BEHAVIOURAL FINANCE AND INVESTMENT DECISION MAKING

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Abstract

The study has been undertaken to critically examine if behaviour and biases of an individual investor have any impact on the selection of alternatives that are available to them in terms of the investments that they make. A brief analysis of the various theories available in terms of the above topic are also examined for their validity. The conclusion drawn based on the reviews of published papers is that behaviour, biases affect decision making and as such an investor has to be mindful of these biases and make sure that he doesn't lose out on opportunities because of this.

Key-words: Behavioural finance

Decision making

Investment

Biases

Theories

Introduction

The study of behavioural finance has increased as the approach of traditional finance has slowed paved way for study of psychological factors which impacts the selection from among the various alternatives and the ultimate decision that is taken by the investors.

The whole concept of behavioural finance is that the psychological aspect and biases that an investor bears within himself affects their behaviour and decisions towards their investments. There are five concepts that come under the umbrella of behavioural finance which are briefly discussed below:

The concept of mental accounting is that an investor would allocate funds for different purposes based on its value that he perceives in his mind and such allocated funds shall be used for the purpose specified.

The second concept is that of herd behaviour, as the name suggests, here the people imitate the actions of the majority, if a major chunk of the population is doing something, say they go long on a stock, the other part of the population would also do the same without giving much thought to their action or making an analysis before leaping into that decision.

The third concept is that of emotional gap, and under this concept, the emotions of the person which are mostly extreme such as anger, greed, fear, anxiety, enthusiasm, excitement, tend to affect the decision making capacity and at times they tend to make the decisions taken by the investor irrational. The gap that arises is in the return in a situation when a rational decision is made versus when an irrational decision is made.

The fourth concept of anchoring tells us that the spending is decided based on a point of reference that is derived from some irrelevant information and is used subconsciously to make a decision.

The last concept under behavioural finance is that of self attribution where the investor makes a decision under the impression that he has perfect knowledge about what he is getting into and he knows the way things work out just because of his experience in the field. The investor has extra confidence in the skills and knowledge he possesses and in this state of mind he tends to make decisions. If things work out just fine and the investor's decision bears the right fruits, he attributes the success to his skills and knowledge, and if things don't go as per plan and give out undesired returns or outcomes, the same blame would be shifted onto luck or factors which are beyond the control of the investors.

Literature Review

Jahanzeb (2012)

The behaviour and how management is used in decision making by the investors is studied, and what are the outcomes of certain interactions of the investors with the parties in the markets, and what are the illusions that an investor has and how to avoid them are discussed.

Sattar et al. (2020)

Biases which are behavioural in nature and how they affect the decisions that are taken by the investors regarding their investments under situations of uncertainty are studied, and it is suggested that psychological factors are to be taken into consideration before making decisions.

Ogunlusi et al. (2021)

Banks in Nigeria which were into investments were studied wherein it was found that there was a significant impact of behavioural finance on decisions taken with respect to investments. Study was also conducted to understand the relationship of heuristic and prospect theory on decisions.

Chaudhary et al. (2013)

The roadblocks that investors face which are mostly psychological when making investment decisions lead them into having irrational behaviour which opposes the principle of wealth maximisation that they want to achieve, and the paper suggests approaches which can be adopted to minimise these problems.

Peteros et al. (2013)

Returns that are generated on the stock market are used in a simulated environment to show how decisions that are taken by investors are at times irrational which leads to them generating lower returns than those expected. Decisions that are data driven should be prioritised in the education system is the suggestion.

Raut (2020)

The theory of planned behaviour is studied and it is found that by making the investors aware and literate in the field of finance, the undue influence that is created on them by the social pressure would be subdued and they would be enabled to take rational decisions.

Kandpal (2018)

There are many factors that influence the behaviour of investors which inturn impact the decisions that are taken by them with respect to investments, and these factors are studied by the author in detail to come to a conclusion that behaviour matters in decisions.

Roopadarshini (2014)

Situations and environment has to be considered before making an investment decision along with many other factors that might affect the same. An investor should also be rational in his thinking and behaviour and should make judgements which are optimal.

Almansour (2017)

The decisions related to investments and how these are impacted by factors which are psychological in nature and how these inturn affect the risk that an investor is willing to take up in his investment is studied by conducting a primary research in Saudi.

Nkukpornu et al. (2020)

The biases that an investor might have be it in terms of behaviour or others tend to impact the decisions that are taken with respect to the investments. Regression model is used to determine the impact the biases have on the decisions.

Objectives

1) To analyse the biases and check if they impact the decisions of investors

2) To determine the relevance of behavioural finance in today's world where there already exists traditional finance

The objectives of the study have been chosen after careful analysis of the published papers and having determined a gap in the same, wherein the study made could act as an improvement in the field, where we understand if behavioural finance is actually influencing the decision making capacity of investors. It is with the help of the published papers that the objectives are proven. The knowledge of these concepts would help investors to be more prepared and aware of the biases and mould their behaviour to be able to take advantage of opportunities that may arise in the due course.

Research Methodology

The method used to confirm the validity of the objectives is the study of past published papers which has proven the objective of the study to be true to the best of the analysis conducted by the authors. Though certain papers referred to are theoretical in nature and do not have an element of data analysis that has been attached to it, they do contribute to the study.

Findings and Discussion

The graph is a depiction of how the implementation of behavioural finance has helped in the improvement of the practices of financial advisors globally.

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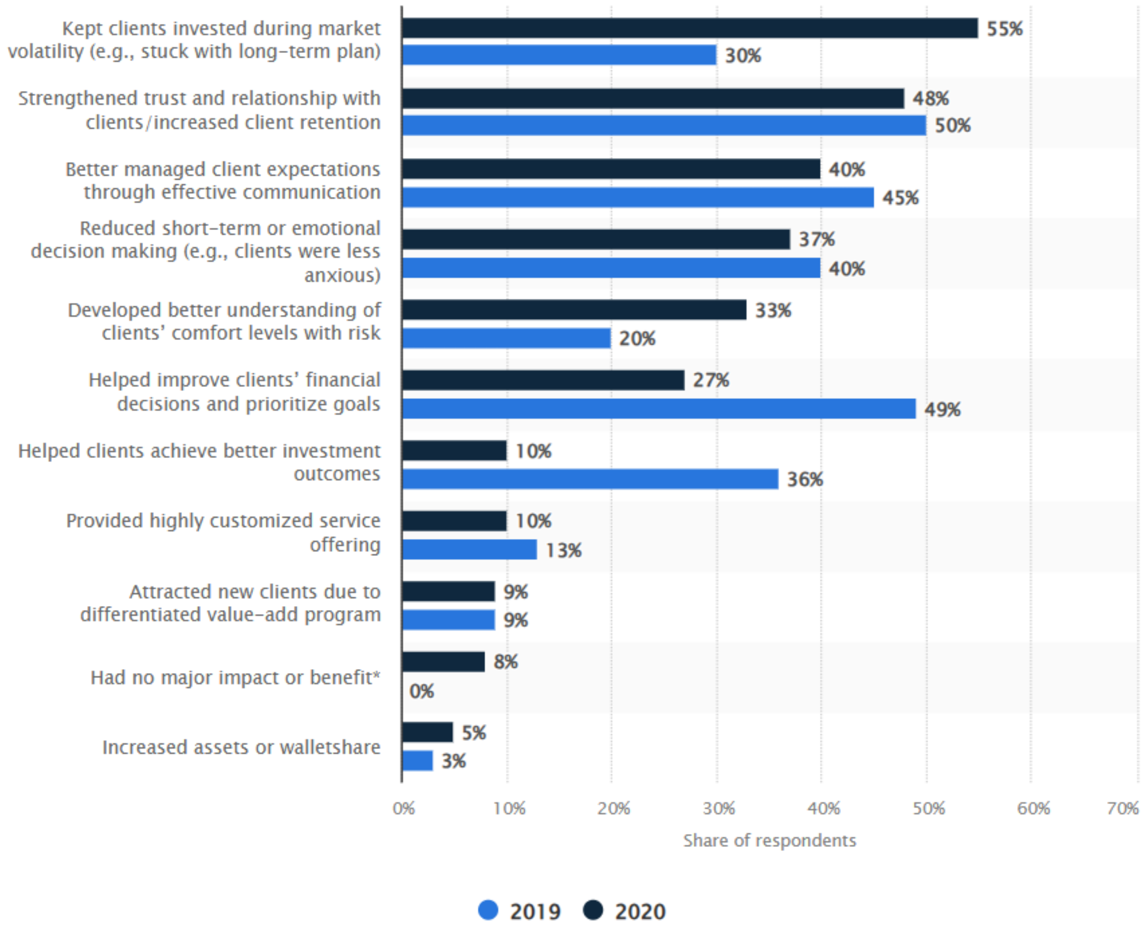
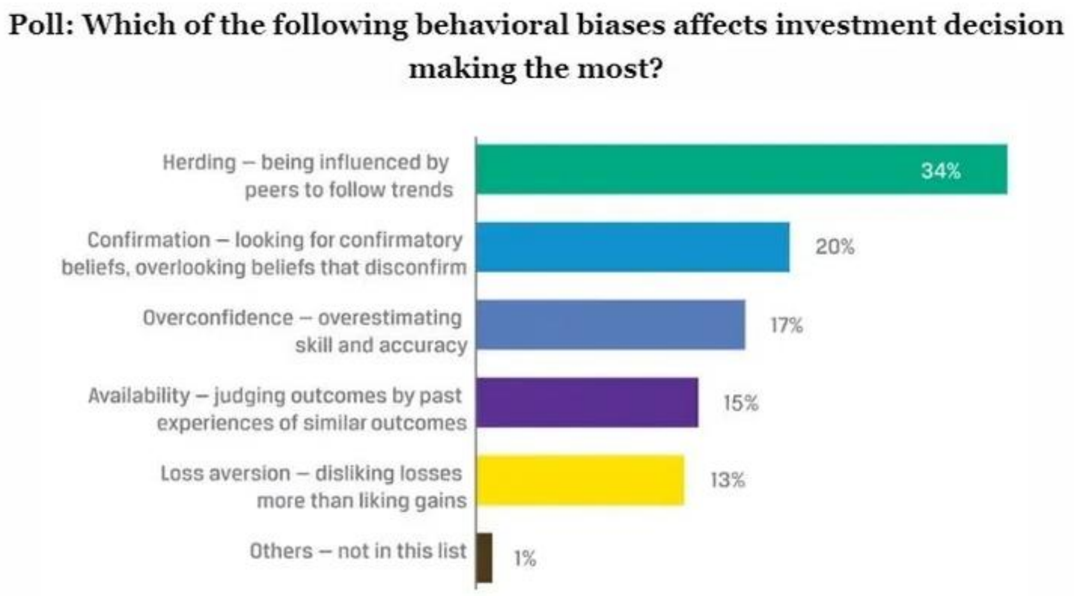


The source of the graph is statista and the graph is an indication of the sentiments of 300 respondents.

The data is proof that there has been an increasing impact of behaviour in the field of finance, much so in the field of investing, and since the data is of the recent past, it could be said that it is relevant. The graph also shows that there has been an increase in the impact that the topic of concern has been having on the investors.



It can also be said that there has been an impact of the biases that the investors have on the decision they make which relate to their investments. This has been proven both by the published papers and the graph depicted above which has been sourced wordpress.

Conclusion

In conclusion, the investors should be mindful of the biases and their behaviour so that they could make sure they make rational decisions, and to ensure if not guarantee maximisation of the benefits and avoid any losses that they would make if they were to take irrational decisions by being under the influence of the biases.

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