Analytical Study of Importance of Behavioral Finance

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Abstract

Purpose of Research: *The paper helps to understand the concept of 'Behavioral Finance' and how it helps to deepen ones client relationships. It has been long observed that investors are not rational in their investment approach at all times. At times they may be influenced by emotional & psychological biases that are embedded in the human psyche, and it can negatively impact their returns in the long term. Behavior Finance, which combines the fields of economics & psychology, may help financial planners to understand investor behavior in a deeper manner, get around the baises & enhance the real returns for them.*

Methodology: *Paper draws information and supports material for the research using secondary sources such as Journal, Internet, and Newspapers etc.*

Expected Results: *Behavioral Finance helps financial planners understand client behavior and improve communication strategies in order to avoid poor decision making & deepen the client relationships.*

Implication: *Behavioral Finance should therefore not be viewed as a rejection of investment models but it picks up where traditional financial model leaves off.*

Introduction: The financial theory based on Modern Portfolio Theory (Markowitz, 1952) and Capital Asset Pricing Model (Sharpe, 1964) has long shaped the way in which Academics and practitioners analyze investment performance. The theory is based on the notion that investors act rationally and consider all available information in the decision- making process, and hence investment markets are efficient, reflecting all available information in security prices. However, researchers have uncovered a surprisingly large amount of evidence of Irrationality and repeated errors in judgment.

The field of "behavioral finance "has evolved that attempts to better understand and explain how emotions and cognitive errors influence investors and the decision-making process. The goal of this paper is to critically analyze the behavioral finance theory and identify its role in deepening client relationships and also to determine its benefits applications

The models within the traditional finance paradigm assume that investors act rationally and consider all available information in the decision-making process. That investors act promptly to new information and update, prices correctly within a normatively acceptable process. Hence, investment markets are efficient and security prices reflect the true 'intrinsic values' of the assets.

Investment market returns are believed to follow a random walk pattern; hence considered not predictable. Underlying all these is the theory if arbitrage, which suggests that rational investors undo price deviation away from the fundamental, values quickly and maintain market equilibrium. As such, 'prices are right' reflecting all available information and there is no 'free lunch': no investment strategy can earn excess risk-free rate of return greater than that warranted by its risk.

The Modern Portfolio Theory (MPT), Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Theory (APT) are the quantitative models that underpin the rational expectations based theories (Markowitz, 1995; Sharpe, 1964; Ross, 1976).

Behavioral finance paradigm has emerged in the response to the difficulties faced by the traditional paradigm. In essence, it argues that investment Choices are not always made on the basis of full rationality, and it attempts to understand the investment market phenomena by relaxing the two doctrines of the Traditional paradigm, that is, (1) Agents fail to update their beliefs correctly and (2) Investors desire, goals affect their choices

Behavioral finance argues that there is *'limits to arbitrage',* which allows investor irrationality to be Substantial and have long-lived impact on prices

Behavioral finance is part of finance that seeks to understand and explain the systematic financial market implications of psychological decision processes.

Warren Buffet defines it as: It is only when you combine sound and intellect with emotional discipline that you get rational behavior.

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It utilizes knowledge of cognitive psychology, social sciences and anthropology to explain irrational investor behavior that is not being captured by the traditional rational based models

Role of Behavioral Finance: People have individual goals, requirements, and desires different habits, different people we trust for advice, different belief about the right decisions on any occasions. But we all exhibit similar psychological baseness in our financial decision making which can lead to poor investment performance.

Understanding financial personality can help you understand why people make decisions they make, how are they likely to react to uncertainty in investing & how you preferences can temper individual preferences, hence helping your clients with right decisions hence building relationship

The role of Attitude, Anxiety and Reaction to dynamical situation plays significant role in retaining and losing a client. Emergence of Behavioral finance has presented new realm for analyzing the ways in which investors make decision that includes Psychological factors

There are typically some irrational behavior that individuals exhibit on understanding of which helps financial planner in dealing with them in a better manner and helps in accordingly communicating and handle their concerns, which are -

1. Individuals tend to spate their money into several mental accounts depending on :

- Source
- Magnitude
- Purpose of such money

2. Some individuals represent loss aversion, which causes their decisions to depend on the problem framed, rather than on net effect on their wealth, this leads to selling of good investments prematurely and to hold on bad investments for too long.

3. Individuals are prone to cognitive biasness, these can be caused tendency to misjudge the outcome, it can lead to assigned incorrect value to the investment

Types of Investors: There are models which helps you to understand the investor concern as no two investors are alike, not even twins in decision making.

1) Barnewell Two-way Model: One of the oldest & most prevalent psychographic investor's models which intended to help investment advisors interface with clients distinguishes two relatively simple investor types, passive & active investors. Barnewall's work suggests that a simple, non invasive overview of an investor's personal history & career record might reveal potential

General Type	PASSIVE		ACTIVE	
Risk Tolerance	Low →			→ High
Investment Style	Conservative	Moderate	Growth	Aggressive
Bias Type	Primarily emotional	Primarily cognitive	Primarily cognitive	Primarily emotional
BITs	Passive Preserver (PP)	Friendly Follower (FF)	Independent Individualist (II)	Active Accumulator (AA)
Biases				
Emotional	Endowment Loss aversion Status quo Regret aversion	Regret aversion	Overconfidence and self-attribution	Overconfidence Self-control
Cognitive	Mental accounting Anchoring and adjustment	Availability Hindsight Framing	Conservatism Availability Confirmation Representativeness	Illusion of control

pitfalls when establishing an advisory relationship. Her analysis also indicates that a quick, biographic glance at a client can provide important context for portfolio design.

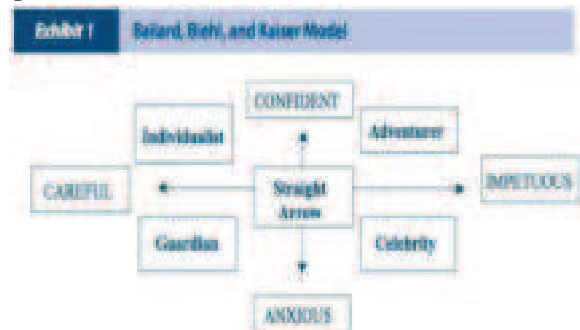
The above table indicates that the passive investors have become wealthy passively, & have a greater need for security than they have tolerance for risk. On the other hand, active investors are the ones who have earn their own wealth and have risked their own capital in achieving this wealth, thus having higher tolerance for risk.

Bailard, Biehl, and Kaiser Five-Way Model:

The Bailard, Biehl, and Kaiser (BB&K) model features some of the principles of the Barnewall model, but by classifying investor personalities along two axes—**level of confidence** and **method of action—**it introduces an additional dimension of analysis.

The first (aspect of personality) deals with how confidently the investor approaches life, regardless of whether it is his approach to his career, his health, or his money. These are important emotional choices, and they are dictated by how confident the investor is about some things or how much he tends to worry about them.

The second element deals with whether the investor is methodical, careful, and analytical in his approach to life or whether he is emotional, intuitive, and impetuous.



The Adventurer: Adventurers may hold highly undiversified portfolios because they are confident and willing to take chances. Their confidence leads them to make their own decisions and makes them reluctant to take advice. This presents a challenge for an investment adviser.

The Celebrity: Celebrities like to be the center of attention. They may hold opinions about some things but to a certain extent recognize their limitations and may be willing to seek and take advice about investing.

The Individualist: Individualists are independent and confident, which may be reflected in their choice of employment. They like to make their own decisions but only after careful analysis. They are pleasant to advise because they will listen and process informational rationally.

The Guardian: Guardians are cautious and concerned about the future. As people age and approach retirement, they may become guardians. They are concerned about protecting their assets and may seek advice from those they perceive as being more knowledgeable than themselves.

The Straight Arrow: Straight arrows are sensible and secure. They fall near the center of the graph. They are willing to take on some risk in the expectation of earning a commensurate return.

Although this model may be useful, it is possible **that investors do not approach all parts of their life with equal confidence or care. It is important to focus on the approach to investing** rather than placing undue focus on evidence from other aspects of their life. In addition, a **limitation of all categorization** schemes is that an individual's **behavior patterns may change** or **lack consistency.**

The Behavioral Process: A Top-Down Approach

Step1: **Interview the client and identify active or passive traits and risk tolerance.**

Step2: **Plot the investor on the active/passive and risk tolerance scale.**

Step3: **Test for behavioral biases.**

Step 4: **Classify investor into a behavioral investor type.**

Benefits of Behavioral Finance:

1. Helps in understanding the client with respect to understanding need, objective, circumstances
2. With the help of behavioral finance one standardize the process to meet client behaviour to advisory process
3. Helps in making good relationships with client & help make them financial government model
4. It helps in behavioral finance one standardize the process to meet client behaviour to advisory process

Empherical Evidence from Stock Market:

Two common mistakes investors make:

Excessive trading-The tendency to disproportionately hold on to losing investments while selling winners. They argue that these systematic biases have their origins in human psychology. The tendency for human beings to be *Overconfident* causes the first bias in investors, and the human desire to avoid *regret* prompts the second.

The behavioral models have been most successful in explaining

- Stock price anomalies related to overreaction, under reaction, momentum strategies, which affect the firm size.
- That a large stock price change, unsupported by news, illustrated the price trend reversals often occur when a majority of market agents follow the same Investing strategy (buying or selling), unsupported by new information, evidence of investor herding is present.

Methodology: Paper draws information and supports material for the research using secondary sources such as Journal, Internet, and Newspapers etc.

Expected Results: Behavioral Finance helps financial planners understand client behavior and improve communication strategies in order to avoid poor decision making & deepen the client relationships. It has an educational role & it helps investors to understand their biases & try to overcome them in order to be able to make long term decisions.

Implication: Behavioral Finance should therefore not be viewed as a rejection of investment models but it picks up where traditional financial model leaves off.

References:

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