



A STUDY OF BEHAVIORAL FINANCE AND INVESTOR'S EMOTION IN INDIAN CAPITAL MARKET

MISAL D.M.*

Department of Economics, C. S. P. M. Arts Senior College, N-11, CIDCO, Aurangabad- 431 004, MS, India.

*Corresponding Author: Email- dilipmisal2012@rediffmail.com

Received: July 22, 2013; Accepted: September 05, 2013

Abstract- Though Investment is a science deals with the study of capital market and then plan accordingly yet the study of investor's emotion has a major role to play with. It is not sufficient to analyze Efficient Market Hypothesis and its drawbacks rather one has to go for a behavioral explanation of investor's irrationality in a consistent and correlated manner. Thus comes Behavioral Finance, the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on market, into existence. In this study I have tried to analyze the concept of behavioral finance along with its four theories to explain the behavioral aspect of investors. This paper also focuses on its limitations.

Keywords- capital market, Efficient Market Hypothesis, investor's emotion, Behavioral Finance, India

Citation: Misal D.M. (2013) A Study of Behavioral Finance and Investor's Emotion in Indian Capital Market. International Journal of Economics and Business Modeling, ISSN:0976-531X & E-ISSN:0976-5352, Volume 4, Issue 1, pp.-206-208.

Copyright: Copyright©2013 Misal D.M. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution and reproduction in any medium, provided the original author and source are credited.

Introduction

If we always assume that financial markets are efficient and investors are rational then why there are so many studies about investor's psychology? Investment managers always want to make money for themselves and for their clients. That is the reason they care about the "psychology" factor of financial market as well as investors. The behavior of investors is not always rational, so investment managers do not forget how the psychology factor of a person plays a substantial role in behavior of financial market. But, modern finance theories have almost completely ignored the role of the complex motivational and cognitive factors that influence investor's (the best asset of a company) decision making. In today's buyer-market, we should face the truth that psychology systematically explores human judgment behavior and well being. It can teach us important facts about how humans differ from traditional economic assumption.

Review of Literature

Earlier economics was closely attached to psychology, which was amply displayed in the study "The Crowd: A study of the popular Mind" by Le Bon [1]. The study was one of the greatest and most influential books of social psychology ever written.

But with the development of Neo-classical economics, it has been taught to us that

- People have rational preferences among outcomes that can be identified and associated with a value
- Individuals maximize utility and times maximize profits and
- People act independently on the basis of full and relevant information.

At that time, expected-utility and discounted-utility models began to gain wide acceptance generating testable hypotheses about decision making under uncertainty and intertemporal consumption respectively. By this time psychology had largely disappeared from economic and finance discussions.

A revolutionary paper in the development of the behavioral finance and economics was published in 1979. Two famous psychologists Kahneman and Iversky [2] published their paper "Prospect theory - An Analysis of Decision under Risk" and where cognitive psychological techniques were used to explain a number of documented divergences of economic decision making from neo-classical theory.

Bondt and Thaler [3] published, "Does the Stock Market Over-react?" This was another milestone in linking psychology with Financial-Market and form the start of Behavioral Finance. They discovered that people systematically over-react to unexpected and dramatic news events, results in substantial weak form inefficiencies in the stock market, which was both surprising and profound. In 1981, Kahneman and Iversky [2] introduced "framing". They showed that psychological principles that govern the perception of decision problems and the evaluation of probabilities and outcomes produce predictable shifts of preference when the same problem is framed in different ways. Gradually a number of psychological effects and factors have been incorporated into behavioral finance only to strengthen the subject.

A Study / Science

The key observations from the study of Behavioral Finance is that

- People often make decision based on approximate rule of thumb, not strictly rational analysis.

- People do not appear to be consistent in how they treat economically equivalent choices if the choices are presented in significantly different contexts, which referred to framing- effect.
- 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.

Theories of Behavioral Finance

There are four theories of behavioral finance. They are as follows

- Prospect Theory
- Regret Theory
- Anchoring
- Over-and-under reaction

Prospect Theory

This theory says people respond differently to equivalent situations depending on

Whether it is presented in the context of a loss or a gain. Most investors are risk averse

when chasing gains but become risk lovers when trying to avoid a loss.

Regret Theory

Regret theory is about people's emotional reaction to having made an error of judgment.

Investors may avoid selling stocks that have gone down in order to avoid the regret of having made a bad investment and the embarrassment of reporting the loss.

They may also find it easier to follow the crowd and buy a popular stock : if it subsequently goes down ,it can be rationalized as every-one else owned it.

Anchoring

Anchoring is a phenomenon in which in the absence of better information, investors assume current prices are about right People tend to give too much weight to recent experience, extrapolating recent trends that are often at odds with long run average and probabilities

Over-And-Under Reaction

"The market does not reflect the available information as the professor tells us. But just as the funhouse mirrors don't always accurately reflect your weight, the markets do not always accurately reflect the information. Usually they are too pessimistic when it's bad and too optimistic when it is good".

The consequences of investors putting too much weight on recent news at the expense of other data are market over or under-reaction. People show overconfidence. They tend to become more optimistic when the market goes up and more pessimistic when the market goes down. Hence, prices fall too much on bad news and rise too much on good news. And in certain circumstances, this can lead to extreme events.

Censure To B.F.

Behind every successful thing, there is always criticism. Behavioral Approach to financial market has many critics. Critics of behavioral finance concede that systematic errors of judgment i.e. bias do exist. Because judgments can be systematically wrong in various ways. But there is a limit to actual impact of this systematic judgment as people actively search out opportunities to exploit such behavior.

1. Fama [4] is the most cited critic of behavioral finance, who typically supports the efficient market theory. In his writing "Market efficiency, long term returns and behavioral finance" he focused that behavioral finance is more of a collection of anomalies that are actually just enhance results and support for the anomalies tend to disappear with changes in the way they are measured.
2. According to Wessels, et al [5] in behavioral finance significant discrepancies between market value of investment and intrinsic value of investments are rare. They stated mispricing is an uncommon and temporary phenomenon that occurs only under very special circumstances and when those circumstances shift "rational investors will step in to drive share prices back to intrinsic value."
3. Lo [6] stated "while all of us are subject to behavioral biases from time to time, traditional economic theorist argue that market forces will always act to bring prices back to rational levels, implying the impact of irrational behavior on financial market is generally negligible and therefore irrelevant".
4. Curtis [7] pointed out a no. of methodological limitations to behavioral finance studies that use experimental designs. These are as follows:
 - Participants of the experiments knew that they were in an experiment and behave accordingly because of an unnatural environment of try to please (displease) the researcher.
 - They do not always follow the instructions.
 - The term "statistically significant" does not necessarily mean that an effect is significant in magnitude.
 - Experience and education often matter once the investors realize their biases they are likely to change and finally the experimenter's expectations of the outcome may impact how participants behave.

Conclusion

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.

References

- [1] Le Bon G. (1897) *The Crowd: A Study of the Popular Mind*, Macmillan.
- [2] Kahneman and Iversky (1979) *Econometrica*, 47(2), 263-292.
- [3] Bondt W.F. and Thaler R. (1985) *The Journal of Finance*, 40(3), 793-805.
- [4] Fama E.F. (1998) *Journal of Financial Economics*, 49(3), 283-306.
- [5] Wessels D., Goedhart M., Koller T. (2005) *MIT Sloan Management Review*, 47(1), 21-23.
- [6] Lo A.W. (2004) *The Journal of Portfolio Management*, 30(5), 15-29.
- [7] Curtis G. (2004) *The Journal of Wealth Management*, 7(2), 16-22.
- [8] Lo A.W. (2005) *The Journal of Investment Consulting*, 7(2), 21-44.
- [9] Sewell M. (2007) *Behavioural Finance*. Department of Computer Science, University College London.
- [10] Sharpe W.F., Alexander G.J., Bailey J.V. (1998) *Investments*, 6th ed.