Aayushi International Interdisciplinary Research Journal (AIIRJ)
Vol - V Issue-XII DECEMBER 2018 ISSN 2349-638x Impact Factor 4.574

The Behavioral Finance Paradigm Shift in Financial Market and its Impact on Investments of Investors

Lakshminarayana N
Research Scholar, CBSMS, Bangalore University, Bangalore, Karnataka
Rekha D.M
Research Scholar, Central College, Dept of Commerce, Bangalore, Karnataka
Madhu S
The National College, Jayanagar, Bangalore, Karnataka

Abstract

The Research paper titled "The Behavioral Finance paradigms in Financial Market and its impact on investments of investors" analyses the importance of behavioural finance paradigms in investor's decision-making process. Behavioural finance basic principles and its theories' investigate the emotional behavior and other characteristic features to explain conceptual and analytical factors and irrational anomalies of investor's behaviour towards their investment in financial markets.

The aim of the article is to identify the relationship between behavioural finance theories and financial decisions of investors and to know whether the cognitive biases reflect the investment pattern of investors. The paper briefly summarizes basic ideas related to the traditional approaches and behavioural finance towards the financial market.

The rational paradigm of behaviour of investors which is the inherent for financial markets is based on the notion that investors act rationally and consider all available information in the decision-making process, while investment markets are efficient and reflect all available information in the price of securities.

In this regard, behavioural theories and behavioural anomalies in the decision-making process are analyzed to know the opportunities in the financial market for investors and examined for description. The secondary sources were applied to ascertain financial behaviour of investors.

Keywords: Behavioural Finance Paradigm, Rational Behaviour, Cognitive Biases, Investment Decisions.

Introduction

Behavioural finance admits that psychological characteristics such as risk aversion, regret, overconfidence, heuristic, prospects etc. plays an important role in financial management of a investors consequently, financial weaknesses could be ascertained which could lead to improvements in financial decision making and wealth maximization of investors. Education in this area is slow and should be popularized in the future, as only some percentage of investors are knowledgeable and can effectively use available financial information.

The study investors investment and finance management is analyzed through rational and behavioural finance paradigms .The rational behaviour of investors which is an inherent for financial markets over decades is based on the notion that investors act rationally and consider all available information in the decision-making process, while investment markets are efficient and reflect all available information in the price of equities.

With this regard the investors have both short-term and long-term financial difficulties and find it impossible to ensure their financial security in a long-run. With this in mind, it can be stated that financial behaviour of investors and their investment pattern is partially rational as they do not always choose the best financial decision in terms of uncertainty and risk.

M. Friedman (1966) emphasizes that the major focus investors features in case of investment is economic rationality of people who are indulge in investment activities. Rational factor of investors would be a supporting foundation in mathematical calculations that allowed interpreting and predicting real-life situations in the equity market.

Efficient market hypothesis is one of the most important financial theory. Fama (1991) which analyses a number of share prices in exchange and concluded that the market is efficient and market participants hold all necessary information required for decision making. Investigators of individual behavioural finances [Kahneman and Tversky (1979) noticed that in theory, behaviour of an individual differs from that in practice and conventional theory of the financial market could not explain and predict all financial decisions.

Review Of Literature:

Nicholas Barberis & Richard Thaler's: A Survey of behavioural finance is of the opinion that the existing financial paradigms is based on the traditional finance paradigm which is a handbook to understand financial markets using models in which agents are rational in nature by 2 behavioural factors i.e., 1) New information availability in the market 2) Acceptable of information taking into consideration based on its consistency in earnings expected returns.

Shleifer & Hirshlefire- in their survey states that the theoretical and empirical work on limits to arbitrage and its closer to financial paradigms in terms of materials covered in assets pricing and corporate financing and also investor behaviour based on their investment model. They mention that when agents are rational and there are no frictions a securities price equals to its fundamental values and the study is on the expected future cash flow and also explains their stated hypothesis.

Daniel Et Al. (1993): He tries to explain by constructing a model of investors sentiments aimed at reconciling the empirical findings of over reactions and under reaction to the market information. Here he discusses about the psychology of investors which motivates them to identify the various portfolios on which various theories has been constructed.

Bernard (1992): He also deals with behavioural factors such as under reaction and over reaction of stock prices to the announcement of companies earnings which shows the results like when the stocks are sorted in to groups based on how much of a surprise is contained in their earnings, the one naïve way is to measure an earnings surprise to look at SUE (standardized unexpected earnings) , which is defined has the difference between the companies earnings in a given quarter and its earnings during the quarter year. Another way to measure an earnings surprise is by the stock price reactions to an earnings announcement. But the finding is that stocks with the positive earnings announcements has public information about earnings is incorporated into prices and also a stock with higher earnings surprises then that also earnings higher returns in the period after portfolio formations.

Bernard and Thomas (1990): They also summarize some evidence on the actual properties of the time series of earnings and provide an interpretation for their findings. The relevant series is changes in a company's earnings in a given quarter relative to the same calendar quarter in the previous year and they also find that the series exhibit an auto correlation of about 0.34 at a lag of 1 quarter, 0.19 at two quarters, 0.06 @ three quarter and -0.24 at four quarters which states that the earnings also depend on the performance of company based on the investment pattern and past actions and reactions.

Fama and French (1992, 1996): These people argue that glamour stocks are in fact less risky and value stocks are more risky, once risk is properly measured and have distinguished risk and overreaction sorts stocks on the basis of long-term growth rate forecasts made by professional financial analysts and finds evidence that analysts are excessively bullish about the stocks they are most pessimistic about based on the paradigms of the stock market.

La porta et al. (1997): He finds evidence of overreaction in glamour and value stocks defined using accounting variables. They finds that the paradigms which are existing in the market specifically shows that the glamour stocks earn negative returns on the day of their future earnings announcements and value stocks earn positive returns. The market learns when earnings are announced that its valuations have been too extremes.

Andreessen and Kraus: They have basic findings for the investors to behave in a certain ways. So they say that the track price –Sell when the prices rise and buy when prices fall, even when the series they are offered is a random walk which is fairly a universal mode of behavior, which is consistent with the reaction to the new in the market. However when subjects are given a series of data with a ostensible trend, they reduce tracking, that is they trade less in response to price movements.

De Bond l (1993): He finds strong evidence that people extrapolate past trends. In one case, he asks subjects to forecast future stock price levels after showing them past stock prices over a period of time and he also analyzed a sample of regular forecasts of the Dow jones index from a survey of members of the American Association of Individual Investors. In both cases, the forecasts change in price level is higher following a series of previous price increases than following price decreases suggesting that investors indeed chase trends once they think they see them.

Delong et al. (1990) and Shleifer and Vishny (1997): According to these authors there is a risk for the investors about the mispricing of stocks which can be exploited by the arbitrages which worsens in the short run. Here they states that the noise trader risk matters a lot to liquidate their positions early, bringing them potentially steep losses. So they are of opinion that there is 'a separation of brains and capital'.

Harris and Gurel (1986) and Shleifer 1986: According to them when a stock is added to the index, it jumps in price by an average of 35% and much of this jump is permanent. The fact that a stock jumps in value upon inclusion is once again clear evidence of mispricing, the price of the share changes even though its fundamental value does not changes.

Statement of Problem

Investors decision is a strong base for the performance of financial market as investors need to plan their investment avenues apart from these issues the relevance study about the equity market volatility and its implications is based on certain assumptions and theories over and above the strongest critic of behavioural finance theories for its obscurity, the cognitive deviation of which is mostly suitable to explain financial behaviour of individuals in certain situations. In addition, Fama (1998) stated that discrepancies in traditional theories could be very rare; while applying behavioural finance theories, some factors could be underestimated basing on one frame and overestimated basing on another. Notwithstanding, certain market fluctuations were defined and explained with the help of the behavioural finance theory. In addition, Friedman's (1966) statement – that irrational investors lose their income promptly due to their irrational decisions.

Objectives of the Study

1. To know the impact of paradigms on the investors behaviour on investment.
2. To know the core behavioural biases of investments.
3. To suggest investors to overcome the biases and to handle the paradigms.

Methodology

Data for this study is purely based on secondary sources such as books, journals, articles and also internet.

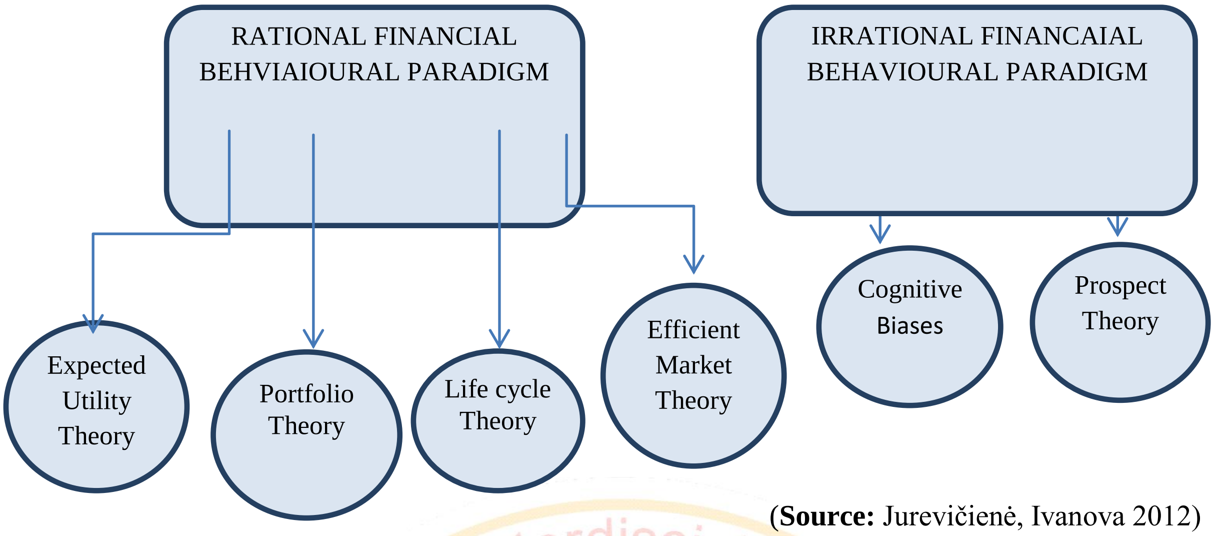
Analysis

The key assumption of all behavioural financial modelsnand theories is that investors who participant in equity or financial market are rational who are in turn investing in equities with the major objective or target is profit maximization. The Expected Utility Hypothesis of Neumann and Morgenstern (1944) is based on Bernoulli's (1954) expected utility theory and states that a rational market participant chooses one investment opportunity from a number of risky options with this the investors' finds way to maximize expected return to increase the level of satisfaction through investments. Expected utility hypothesis is often used to solve uncertain degree problems. Markowitz (1952) stated that an investor has to make a decision being in ignorance of which of the alternative investment portfolios would give more income. The basic idea of Modigliani and Brumberg (1954) states that a individuals tries to lower their consumption to ensure approximately the same level of life graph is maintained throughout investors entire life. The investor focuses on present requirement with an assumption that the savings is given much priority than expenditure for today and also the future income, i.e. the average income receivable now and in the future. Developing this theory, Friedman (1957) expounded the permanent income theory where he points out that there was the statement that population seek to maintain more or less the same level of consumption throughout the entire life for which to maintain this more and more investment avenues are identified and selected. This also reflects that the psychological factor plays a major role in such decision makings.

Efficient market hypothesis is one of the most important financial theories. Fama (1991) analysed a number of share prices in exchange and concluded that the market is efficient and market participants hold all necessary information required for decision making in order to make an investment in financial market as more uncertainties are attached with the equity or investment market. Investigators of individual behavioural finances Le Bon (1896), Raiffa, Raiffa (1968), Kahneman and Tversky (1979) noticed that in this theory, behaviour of an individual differs from that in practice and also states that the conventional theory of investments could not explain and predict all financial decisions. Criticism was mainly concentrated on the fact, that profit maximization criteria could be less significant for an investors as they wants to gain sufficient profit to satisfy personal demands in present as well as future where return and risk as to be considered equally to balance their portfolio(Ващенко 2007).

Behavioural finance emerged in 1980s as a response to emerged failures of the core economic models in traditional market to explain anomalies in financial markets. This approach is based on the concept of explaining behavior through biases of belief information and non-standard preferences to make an argument for irrational behaviour among agents that can explain persistent mispricing of assets and other anomalies (Baker 2010) and also behavioural factors controlling decision making of investors in equity market. French sociologist Le Bon was the first who noticed features of irrational behaviour, i.e. described the impact of the market on the decision-making process of an individual for this there is a requirement of making comparison between the rational and irrational financial paradigms which has a base for identifying various theories that has an influence on the performance of stock market for which there is a need to understand those theory for investing in financial market. This is the reason behind there is need of information to be given to the investors about the performance of stock market based on certain paradigms. So comparison between rational and irrational aspect in case of investment is quoted in the Fig-1 for the sake of understanding two different dimensions of investments made by investors in financial market.

Figure 1: Two Basic Paradigms in Finance Management



(**Source:** Jurevičienė, Ivanova 2012)

The above figure mentions that rational financial paradigms states certain theories for investment behaviour of investors like firstly expected utility theory 1944 states that the expected utility hypothesis is a tool for analyzing situations where individuals must make decisions without knowing which outcomes may result from that decisions which is taken under uncertainty. Secondly the portfolio theory propounded by Markowitz in 1952 was a foundation for modern portfolio theory as a mathematical calculation to identify the risk and return associated with it. Thirdly Life cycle theory of financial planning introduced in 1954 is related to the income and expenditure pattern of investors throughout their life. In order to accomplish the lifetime goal investors would borrow early in life when income and assets are low and needs are high. Lastly, The efficient Market Hypothesis theory (1979) which reflects all available information wherein the strong form of the EMH additionally claims that stock prices in the stock exchanges instantly reflect even the hidden insider information which explains that it is impossible to beat the market consistently on the risk adjusted basis since the market prices should only react to new information.

In case of Irrational financial Paradigm the prospect theory of Kahneman and Tversky (1979) stated that people view gains and losses differently and loss makes a greater emotional impact on investors than gain. In addition, Fama (1998) stated that discrepancies in traditional theories could be very rare while applying behavioural finance theories, some factors could be underestimated basing on one frame and overestimated basing on another.

A number of empirical investigations in behavioural finance are focusing on foreign markets (Polak 2012) with their pattern for investor's psychology and biases (Muradoglu, Harvey 2008). These interpretations may vary depending on differences in culture and mentality of citizens. Since behavioural finance is not based on mathematical models, it is crucial to define emotional characteristics of market participants, because peculiarities of financial decision-making depend on them.

Conclusion

The rational behaviour of investor in finance paradigm combines a number of financial theories that illustrate the sequence of financial decisions by assumption that an investors is a rational and motivated by financial market participant with profit maximization as his/her main goal. This paradigm does not take into account psychological motives, expectations or selective reception of information. Thus, the rational finance paradigm defines that a financial decision is theoretically optimal and does not reflect the real choice of a market participant.

The analytical review of various theories and models of behavioural finances have a large practical value as they allow explaining the events in the market and predicting the behaviour of investors in different situations as well as in comparison with the developing efficient market strategies.

In financial management anomalies, there is no precise definition of irrational investors. The literature review of investor's behaviour revealed features of irrational behaviour. Some characteristics (such as the winner's curse effect or loss aversion) are similar to those established by scientists of behavioural economics and the absences of the market impact are recognized as unique psychological features of investors

Financially investors are attempting to be successful in the financial market. They could be non-conscious of their financial decisions, as they can't always justify the financial motives, and, with a degree of uncertainty, their behaviour is irrational in terms of a certain risk level.

The identified behaviour features of investor's confirm the necessity to consider behavioural factors in managing financial decisions of an individual. And also indicates that the behavioural factors will also have an influence and related to the investment decisions made by them on various investments in equity market.

References

1. Fama, Eugene F., 1998, Market efficiency, Long term Returns, and Behavioural finance, Journal of Fiancial Economics 49, 283-306.
2. Russell, Thomas and Richard H.Thaler, 1985, The Relevances of Quasi- Rationality in competitive markets, American Economics Review 75, 1071-82.
3. Thaler, Richard H., and Eric J.Johnson, 1990, Gambling with the house money and trying to break even. The effects of prior outcomes on Risky choice, management science 36, 643-60.
4. Werner F., M. De Bondt, and Richard H. Thaler, 1985, Does the stock Market Overreact? Journal of Finance 40, 793-808.
5. Werner F., M De Bondt, and Richard H. Thaler,1987, Further Evidences on Investor Overreaction and Stock Market Seasonality, Journal of Finance 42, 557-81.
6. Kamath, R.R., 1997, Long-term Financing Decisions views and practices if financial Managers of NYSE firms, Financial Review 32, 331-56.
7. Lee, I., 1997, Do Firms Knowingly sell overvalued equity, journal of Finance 52, 1439-65.
8. Kahneman, D., and A. Tversky, 1979, prospects theory: An Analysis of decision under risk, Econometrica 47, 263-91.
9. Kothari, S.P., and R.G. Sloan, 1992, Information I prices about future earnings: Implications for earnings response co-efficient, Journal of Accounting and Economics 15, 143-71.
10. DeBondt, w., and R. Thaler, 1995, Financial decision making in markets and firms: A behavioral perspective.
11. Abarbanell, J., and V. Bernard, 1992, Tests of analysts overreaction/Underreaction to earnings information as an explanation for anomalous stock price behaviour, journal of finance 47, 118j-1207.
12. Loughran, Tim, and Jay R, Ritter, 1995, The new issues puzzle, Journal of Finance50, 23-51.
13. Américaine [Rational Man's Behavior in the Presence of Risk: Critique of the Postulates and Axioms of theAmerican School],
14. Baker, K. H. 2010. Behavioural Finance: Investors, Corporations,and Markets. New Jersey: John Wiley & Sons.
15. Beck, J. S. 2008. Kognityvinės terapijos pagrindai [The Basicsof Cognitive Theory].
16. Bernoulli, D. 1954. Exposition of a new theory on the measurement of risk, Econometrica 22(1): 23–36.
17. Fama, E.1991. Efficient Capital Markets: II, The Journal of Finance 46(5): 1575–1617.