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Behavioural Finance: The Importance of Psychological Factors in Financial Decision Making

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Abstract
Behavioural finance is the new concept emerged in financial economics as an alternative to the traditional finance. Behavioural finance is crucial and important part of Behavioural Economics. Most of the Economics theories are based on assumptions. So, Standard economics or standard finance being economics theories based on certain assumptions. The most important assumptions in standard economics or in standard finance is that markets are perfect. Another important assumption is rationality. Whenever people make decision under uncertainty, they consider all probabilistic outcome of alternatives and select the best alternative which maximize their utility as proposed by expected utility theory. Here the important question is "Are we rational?" To what extent the predicted results are reality? Do all of us make decisions in accordance with expected utility theory?
In reality, most of our decisions are governed by emotions. In real life, customers, users, and investors make decisions based on anchoring bias, bandwagon bias, endowment bias, hindsight bias, pain- of-paying, nudging etc.
This paper is prepared to address the fallacies of neoclassical economics and to support the behavioural economics and finance theories. To study the concept in detail, the paper is divided into different parts based on priority.
KeyWords: Psychological factors, Behavioural Economics, Anchoring bias, bandwagon bias, endowment bias, hindsight bias, nudging

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I. Introduction

Traditional Economics and Finance models are based on the assumptions 'rationality and perfect Market'. The basic assumption of financial theories explain that all investors are rational and securities markets are efficient, but psychologists argue that all investors cannot be rational as their investment decisions are affected by cognitive behaviour and extreme emotional bias. So, they put forth the challenge to this assumption of standard finance. Psychologists explain that in real life the customers' buying decision, investors' investment decision and users' consumption patterns are guided and directed by their emotions, sentiments, bias, sociological and psychological appeal. The assumption of perfect market, which means that there are no transaction costs, no taxes, economic agents have all the information which is freely available to everyone.

'Rationality' under Standard Economics means people make decision as per expected utility theory even under uncertainty. While making decision, they consider all probabilistic outcomes of alternatives and select the best one which gives them maximum utility. To select the best one, they test pros and cons of each and every alternative. But in reality it does not happen like that because sometimes situation demands sudden reactions. For E.g. If the fire takes place suddenly in the apartment, people think and analyze the various ways and means of rescues, the pros and cons of various alternatives, until they take decision, there will not be any lives. So, under uncertainty condition, rationality concept does not work. If people are not rational, it doesn't mean that they are irrational but they are normal, so, they work according to the situation.

The present paper describes the selection problem of various class of people under different circumstances and also complement the modern neoclassical economics. Behavioural Economics and the Behavioural finance has emerged to support the neoclassical economics and the financial theory.

Behavioural Finance applies psychological behaviour of human to the financial decision making. It focuses on emotional, societal, sentimental, psychological, cognitive factors in decision making. So, people don't try to optimize the decision making through the best one alternative selected but on the basis of personal satisfaction and bias.

Objectives of the study:
1. To know the relation between human behaviour and Financial decisions.
2. To know the role of human psychology in financial decision making.
3. To understand that always standard theories do not help in most of the decision making in normal course of life.

Conceptual framework

The early classical economists such as Adam Smith, David Recordo and some others thrown light on behavioural aspects of economics. Adam Smith, in his work "An enquiry into the Nature and Causes of Wealth of Nations" complemented with his another work " The Theory of Moral Sentiments" in which he analyzed the humane, altruistic side of human nature and behaviour.

Behavioural Finance gained much importance in 1980s as Daniel Kanhemann, known as father of bahvioural finance and Amos Tversky propounded most important theory on Bahavioural Finance called "Prospect Theory" in the year 1979. Daniel Kanhemann got the Nobel prize for the same work in 2002. Both of them contributed much to the field of Bahvioural Finance. They published nearly 200 papers, most of them related to psychological concepts with implications for the behavioural Finance.

Robert J Shiller, who received Nobel prize in the year 2013 made immense contribution to this field. In his work "Irrational Exuberance", he predicted the Global financial crisis of 2007 and warned the world.

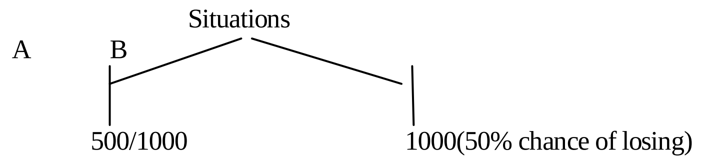
The recent and the prominent name in this field is Richard Thaler. He got Nobel prize in 2017 for his contribution to Behavioural Finance. ' Quasi-Rational Economics', 'The Winner's Curse: Paradoxes and Anomalies of Economic Life', and 'Advances in Behavioural Finance (Editor) Volume I and II are the important books authored or edited by him. The important concepts like mental accounting, Nudge theory, endowment bias etc. are his contributions.

Other important names heard in this area are Dan Ariely, Werner D Bondt, Hersh Shefin, Meir statman etc. They made effort to predict errors committed by human while making decisions or evaluating the risk and uncertainty conditions.

Important concepts and Biases

Prospect Theory: This concept was developed by Kahneman and Tversky in the year1979. Prospect theory states that the investors want to avoid the loss or dis-utility as they experience loss is more than equal amount of utility gained by them because losses have more emotional impact than the equal amount of gain.

For E.g In a Group discussion with students, two situations were given: A and B. In Situation A, one gets Rs. 500 out of Rs. 1000. And in situation B, out of Rs.1000, there is chance of losing 50%. They were asked to select the situation.



Majority students selected situation A is favourable. The effect of both the situations are same. Either A or B can be selected when we think logically. Those who selected situation A is more risk averse than those selected B.

Disposition Effect: Hersh Shefrin and Meir Statman stated 'Disposition effect' in 1985 which states that when the investors invest in Stock market, they sell the securities which experience price appreciation but they don't sell the securities which are declining in their market value because they don't want to suffer loss.

Actually the logical action is to sell the value declining securities as there would be further decline and to retain the value appreciating securities as there would be further increase in value.

Mental Accounting: In 1985 Thaler established this concept. As per this concept, people mentally allocate their current and future wealth into non- transferable separate compartments and different levels of utility are assigned to every group.

It has an irrational impact on the consumption and other decisions. For E .g : if a person saves for children education instead of paying his account debit balance, it leads to burden of interest.

This behaviour shows that people assign different functions to each asset group, which is irrational and detrimental effect on their decision behaviour.

Anchoring : An anchor is a reference point, a rule of thumb or a heuristic used by the people to make decisions but it may not have direct or indirect relevance to the decision making, however it affects people's decision. Usually people anchor on the first piece of information they receive.

For e.g : Jewelry Industry creates diamond engagement ring is symbol of love. Conventional wisdom suggests that it should cost around two month's salary of the groom. Two months' salary is great amount, so, it is completely irrelevant reference point created by jewelry industry to maximize its profit. Diamond ring does not value the love for the other person.

Bandwagon Bias: It is the tendency of the people to conform that they are part of the group or crowd or things because others believed in them. In this, people mimic the actions of the group. People follow the group to become a member in a group and large group could be right. It happens when individual does not have prior experience.

For E.g: In Bangalore, Road-side sellers have created the group ' pretending buyers'. The sellers on the road announces the prices of the articles in a louder voice, then all the pretending buyers rush to buy the articles, looking at this rush other passengers also turn to the roadside sellers and buy the items. When true customers leave that place, 'pretending buyers' come back and keep the items in its place.

Endowment Bias: It is the tendency of the people to attach a very high value to our own goods or things or people regardless of the actual worth. It happens when we overvalue our own goods irrespective of market value. It leads to demand more to give up the object than they would be ready to acquire it.

For e.g : In a Virtual Online market, the companies assure all the free trials, money back guarantee to capture the market on endowment bias bases. When we order for something, with a money back guarantee scheme, unless and until it is very bad, it is very rare to return the goods because as soon as we receive the goods and starts using it we attach the sentimental value to it.

This endowment bias can be seen in our great epic mahabharatha. Dhritrashtra and Gandhari had blind love for their sons. As Dhritrashtra was blind, his younger brother Pandu became the king. But he wanted his son Duryodhana to become the king even though he knew that Pandavas were more worthy to become the king than his son.

Hindsight Bias: It is the belief of the people that they know the outcome of the event before it actually takes place. People actually suffer from hindsight bias after actual event takes place. It is also termed as Overconfidence. Usually overconfident investors and traders believe that they have extra –ordinary abilities which would always result in positive effect. The investors who are overconfident very often buy and sell the securities in the financial market, it leads to excessive transaction costs.

For E.g Speculators in the market expect either rise or fall in the price of the securities in future. If it does not happen as they expected, they have to suffer a loss,

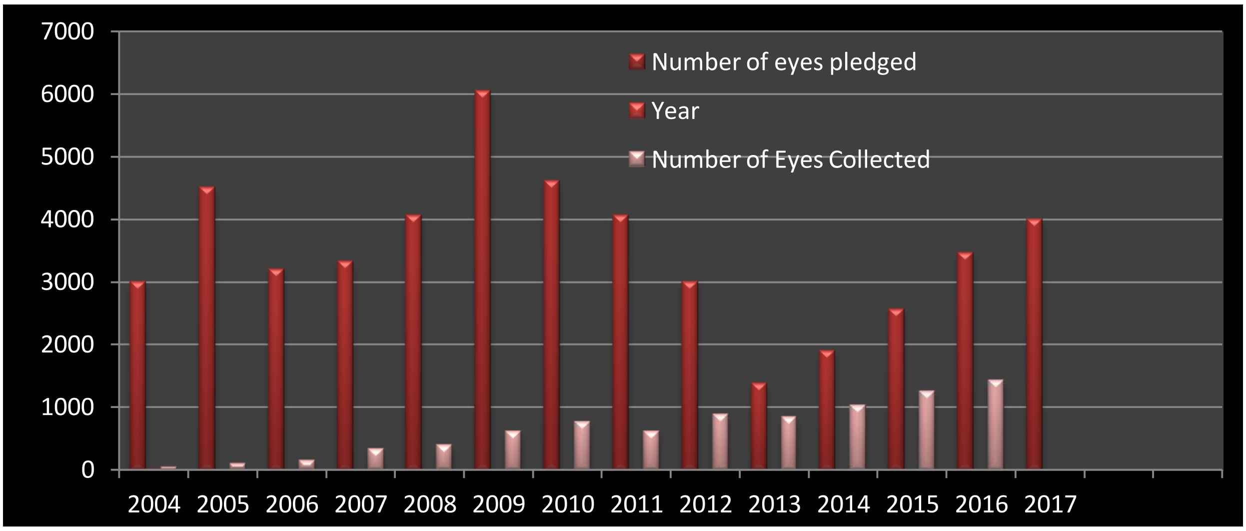
Pain of paying: When people make payment in hard cash, the pain is maximum because humans don't want to part with hard cash. Usually normal people to reduce the pain of payment use debit card, credit card, Paytm, Amazon pay, mobile transactions, or online transfer etc. But the rational people do not find any difference in these.

Nudging: Nudges are the plans to direct the people in particular direction and also allow them to go in their own ways. Usually nudges influences us subconsciously. These are used to get the desired results. All the famous brands, logos, taglines, slogans create emotional appeal to their product one or the other way. Richard Thaler got Nobel prize for his Nudge theory in 2017.

For E.g Kannada Film Actor Dr. Rajkumar inaugurated "Dr. Rajkumar Eye Bank" in 1994 and also willed his eyes. After the sad demise of Rajkumar in April 2006, the corneas of Rajkumar were collected. This movement was very heart touching and motivated number of people to follow him. There was great increase in number people who have pledged and donated their eyes. As per the available information about 26,000 people pledged their eyes so far.

The following table shows the data regarding eyes pledged by the people and collected by the hospital

Year	Number of Eyes Pledged	Number of Eyes Collected
2004	3000	44
2005	4500	94
2006	3200	150
2007	3320	336
2008	4059	385
2009	6051	608
2010	4610	767
2011	4050	609
2012	3005	878
2013	1370	829
2014	1900	1026
2015	2552	1249
2016	3455	1422



The problem of inertia: It is a tendency for emotions to affect from the agreed course of action 'having second thoughts'. It affects financial plan as a barrier to effective financial plan. It confuses so many investors to invest. For e.g.: Salary rises by 5%, it increases the take home salary. But at the same time employees are forced to save more equal to salary increased. It results in no effect on the take home salary.
Availability bias: This is used to evaluate the event on the basis of frequency of occurrence.

II. Review of Literature

To prepare this paper nearly forty eight papers were downloaded and studied. The findings of the different authors were analyzed. Each and every concept is found relevant. We have discussed few findings to support this paper.

1. C.V.Purushotham, in his study about individual investor's decision making found that Investors make decisions based on the information available but the processing of information varies as all the investors do not have similar psychological factors. The presence of these factors makes it difficult for stock market analysts to determine asset prices.

2. Chandra, Abhijeet and Kumar, Ravinder (2011), in their study " *Determinants of Individual Investor Behaviour: An Orthogonal Linear Transformation Approach" considered the irrationality of Expected utility theory for the individual investors and they found the behaviour related aspects in investment decisions. They examined the psychological and contextual factors in investment decisions of the individual which affect most. They focused on five major factors which influence investors' behabious in Indian stock market.*

3 Barber, B. M., & Odean, T. (1999), in their study "The Courage of Misguided Convictions" described empirical tests of their two predictions of behavioural finance that have implications for the individual investors and the professional investors. They predicted firstly that investors tend to sell their winning stocks and hold their losing stocks. Secondly because of the overconfidence investors trade too much. They described the tendency to sell winners too soon and hold losers too long as the "the disposition effect". To test this effect , they used account data from discount brokers and found that 50 percent of individual investors likely sell a sinning investment that the losing investment. It was also found that many sold in tax-motivated selling in December**..**

4. In the words of Meir Statman, Santa clara University, "People in standard finance are rational. But people in behavioral finance are normal." Statman further added in his exemplary research work in the field in 2014, "Behavioral finance substitutes normal people for the rational people in standard finance. It substitutes behavioral portfolio theory for mean-variance portfolio theory, and behavioral asset pricing models for the CAPM and other models where expected returns are determined only by risk. It expands the domain of finance beyond portfolios, asset pricing, and market efficiency. It explores the behavior of investors and managers in direct and indirect ways, whether by examining brains in MRIs or examining wants, errors, preferences, and behavior in questionnaires, experiments, and the field, saving and spending behavior. And it explores financial choices affected by culture, fairness, social responsibility, and other expressive and emotional wants."

5. Kumar, S., & Goyal, N. (2015), in their study "Behavioural biases in investment decision making – a systematic literature review" focused on individual behaviour biases in investment decision making. They tried to analyse the impact of cognitive biases on trading behaviour, volatality, market returns and the portfolio selection. The authors used combinations of four different biases - Overconfidence, Disposition effect, Herding, Home bias for decision making. They found the la ck of empirical research on individuals those who exhibit herd behaviour, focus on equity in home bias and decisive empirical finding on herding bias

6 Waweru, N. M., Mwangi, G. G., & Parkinson, J. M. (2014), In their study " Behavioural factors influencing investment decisions in the Kenyan property market" investigated on the perceptions of estate agents in the decision making behaviour of property investors using behavioural finance theories. They found that anchoring and representativeness are the major behavioural factors influencing the property investment decision making. They also found that price and location of the property also major factors in property investment decision making. The result of the study indicated that price changes and property market information have high impact on the property investment decision making.

III. Data/Methodology/ Approach

The concepts used in Bihavioural Finance from its inception are used as an approach to the study. Attractive concepts, discussions and representation of concepts in different database from 1980 to 2019 has been used.

Personal observation of the situational behaviour, advertisements in different media, discussion with the students in the classroom has been made use to discuss. The discussion with the students are placed wherever they are needed to test the concepts.

IV. Findings and Suggestions

In this study, it is found that all the decisions of the human beings and organizations are governed and controlled by the psychological aspects, the surroundings, the peer groups, emotions, sentiments etc. The percentage of influence may differ but it is definite. The study of human Behaviour is must not only in the finance field but in all other fields as they are the base for all. These days we find that all commercial decisions are supported and guided by scientific approach.

V. Suggestion

There is enough scope for this study. Now- a- days all the studies are human centered, so, research in this field is much required. If effective study in this field is undertaken, Investors, decision-makers can be properly guided and directed to take the correct decision to implement. Health and happiness are the basics of the day, so, human values are to be considered.

VI. Conclusion

The business finance is the combination of finance and psychology. It considers human behaviour in all aspects of decision making. So, we need to concentrate more on human behaviour rather than mechanism in decision making in any sector. Human psychological aspects are very important, so, there is a need for training to understand human psychology in every field of business.

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