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Behavioural Finance: a Literature

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Abstract Behavioral finance is a systematic study of investors' investments in the stock market, and various investments avenues are available in the market, every individual, professional investors, and financial service firm's deal with different securities for maximization of profits and minimization of risk during the process, so many biases knowingly and unknowingly involved by the investors.

Keywords: Behavioral finance, Investors Biases, Individual investors, Professional Investors, Financial service firms, investments.

I. INTRODUCTION

In the year 1970 a time most of the academicians tuned towards with social psychology, a field neglected by economists and most of them struggled for giving answers on various investments related aspects, the mathematical tradition continued through professor Tversky, Kahneman, Thaler, Barberis, and Shleifer started to foster.

The efficient market hypothesis visible in a more significant with empirical proof has mentioned over the years. The low assumption of the related to efficient markets is most of the time assumes that individual investors and traders are rational. In detail, the efficient market hypothesis does not imply for all the traders and investors are rations, but it does mention or assume that markets are rational by the sense that markets show an unbiased analysis for the future investment decisions.

"Bounded Rational," rather than rational and has mentioned with a model in which utility maximization was replaced by satisfaction; Gustavo in the year 2010 indicated that consensus, as there appears to be around bounded rationality, is only very superficial.

While the expected utility theory measures that people willing to take a risk when facing prospects that might impact on lifetime wealth, which is most of the time not true, loss Aversion, tendency is like pain of loss more than the pleasure of an equal gain, and mental accounting is the tendency to isolate each risky choice, must be the critical components of a good theory of risk attitudes of individual or group investors.

Definition of behavioral finance

"Behavioral finance is the study of how psychology influences the behavior of market practitioners, both at the individual and group level, and the subsequent effect on the market." **(Sewell 2010).**

II. OBJECTIVES OF THE STUDY

1) To know about Introduction of behavioral finance
2) To know about the review of the literature of behavioral finance

Scope of the study

This study contains the introduction of behavioral finance with relevant concepts,

Biases and review of literature on the brief concern. The study focuses to know the key changes in investment decisions made by the individual, professional investors and financial services firm.

III. RESEARCH METHODOLOGY

To finding information on behavioral finance used and gathered secondary data from a set of books and documents.

Limitations of the study

1) Limitations of the research related to theoretical and conceptual hence there is no empirical study on the paper
2) Discussed few reviews on behavioral finance

Professional investors

Professional investors are not exempted from the biases from real investment decision situations because every skilled investor needs to enter in the market in specific time to take advantage of arbitrageurs and noise from other traders, but even professional traders are not easy to survive in the market without a proper plan of action in the stock market.

Individual investors

Individual investors having different set of investment goals compare to professional investors because they follow their investment strategies for maximization of profits and minimization of risks, most of the investors failed to prepare portfolio for diversification, they influenced with various biases for investing in equity segment area and most of them like to prefer mutual funds for making investments.

Financial services firms

Financial services firms always take the advantage from both professional investors and individual investors, because professional and individual investors have limited knowledge, skills for making investments, so they have their own biases in investments, in this scenario, they take gap advantage to take profits in a given period. It is the responsibilities of regulators conduct various awareness programs and workshops for shining the skills of professional and individual investors for building health investment environment, promoting better investments.

Transaction costs

Transaction costs always is essential for both professional investors and individual investors in the stock market, there were number of situations, where brokerage companies used to charge more transaction costs in the form of commissions, bid-ask spread, premium charges for doing investments and trading,

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for bearing such huge margin costing, investors not comparable for making investments in the stock market. This is the responsibility of regulatory authorities to monitor the transactions of different stock exchanges and brokerages in different regional areas.

Behavioral Finance Biases

Overconfidence and over-optimism

individual investor and group investors most of the time influencing with overconfidence and over-optimism with their investment because they can predict the market with their knowledge and sentiment, in fact, they don't want to update and compare with other investors and traders in the market, it leads overconfidence and over-optimism in the market.

Representativeness

Investors and traders look ahead of different situations involved while trading and investing in the market because of most of the time, the decisions based on superficial rather than underlying probabilities.

Conservatism

Market analyzers like to convince themselves with their own beliefs on any new piece of information regarding company, industry, and sector-wise.

Availability bias

Most of the investors overstate the probabilities of recently acquired trading and investment experience; they follow their principles to make profits.

Frame dependence and anchoring

In the stock market, channel providers can generate a various piece of information for trading and investing money, so these factors, directly and indirectly, influence their investment decisions in the market.

Mental accounting

Every individual investor and group investors trade and invest in their comfort zone; this leads to psychological trading bias while investing and trading in the stock market.

Regret aversion

Individuals take their own investment decisions, and they bear particular emotional pain while trading and investing in the stock market.

Barriers for the investors towards stock market

- As herein competitive world human beings are searching for harmony and unity, but behavioral finance has a substantial impact on the financial markets, the investors always need to explore trading and investing features for making effective profits and reducing risks.
- The theory most of the receives people's criticism by expiring doubts and challenges in the investment wise but it has the strong potentiality to investors on the concept, model and theory wise with logical explanation are always recommendable to investors.
- There is complexity in between two variables one is bounded rationality and non-efficient market. It helps to the groups or individual wise investment decisions, but they are biases to study in total market-smart, the whole interpretations will be made sentiments of the groups and individuals accordingly.
- In behavioral finance applications related to mathematical models and some stress on a group or individual experimental method, some consider the issue broadly with traditional fiancé, which cannot explain the object of the study for behavioral finance.
- As the progress of behavioral finance depending upon the theory because it mainly depends on modern cognitive science and the application of the result directly impact on the development of behavioral fiancé.
- In behavioral finance has the most significant challenge on the computer technology simulation and limitations of the cognitive ability of the individual investors or group investors in the simulation.
- Theoretical explanation under behavioral finance related to the financial market is unsystematic and limited research results of behavioral economics.
- For a perfect theoretical system, behavioral finance implementation is very difficult for suiting the logical thinking of theory, research methods of behavioral finance and hardly promote the development of equations in the trading area and investment-wise.

Behavioral Finance Review of Literature

(Markowitz, 1952 & Sharpe, 1964) mentioned in the financial theory based on Modern Portfolio theory related to capital asset pricing model has a significant contribution to the field of behavior and investment performance of a different set of investment avenues in the stock market. The theory explains the notion that investors act rationally and consider all available information for taking the investment decision-making the process.

The heuristic is defined as the investment decision making more natural, and especially in complex situations and environments mentioned by **(Ritter, 2003),** there is systematic complexity reduction process mentioned with different probabilities and predicting values to simpler judgments **(Kahneman & Tverksy, 1974).**

Heuristics investment decisions making is quite useful, especially when time is limited **(Waweru ett al., 2008)** they are so many biases involved and mentioned by **(Kahneman & Tversky, 1974, Ritter 2003)**.

(Kahneman & Tversky,1974) are one of the best writers on the subject of heuristics with different factors, namely representativeness, availability bias, and anchoring.

(Kahneman & Tversky, 1979) people like to react differently for the anticipation of gains or losses on their various investment decisions, and the probable outcomes are different compare to realistic situations.

Thaler and Barberis (2002) Behavioral finance has two major significant scenarios, one is limits to arbitrage, and the second one is psychology. Limits to arbitrage means, seek to explain the existence of arbitrage investment opportunities which do not change quickly in the stock market. Every investment and trading position takes specific time for getting a result in the stock market, so until risk and return will be correlated. It is mainly related to arbitrageurs coexisting with not entirely wise investments of the investors in the stock market, and most of the time not able to get profits from the stock market dislocations.

Understanding the past and existent of arbitrage investment opportunities, although theoretically counter-intuitive, is not enough to make share estimations and predictions in the stock market.

This will relate to how they misunderstood the Bayless law or deviated from the subjective expected utility theory. To mention on the type of irrationality, investigators have turned to experimental evidential proof compiled by a cognitive psychologist on the biases that arise when people form beliefs, and on the people preference towards stock market investments and trading decisions.

Most of the investors face problem to take investment decision making under uncertainty because traditional finance investor's decisions are based on the assumption to follow the rules of probability. But in violation of Bayes rules is the most people like to overreact to unexpected and different views on news events mentioned in the year **(Bondt & Thaler, 1985)**. Capital asset pricing model plays a significant role while calculating concern risk and returns doing investment and trading.

Behavioral finance is a study of the influence of the psychological factors on financial markets evolution. In other words, majority of influencers influencing them either knowingly or unknowingly throughout their investments because psychological factors play a significant role while investing, their investments depending upon their understanding personality in investment nature, though they prefer different time horizon investments. They are so many factors influenced while taking trading and investment decisions. The classical finance assumes in most of the scenario capital market are efficient, investors are rational, and it's not possible to outperform the market over the long term.

(DeBondt & Thaler , 1995) financial markets are the key for investment decision making and the individual investors behavior changes on perspective behavioral fiancé, and most of the time investors likely to react over or under reaction to price changes based on the past trends of the script and news regarding product or service of an organization, in the most of the time investor not likely to depending upon the fundamentals underlying a stock.

Ritter (2003, p.429) mentioned in the behavioral finance on psychological aspects and suggested that personal buying and selling activities on the respective subject of several cognitive illusions. The most of the illusions are classified into two major groups: one is illusions caused by heuristic investment decision process, and another one is illusions are from the adoption of psychological frames grouped in the prospect theory as for **(Waweru et al., 2008, p.27).**

(Waweru et al. 2008) mentioned with two major factors, namely Gambler's fallacy, and Overconfidence, which are drawn from heuristic theory.

Prospect theory and expected utility theory are best to consider investment decision approaches from different investment avenues. Prospect theory focuses on subjective decision making, and expected utility theory focuses on investor's rational expectations **(Filbeck, Hatfield & Horvath, 2005, p.170-171)**.

Prospect theory **(Waweruu et al., 2003)** mentioned individual investment decisions affect various biases and factors like Regret Aversion, Loss aversion, and Mental accounting.

(Caparrelli et al., 2004) Herding investors act only with other investor's decisions because lack of knowledge and information on the surrounding environment and always seek group advice and expert advice for their investment decisions. There are several elements involved in the herding behavior, such as overconfidence and bulk of volume considered by the investors.

Waweru et al. (2008) identify the significant factors in the market and their inverse proportion on investors' decision making based on the price changes, market information, past trends of the different stock scripts, customer esteemed preferences, over-reaction on price changes in the market.

Herding effect on investment decisions done based on other investment actions in the market, moreover the investment decisions are depending upon the different investment decisions made by investors and investors tend to invest money from market experts or other investors to gain the return in a given period of time, the risk and return models has different impact on the various asset pricing theories **(Tan, Chiang, Mason & Nelling, 2008, p.61).**

(Kallinterakis, Munir & Markovic 2010) Marketing expert investment decisions are considered by retail investor's decisions and other investors because of the low ability and skills of the retail investors always like to seek advice in the market.

(Waweru et al.,2008) Mentioned with a different time horizon of the investment and investors sentiment on buying and selling securities in the market, script selection, and volumes trading behavior. In this, Waweru concluded that buying and selling securities investment decisions of an investor are majorly affected by other investment decisions, herding investment behavior to have a sense of regret aversion for their investment decisions.

Behavioral finance explains that psychological and emotional factors influence investment decisions. In most of the situations, human behavior towards investment carries with emotional complexity, fear and greet etc. these all purposes are explained certain financial investment decision making **(Birau, 2011)** The classical financial theory is not an unrealistic and incomplete solution to a complex for changing the problem. In most of the scenario, financial market anomalies cannot be explained using traditional models. Behavioral fiancé more clearly explains the factors and emotions involved in past relevant investment decisions made by the investor, but in other scenarios, it cannot accurately estimate the investor will consider the future investment decisions. The efficient market hypothesis assumes the capital market information is more reliable for making investment decisions. Classical fiancé is related to the efficient market hypothesis if the investors don't understand the concept then they cannot predict the market movement, price reflections of the scripts, past trends, price and volume change variations if the market which prices always reflect then it is known as the efficient market.

Sahi, Arora, and Dhameja (2013) mentioned how investors react and make investment decisions, and the title contains "An Exploratory Inquiry into the psychological Biases in Financial investment Behavior." The authors attempted to know about investors sentiments towards trading and investment and identified most of the biases during the research survey.

- Most of the investors invite risk according to their knowledge; most of the time, investors like to prefer known risks over unknown dangers in the stock market.
- Investors don't go to the reference made by the experts

- Most of the investments made according to easily available information in the market, they don't want to estimate the consequence of the news and weight age of the report and how the news impacts in the market.
- Investors play a sensitive role while coming to investment with regards to risk level they are willing to offer.
- They would like to select different investment avenues according to their income level.
- We often see investments done according to social responsibility and not for the profit motive. It creates a bias for their investment.
- They like to switch only one Investment Avenue, which makes them comfortable for doing trading and investment vice versa.
- Always seek existing knowledge could have been better for making investments.
- Investors most of the time be reluctant to losses
- Feel regret with their investment decisions
- They are less confident enough to make investment decisions, and they don't have a specific target area to entry and exit from the script. Lacking setting the trade goal or investment goals in the stock market.
- Majority of the investors follow their relatives and friends for investing, so it creates more confusion for the investors to make appropriate investment decisions in the market, it leads to more losses for the investments.
- Most of the investors failed to understand the trends in the market with different time horizons. The trend is significant to make decent profits in the market.

IV. CONCLUSION

Behavioral finance is a scientific study investments sentiments and trading scenarios in different intervals, in the process more biases involved for making investment decisions and it provides clear guidance to investors to predict market conditions through psychology and behavior of the individual investors, professional investors and different financial services in the market.

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