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A Study On The Role Of Behavioral Finance Among Young Entrepreneurs

Dr. R. Ganesan

M.Com, M.Phil, Ph.D, Associate Professor D.G Vaishnav College

A. Bhuvaneswari

M.A. Corporate, M.Phil Corporate Secretaryship, Net Reserach Scholar, D.G.Vaishnav College Arumbakkam Chennai

Abstract: Behavioural finance is a study on irrational behaviour .The study is concentrated on cognitive biases and gives empirical evidence on the existence of cognitive biases. Overconfidence, Mental accounting and risk aversion is discussed in our study.

Keywords: Behavioral finance, over confidence, herd behaviour, mental accounting and risk aversion.

I. INTRODUCTION AND DESIGN OF STUDY

A. INTRODUCTION

Behavioral finance is new field that combines behavioural and cognitive psychological theory with conventional economics and finance to provide explanation as to why people make irrational decisions. Research in behavioural finance helps entrepreneurs in decision making and making them understand the different cognitive biases and errors that occur in their business. Entrepreneurs are the basis for building any nations economy. They are the wealth creators, job creators and alleviate poverty.

B. STATEMENT OF PROBLEM

The studies with respect to behavioural finance usually targeted the investors in stock exchange but not much articles and research work concerned with entrepreneurs are published. The entrepreneurs make major contribution to increase the GDP of the country. We are living in a period where small business plays an important role in economic prosperity of the country. For every small entrepreneurs decision making plays an vital role in their small business. At the basis of decision making lays behavioural finance which is a phenomenon with both finance and psychology combined to together replacing traditional finance which believes that humans are rational. It is necessary to identify the irrational decision making behaviour that is found among the entrepreneurs, theses irrational decision making behaviour is further more divided in to heuristics and cognitive bias. The research is conducted to identify and understand the biases found among the entrepreneurs.

C. OBJECTIVE OF THE STUDY

- ✓ To study the Confidence level among the young entrepreneurs
- ✓ To examine the risk aversion factor among the young entrepreneurs
- ✓ To study the mental accounting behaviour among the young entrepreneurs.
- ✓ To identify the savings behaviour among the young entrepreneurs

D. LIMITATIONS OF THE STUDY

Although many number of cognitive bias influence in financial decision making only a few cognitive bias is taken for our study. The study is also restricted to only students who are pursing degree as well doing business. they cannot be taken as general representation of entrepreneurs of Tamil Nadu.

E. RESEARCH METHODOLOGY

a. SOURCES OF DATA

✓ *Primary Data*

Primary data has been collected through structured questionnaire consisting of close ended multiple choice questions.

✓ *Secondary Data*

The sources of secondary data are various research journals, books, research papers and banks websites.

b. SAMPLING METHOD

The sampling method adopted for the study is "Convenience sampling".

c. SAMPLE SIZE

The sample size for the study is 50 to be collected from young entrepreneurs who are pursuing their commerce graduation and simultaneously doing business.

d. STATISTICAL TOOLS USED OR APPLIED:

The following statistical tools were applied in order to analyse the data and interpret the same in order to draw conclusions with respect to the objectives set.

✓ Chi Square analysis
✓ Frequency tables

Chi-square analysis was used in order to identify the association between any two given variables. One way ANOVA was applied in order to find out the each variable and also to ascertain the association between a dependent variable and group of independent variables.

CHI SQUARE ANALYSIS

Chi-square is a statistical test or instrument that is used to identify the relationship between any two given variable i.e. Dependent and Independent.

Pearson's Chi-square is the most commonly used type of Chi-square test, which was also used for this study. Pearson's chi-square test calculates the probability of association between two variables. In other words, it examines whether or not the association is statistically significant.

Based on the literature review and the data collected through questionnaires, the following statistical tools were applied.

II. REVIEW OF LITERATURE AND CONCEPTUL FRAMEWORK OF BEHAVIORAL FINANCE

BEHAVIORAL FINANCE

✓ PACIFIC-BASIN Finance Journal, Behavioral finance – Jay.R.Ritter, Department of Finance , School of Business administration, University of Florida
Behavioral Finance encompasses research that drops the traditional assumptions that drops the traditional assumptions of expected utility maximisation with rational investors in efficient markets. The growth of behavioural finance research has been fuelled by the inability of the traditional framework to explain many empirical events by building two blocks one with behavioural finance and other with arbitrage.

✓ Behavioral Corporate Finance-A Survey Malcolm Baker, Richard S. Ruback, Jeffrey Wurgler. National Bureau of economic research, Cambridge.
Research in Behavioral Corporate finance takes the study of non standard preference and judgemental biases on managerial decisions, overall Behavioral approaches helps to explain a number of important financing and investment patterns.

✓ OXFORD Journal , The Society for Financial Studies , Author Werner De Bondt, Discussion of "Competing theories of Financial Anomalies"
Modern finance built on the logic of rational choice, helps our understanding of market behaviour when the forces of arbitrage are strong. The conventional economics has failed to explain how assets prices are set.

✓ A Survey study of factors influencing Risk-taking behaviour in Real world decisions under uncertainty, Manel Baucells, Cristina Rata
The study of real world decision making is a broad research that can be tackled from several angles. The goal is to gain an understanding of decision making under uncertainty by means of a survey that required subjects to fit some real decisions into decision analytic framework.

✓ Gender difference in Personal Financial Literacy, Among College Students, Haiyang Chen, Ronald.P.Volpe Financial Services review William Paterson University Wayne
Personal Finance knowledge is not very attractive to women compared with men. Gender Bias related with financial literacy, women have less interest and confidence in personal finance.

BEHAVIORAL FINANCE

HISTORY OF BEHAVIORAL FINANCE:

Behavioural finance is a relatively new field that seeks to combine behavioral and cognitive psychological theory with conventional economics and finance to provide explanations for why people make irrational decisions.

Psychologist Daniel Kahneman and Amos Tversky are considered to be the father of behavioural finance. They have published more than 200 research papers and articles which relate to psychological concepts with implications for behavioural finance. Richard Thaler another economist who worked with Kahneman and Tversky developed the concept of mental accounting. Behavioral finance combines social and psychological theory with financial theory as a means of understanding how price movements in the securities markets occur independent of any corporate actions. Behavioural finance is a new paradigm which supplements the standard theories of finance by introducing behavioural aspects to the decision making process. Behavioral finance studies how the emotion and psychology of the investor affects investment decisions. Current accepted theories like Modern portfolio theory and Efficient market hypothesis are referred to as standard finance or traditional finance which is based on the foundation that Investors behavior are rational, markets are efficient and expected returns are function of risk and risk alone. behavioral finance argues that investors behavior are not rational and markets are no longer efficient, emotions play a major role in all decisions, Individuals view the situation in their own unique way,even sound human being would creep emotions and irrationality in their conclusions and decisions . Behavioral finance has been defined in various ways Linter1998 defines it as" the study of how humans interpret and act on information to make informed investment decisions. De Bondtv2004 defines as "a theory which explores financial issues with the help of ideas borrowed from cognitive psychology".

Behavioral finance also referred to as behavioural economics, combines economics and psychology to analyse how and why investors make their financial decisions. Behavioral economics refers to economic irrationality and economic anamolies whereas behavioral finance recognises the individuals including professional investors use heuristics to make investment decision. Behavioral finance views Irrationality as heuristics and biases. Heuritics include representativeness and availability and Biases include emotional (based on what one feels) and cognitive (based on thinking).Buchanan and Huczynski 2004 concur that cognitive biases are systematic distortions when people make decision. Cognitive biases are done by wrong reasoning.cognitive biases include Over confidence, mental accounting, confirmation bias, risk, Gamblers fallacy. Heuristics are simple rules and short cuts to solve problems.

Cognitive Biases

Over confidence

Nevins (2004) defines overconfidence as, people who are overconfident in their own abilities. He observes that investors and analysts are particularly overconfident in areas where they have some knowledge. An after effect of overconfidence is overtrading, which leads to poor investment decisions. (Nevins 2004). Ritter (2003) stated that entrepreneurs are likely to be overconfident in their decision making. Phung (2004) views individuals overconfident as overestimate or exaggerate their ability to successfully perform a particular task.

Mental Accounting

Hirshielper (2001), mental accounting is a kind of narrow framing that keeps track of gains and losses related to decisions in separate mental accounts. Thaler a pioneer of behavioural finance developed the concept of mental accounting. Thaler defines (1985) mental accounting as the tendency of people to separate their money into several accounts. Charupat and Deaves (2003) explain that mental accounting has hoe people think about spending money and how they save money for the future.

LOSS AVERSION

Kahneman and Tversky propoe loss aversion. They argued that the impact of loss has stronger impact than the impact of gain. Loss aversion refers to the tendency for people to prefer avoiding losses than acquiring gains. They believed that loss aversions can cause individuals to make unsound financial decisions. In a research study, Odean (Charupat&Deaves, 2003) reported that investors realised gains more frequently than they realised losses. Loss aversion can cause investors to be more conservative in their investment strategy.

HERD BEHAVIOR

Herd behaviour is tendency of an individual in a group act collectively without centralised direction. For an individual is said to have herd behaviour if the investor makes investments without knowing other investors decision, there are several reasons for herd behaviour. First they may think that others know something about the return on their investment and their actions reveal this information. Secondly it is relevant only for money managers who invest on behalf of others, the incentives provided by the compensation scheme and terms of employment may be such that imitation is rewarded. Thirdly the individuals may have an intrinsic preference for conformity.

SME-ROLE AND RELEVANCE IN ECONOMIC DEVELOPMENT

From an individual street hawker to a complx multinational enterprise, every business has it stakeholders and its impact on society as both positive and negative impact. The SME and micro-enterprise sector comprises of very broad range type of businesses, from traditional family business to self employed people. SMEs are particularly important in supporting economic growth in developing countries .SMEs are the back bone of industrial development. They always represent the model of economic development, which emphasized high contribution to domestic production, significant export earnings, low investment requirements, employment generation.

III. ANALYSIS RELATING TO OBJECTIVE

This chapter intends to statistically analyse the data collected using statistical tools and draw inferences thereof. The analysis highlights the degree of financial behaviour prevailing among the students pursuing commerce graduation and also doing business.

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VARIABLES TAKEN UP FOR THE STUDY

The variables taken up for the study are financial behaviour variables like

- ✓ Overconfidence
- ✓ Mental Accounting
- ✓ Risk Averse
- ✓ Herd Behavior

React in worst scenario

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	over confident	1	2.2	2.2	2.2
	confident	23	50.0	50.0	52.2
	neither nor	17	37.0	37.0	89.1
	less confident	5	10.9	10.9	100.0
	Total	46	100.0	100.0	

Table 3.1: Reaction In Worst Scenario To Analyse Confidence Level

Interpretation: Reacting in worst scenario is related to confidence level of the respondents. The table shows us clearly that they are confident in taking decision in worst scenario. Majority of them were confident in handling worst scenario.

Risky projects

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	willig to take more risk	5	10.9	10.9	10.9
	willing to take risk	22	47.8	47.8	58.7
	neither nor	2	4.3	4.3	63.0
	willing to take low risk	15	32.6	32.6	95.7
	no risk	2	4.3	4.3	100.0
	Total	46	100.0	100.0	

Table 3.2: Risk Behavior

Interpretation: Respondents by willing to take risk have again proved that they are confident in accepting risky projects. Only 32.6% of the respondents were willing to take low risk.

Allocate money

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes always	5	10.9	10.9	10.9
	Always	9	19.6	19.6	30.4
	neither nor	2	4.3	4.3	34.8
	at times	29	63.0	63.0	97.8
	not at all	1	2.2	2.2	100.0
	Total	46	100.0	100.0	

Table 3.3: Mental Accounting

Interpretation: Majority of the respondents allocate money, this evidently shows us the mental accounting behaviour among the respondents. Respondents allocating either always or at times, do allocate money and as proved the existence of bias.

Friends influence

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes always	1	2.2	2.2	2.2
	Always	2	4.3	4.3	6.5
	neither nor	5	10.9	10.9	17.4
	at times	22	47.8	47.8	65.2
	not at all	16	34.8	34.8	100.0
	Total	46	100.0	100.0	

Table 3.4: Herd Behavior

Interpretation: Friend influence is correlated to herd behaviour one of the cognitive biases, the above table shows us that respondents are influenced by their friends when they make investments

Blue sky innovator

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	low risk	30	65.2	65.2	65.2
	high risk	16	34.8	34.8	100.0
	Total	46	100.0	100.0	

Table 3.5: Blue Sky Innovator

Interpretation: Blue sky innovators are those who want to venture into new and challenging projects apart from the routine business. Blue sky innovators can be correlated to risk averse behaviour. The above table shows that the respondents while considering a new project or innovative projects are quite risk averse and

Money value

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yourself	9	19.6	19.6	19.6
	your friend	17	37.0	37.0	56.5
	Both	17	37.0	37.0	93.5
	Don't know	3	6.5	6.5	100.0
	Total	46	100.0	100.0	

Table 3.6: Money Value

Interpretation: Knowledge of time value of money shows that they are not aware of time value of money.

Investments in past one yr

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Invested before evaluating	7	15.2	15.6	15.6
	Invested after evaluating	16	34.8	35.6	51.1
	None	22	47.8	48.9	100.0
	Total	45	97.8	100.0	
Missing	System	1	2.2		
Total		46	100.0		

Table 3.7: Investments In Past One Year

Interpretation: Investments in past one year is recorded to identify the savings behaviour commonly found among the respondents. 47.8% of the respondents have not invested anywhere showing lack of savings behaviour while 34.6% of the respondents have invested only after evaluating.

H0: There is no association between Type of business and Confidence.

H1: There is association between Type of business and Confidence.

Type of business * react in worst scenario Cross tabulation

		react in worst scenario				
		over confident	confident	neither nor	less confident	Total
type of business	family owned	1	14	10	4	29
	self owned	0	9	7	1	17
Total		1	23	17	5	46

	Value	df	asymp
Pearson Chi-Square	1.380^a	3	.710
Likelihood Ratio	1.775	3	.620
Linear-by-Linear Association	.067	1	.796
N of Valid Cases	46		

Table 3.8: Chi Square Type Of Business And Confidence

Interpretation: Type of business does not have any effect on the confidence level of respondents. The calculated p value is more than the critical value of .05 accepting the null hypothesis, therefore there is no significant difference between type of business they run and confidence level. Whatever business they run they show over confidence in investing risky projects.

IV. SUMMARY OF FINDINGS AND CONCLUSION

A. FINDINGS

- ✓ Respondents by willing to take risk have again proved that they are confident in accepting risky projects. Only 32.6% of the respondents were willing to take low risk
- ✓ Mental Accounting Bias: Majority of the respondents allocate money, this evidently shows us the mental accounting behaviour among the respondents. Respondents allocating either always or at times, do allocate money
- ✓ Over Confidence Bias: Reacting in worst scenario is related to confidence level of the respondents. The table shows us clearly that they are confident in taking decision in worst scenario. Majority of them were confident in handling worst scenario.
- ✓ Herd Behavior Bias: Friend influence is correlated to herd behaviour one of the cognitive biases, the above table shows us that respondents are influenced by their friends when they make investments
- ✓ Risk Averse Bias: Blue sky innovators are those who want to venture into new and challenging projects apart from the routine business. Blue sky innovators can be correlated to risk averse behaviour. The above table shows that the respondents while considering a new project or innovative projects are quite risk averse and
- ✓ Investments in past one year are recorded to identify the savings behaviour commonly found among the respondents. 47.8% of the respondents have not invested anywhere showing lack of savings behaviour while 34.6% of the respondents have invested only after evaluating.
- ✓ There is no significant difference between type of business they run and confidence level. Whatever business they run they show over confidence in investing risky projects.

B. CONCLUSIONS

In this study the objectives are primarily investigated among the young entrepreneurs who contribute to the financial sector. From the empirical results four of the cognitive bias is more distinct, like overconfident bias, the mental accounting, loss aversion, herd behaviour. There are many cognitive biases, further research can be made with big entrepreneurs and other biases can also be studied.

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