial markets.

Behavioral finance represents an area of research that attempts to understand and explain how reasoning or cognitive errors influence investor decisions and stock market prices. Thus, behavioral finance combines principles from the fields of individual and social psychology with classical financial theory to understand and highlight the performance of stock markets.In consequence, the behavioral finance area is summarized in essence to explain financial market anomalies on the basis of the study of investor's behavior and decision making process.Metaphorically speaking, behavioral finance it is an alternative solution to the difficulties faced by the classical theory in explaining certain financial phenomena. In deep contradiction to the classical paradigm, behavioral finance assumes that investors may be irrational in their reactions to new information and investment decisions.

In these conditions, it can be tough for normalinvestor to adjust with the price change caused by the irrational investors due to present limits of arbitrage. The theory of arbitragevalidates that if irrational investors cause deviancies from fundamental value, rational traders will often be helpless to react on it.Emotion are difficult to interprete includes the following primary feelings: anxiety, greed,happiness, satisfaction, desire or vanity. It is often seen that all the emotions restrict in certain sizes in a financial investment decision making.According to Tilson, there are Common Psychological Mistakes, such as:

a) Bullish approach of Overconfidence
b) Estimating future with past data
c) going with the crowd
d) Misinterpretation randomness in market position
e) Obligation and uniformity bias
f) Anxiety, fear of change
g) Interpreting irrelevant info
h) Loss aversion
i) Use of mental accounting methods
j) Taking emotional decisions
k) Fear of ambiguity
l) Embracing certainty
m) Overrating the probability of happenings based on previous trend or experiences and taking hasty decisions
n) not taking action due to an plenty of attractive choices
o) Fear of wrong decision and feeling stupid (regret aversion)
p) Unwillingness to admit mistakes
q) Believing that one's investment success is due to wisdom rather than a rising market, but failures are not one's fault
r) Failing to accurately assess one's investment time horizon.
s) A tendency to seek only information that confirms one's opinions or decisions
t) Recognition of large and small information which can be impacted
u) Unfamiliarity with the techniques and information.

Behavioral finance realize a connection relating financial theory to practical investment analysis in order to provide a means of understanding the financial market complex situations. In fact, the main idea is finding anexplanation for market inefficiencies such as :mispricings, irrational investment decision

making and return anomalies.

The influence of informational asymmetry, psychological, sociological and demographic structures can represent up to a certain level, a relevant answer to financial market anomalies. Investors are different some of the other in relation to numerous factors, such as: socio-economic background, financial context, level of education, religion, age, sex, traditions, ethnicity, marital status, and so on. They form expectations and beliefs that influence their investment decisions in a dramatic proportion. An optimum investment decision it cannot be achieved if the investor ignore all of these factors influence.Behavioral finance paradigm focusing on the cognitive psychology suggest that the investment decision making process may be analysed successfully through the following variables : overconfidence, herding complex,overreaction, conservatism, preconceived ideas, excessive optimism, representativeness, irrationality or rational way of thinking and the impact of media channels. Empirical studies show that investors are overconfident in their judgments and due to this seemingly insignificant appearance they make mistakes when perceive information and form their beliefs. Also, investors overreact in certain circumstances or they act under the impulse of some beliefs such as those mentioned above.

FINDING AND OBSERVATIONS

1.Finding to objective 1To understand how emotions and cognitive errors can affect financial affairs.

It is said that feelings and emotions that may be termed as unrelated feelings and emotions can affect decisions. Lack of emotions in the decision making process destroys the ability to make rational decisions, and hence such people become socially dysfunctional. Background feelings and moods influence financial decisions and such a phenomenon is called misattribution bias. If someone is in a good mood, he/she is more likely to be more optimistic in evaluating an investment. Good (bad) moods will increase (decrease) the likelihood of investing in risky assets like stocks.

Feelings have been established as a major factor in buying and selling of investments in the market. However there are a few more factors that play a vital role. THE SUN, is one important factor! Psychologists have been determining on the fact that the sun affects one's decisions in investment. Without the sun one feels bad. When the sun is out, one feels good and this good mood gives out an optimistic feel about the future prospects and affects the decision making process. Yes, even financial decisions may be affected by sunshine. Investors hence tend to sell stock on sunny days. Researchers use a weather scale with 9 levels to determine the levels between completely sunny to completely miserable.

2.Finding to the objective 2-To understand the influence of heuristic (rule of thumb) factors in decision making

The crucial observations is listed as follows

1.Investors make judgment based on approximate rule of thumb, not sternly on balanced analysis.

2.Investors are not necessarily are careful to the equivalent choices if the choices are presented in significantly different contents, which referred to framing-effect.

3.There are explanations for observed market outcomes that are contrary to national expectations and market efficiency, which include mispricing, non-rational decision making and return anomalies.

From the above observations, it is clear that judgments can be systematically wrong in various ways. Systematic errors of judgment are called biases. Financial decisions are made in situations of high complexity and high uncertainty that preclude reliance on fixed rules and compel the decision-maker to rely on intuition.

CONCLUSIONS:

Behavioral finance represents a revolution in financial theory. The combination of financial theory with other social sciences resulted in the appearance of behavioral finance. This is a relatively young and promising field of modern finance which has registered remarkable progress in the last decades. Behavioral finance highlights the psychological edge of investment decision making process, in strong contradiction to the Efficient Markets Hypothesis. The most important issue regarding efficient market theory is that it is not possible to outperform the market over the long-term. Onthe theory of EMH which suggests thatseveral information is accessibleto all investors or market participants, so stock prices always incorporate and reflect all relevant information.

Due to this issue, the price of a stock should reflect the knowledge and expectations of all investors or market participants. It is a certainty that it is not possible to separate an investor'spersonality and the investment decisions that he may make. Thus, it cannot be ignored the importance of understanding the individual financial behavior of capital market investors. There is no need to make extensive psychological

assumptions to understand that investment decision do not focus strictly on financial theory. Investors, both amateurs and professionals, make their choices in a way that it cannot be considered absolutely rational. There are indisputable arguments in favor of both theories, as both present certain limits. Behavioral finance is not a perfect replacement to classical finance paradigm, but it is an alternative solution to the difficulties faced by the traditional theory in explaining certain financial phenomena. The study provides important information to investment professionals, stock market regulators and companies listed on stock exchanges. The findings of this study can be used to attract investors and increase their participation in equity market. Probably the only undeniable truth is that financial markets are extremely complex and unpredictable to believe that we can understand perfectly their mechanism.

The field of modern financial economics assumes that people behave with extreme rationality, but they do not. The two common mistakes investors make i.e. excessive trading and the tendency to disproportionately hold on to losing investments while selling winners have their origins in human psychology. Because the tendency for human beings to be over confident causes the first mistake and the human desire to avoid regret prompts the second. So, psychological research teaches as about the true form of preferences, allowing us to make finance more realistic within the rational choice framework. This is the reason today Behavioral Finance is a rapidly growing area that deals with the influence of psychology on the behavior of financial practitioners. The above-mentioned arguments are provided for why movements towards greater psychological realism in finance will improve mainstream finance. Apart from these things this particular area also collectively predict some outcomes where the traditional models failed along with reaches, the same current predictions as the traditional models.

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