Behavioral Finance and Investment Advisers

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Abstract: Behavioral finance, which is claimed to be the most comprehensive investment theory compared to the traditional financial model, studies the effect of psychology, biases, stereotypes and cognitive and emotional errors on investment decision making processes. Recognizing the impact of psychology on investment processes basically implies approving of the behavioral theory. Provided that this assumption is made by knowledgeable, experienced and influential investment advisers, the significance of the behavioral theory is enhanced in interpreting irrational investment behavior and, overall, investment processes.

Keywords: Behavioral Finance, Investment Advisers, Stock Market, Psychology.

I. Introduction

Behavioral finance, the new financial theory about investment decisions, originated from the weaknesses of the mainstream theory, which holds that those involved in investment processes always act rationally, and capital and stock markets are always efficient and predictable.

Behavioral finance research has demonstrated that psychological factors, biases, and cognitive and emotional errors hamper rational thinking and efficient investment decisions. It has also emphasized the significance of all types of investors, of individual investment processes, and diversification in stock market investments.

Irrationality in psychological particularities can be encountered only if the importance in making investment decisions is recognized. In addition, the awareness of emotional and cognitive errors implies approving of the new theory of investment behavior.

The present paper investigates the significance of behavioral finance in making investment decisions and offering investment advice. The first part describes the concept of behavioral financial and its relationship with the stock market and decision making processes. Subsequently, it examines the relationship between cognitive and emotional errors and investment advisers in the Greek stock market. Finally, it discusses the results in terms of the answers given by the subjects concerning the impact of psychology on investment decisions and advice in the case of Greek stock market advisers. In this framework, the present research investigates the significance of psychology in investment processes and, consequently, the approval of the new behavioral model.

Behavioral Finance and Investment Advisers

Behavioral Finance is "the study of how psychology affects financial decisions and financial markets" (Shefrin, 2001). Endorsed by other disciplines, such as Statistics, Mathematics, Sociology, Psychology, and Anthropology, Behavioral Finance attempts to describe how human psychology, and in particular, human behavior, affects investment decisions. It investigates the application of psychology in finance, with emphasis on cognitive biases (Hirshleifer, 2014). In Sewell’s (2005) terms, it is “the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets.” It relies on a traditional approach of the economy in conjunction with psychology and results in empirical analyses using behavioral models (Duxbury, 2015).

In the great work of two distinguished psychologists, Kahneman and Twersky, the pioneers of the new theory, it is stated that heuristics and biases shape financial decisions under uncertainty. In addition, Thaler (1980), who also contributed to the establishment of the new emerging paradigm, argued that investors frequently act rationally; he suggested that the Prospect Theory be the basis of an alternative descriptive model.

The proponents of the new financial theory assumed that Behavioral Finance has come to fill the gaps in the traditional theory and, in addition, to highlight its weaknesses. This alternative approach postulates that some financial processes are likely to depend upon the investors' less rational behavior (Barberis, 2007).

The standard financial model perceives a world of programmed, "cool" investors aiming at maximizing profits. It was the simplest rather than the 'right' model, "easier to formalize and practically more relevant"
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(Thaler and Mullainathan, 2000). Behavioral Finance thrived precisely in the simplified and unobtrusive form of the mainstream model.

Before the emergence of the new behavioral paradigm, financial research was based on efficient markets and rationality, which is typical of investors. Critics of the standard financial model argue that the stakeholders of investment processes and the stock markets are described and addressed, under the theory of Efficient Market, as soldiers.

The new financial approach urges that investors’ perceptions and decisions are based on their emotional state at a specific time. “People do not always make choices in a rational and calculated way. In fact, most human decision-making uses thought processes that are intuitive and automatic rather than deliberative and controlled” (Erta, Hunt, Iscenko, Brambley, 2013).

Behavioral Finance and the Stock Market

Since emotion is a regulatory factor in all forms of investments made by individuals during their lifetime (investing in family, knowledge, career), why be an exception in the less abstract but literal financial investment. In terms of Shefrin (2000), financial markets are governed by fear and greed. The fact that emotions combined with the investors’ biases is the most significant reason for deviating from rational investments. What is not worth mentioning in the framework of the Efficient Market theory is the cornerstone of Behavioral Finance.

Disputes against the Efficient Market theory made by behavioral theorists are also related to information availability and its direct effect on stock prices. Traditional financial models assume that stock prices respond quickly to new information and accurately reflect their fundamental value. Recent research demonstrates that capital market frictions and the psychological limitations of stock market investors can cause asset prices to deviate from their fundamental values for a considerable length of time (Gokhale, Tremblay, Tremblay, 2015).

On the other hand, opponents of the standard financial theory hold that investment processes have demonstrated that sometimes information is available in closedinvesting groups, and is also available to speculators long or shortly before it reaches the general public. They are also skeptical about how information is disseminated and they question the valid and unbiased way of information dissemination considering that capital markets (both in terms of availability and access) are inefficient as far as information is concerned. Shefrin (2000) states that the three mainstays of behavior are:

- Heuristics: the non-rational processes under which investment decisions are made
- Framing: the context, the investors’ stance towards a problem, and the available information
- Market anomalies: market anomalies cause inefficient markets.

Psychology, biases and investment advisers

According to Behavioral Finance, the effect of psychology, biases, and emotional and cognitive errors on an individual’s decisions is substantial and fundamental. Similarly, it is essential to decisions directly related to investments. In effect, the emotional and cognitive errors of investment professionals who manage customer portfolios in the stock market are crucial to ensuring the best function of the market.

Investment advisers can influence and guide clients. Their role is critical in influencing clients’ final decisions and, accordingly, the stock market progress; it becomes, thus, evident that the impact of psychology on investment adviser’s decisions is essential.

To avoid unreasonable investment choices due to biases and cognitive and emotional errors, investment decision making should be based on the common view that biases and emotional and cognitive errors can produce irrational thinking. Followed by the study and awareness of mental, emotional and psychological conditions, the specific perception directs to rational investment decisions.

Awareness of heuristics, cognitive and emotional errors and biases deter irrational thinking and contribute to preventing it. Recognizing that an individual can develop special features during investment decision making processes is vital to correct decision making processes.

The Survey

Provided that investment advisers are able to appreciate the effect of psychology on investment decisions, they can cope with irrational thinking, and, consequently, appreciate the role of behavioral finance.

In this framework, the present survey was based on the following question addressed to investment advisers: “How do you think your psychology, emotions and biases can affect your investment decisions?”

The question was addressed by the Capital Market Commission to certified executives working in stock market companies located in Athens in the period from 6 February to 19 March 2015.

The survey sampling has ensured the satisfactory dispersion and representativeness of the researched population:

- 23 participating companies (43% of the total number of 53 companies)
• Representativeness of companies: eligible for managing ~ 75% of the total value of stock market transactions,
  (ASE, HELEX - March 2015).

The corpus of data includes 81 answers to the survey question measuring on a 9-point scale, as applied by a large number of scholars (Derek, Tanniru, 2000, Vavra, 1997), who consider large scales with nine and ten points as acceptable. A 9-point scale enables eliciting more truthful / spontaneous answers and also neutral answers. In addition, when respondents are absolutely negative or positive, items 9 and 1, can replace "Yes"/ "No" answers, respectively.

II. Research Results

Data collection demonstrated that 40% of the survey participants (the total sum of percentages for points 7 (22%), 8 (12%) and 9 (6%)) do not make investment decisions and choices based on logic and rationality. Adding the positive gradient of point 6, scores are rated at 59% (40% + point 6 = 19%). The respondents hold that their investment behavior and the method employed to restructure or construct portfolios are made in the light of socio-psychological factors and biases.

Based on heuristics, emotional processes, culture and biases, the respondents’ investment choices are differentiated and shaped accordingly, 60% of the respondents are not rational decision makers on account of the psychological processes involved in decision making.

In addition, the executives’ emotions, psychological state and biases are perceived as a regulatory factor for clients’ investments. Thus, the organized and efficient function of the stock market is jeopardized, since investment misplacements, bubbles and irrational decisions result in market failures and imbalance.

Overall, the specific high scores demonstrate awareness of human weaknesses. The respondents are basically human beings and prone to cognitive and emotional errors. Those who are able to recognize weaknesses, biases and errors can improve their professional profiles and rationalize irrational behavior. Self-awareness results in self-improvement and self-control. In addition, the specific results in relation to the impact of emotions demonstrate the appreciation and approval of the new behavioral theory.

18% of the subjects (the total sum of points 1 (6%), 2 (5%) and 3 (7%), or 25% if point 4 (7%) involving neutral attitudes is added) claim that they are not influenced by upsurge of emotion and biases, thus, providing evidence that the specific results reflect either the rational part of the capital market or those who act under the influence of rational illusions.

As regards imperfect knowledge and misconceptions about correct decisions, the executives and clients involved in such circumstances are more liable, since failure to recognize errorsimplifies error repetition.

Neutral answers (point 5), estimated at 16%, are also considered answers in favour of rationality concerning the specific survey question, and are added to the total number of scores related to rational decision making.

The analysis of the results demonstrated that 47% of the participating executives of a higher educational status recognize their weaknesses and biases, 52% of those who act as financial advisors are affected by their psychological state, whereas those who manage portfolios, only 16% are unaffected by emotions and biases, similarly to stockbrokers. In addition, 41% and 48% of those who are affected by emotions apply conservative and aggressive financing policies, respectively.

Recognition of emotions and biases in investment decision making processes implies approving of the new financial theory and aiming at rationality.

III. Conclusions

Rational investment decision making is the result of implementing the new behavioral theory which has come to remedy weaknesses of the traditional paradigm. Recognizing the impact of psychology, biases, and emotional and cognitive errors on investment decisions enables coping up with investment misconceptions.

The behavioral theory emphasized that irrationality and non-rational choices and decisions are the result of investors’ emotional and cognitive errors. Thus, recognition of the significance of psychology in decision making processes basically implies approving of the new theory of behavior.

It is worth noting that the stakeholders of investment processes exercise influence and manage portfolios of other investors, and also provide expert advice and guidance. Thus, the research investigating their contribution and support is particularly crucial.

To investigate whether psychology, emotions and biases can affect investment decisions made by certified executives of stock market companies in Athens, the present research attempts to determine whether the subjects, who are stock market experts with a sound stock market background, approve of the new financial theory. The research analysis demonstrated that 59% of the respondents admit that investment suggestions and advice are affected by their psychological state at a specific time, and thus, they are likely to be irrational.
Recognizing the effect of emotional and cognitive errors results to examination and awareness of psychological, emotional and mental status; thus, the study of the investment behavioral model contributes to controlling irrationality and achieving profitability.

However, the analysis results demonstrated that about 25% of the research participants are not affected by biases and psychological conditions when they make investment decisions, which may imply that the specific number reflects the rational part of the capital market or those who act under the influence of rational illusions.

Overall, more than half of the sample recognize the importance of the new theory of behavior and, as a result, the shortcomings of the traditional paradigm. As the role of psychology is critical in stock market decisions, the significance and dominance of behavioral finance is great.

References

Books

Papers