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Behavioural Finance Studies – Emergence And Development

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Abstract: ***Finance plays a vital role in every aspect of life whether institutionally or individually, and therefore, with the intense growth and development in the global and domestic financial markets, the field of behavioural finance has also strengthened its roots in the economy. Behavioural finance is the study of the psychology of an average investor, whether individual or an institution; it is also regarded as open-minded finance by Richard Thaler (a founding father of behavioural finance). Behavioural finance aims at the discovery of various market anomalies by understanding and studying the psychological behaviour of the investors towards the money market. Behaviour finance has revolutionized the whole perception of investments by marrying the subject of investments to behaviour and psychology. This study synthesizes on the emergence and development of the behavioural finance studies and will draw a unique conclusion with an ambitious research plan and an all-inclusive literature review.***

Keywords: ***Behavioural finance, efficient market hypothesis, financial markets, investor's decisions, investor's psychology.***

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I. INTRODUCTION

Financing in the money markets has become very promoted in recent decades. Commonly, investment decisions are dependent upon the future aspects and the financial status of the investments, but sometimes the decision may be irrational and can be bent over to the moods and instant perceptions of the investors, which can be analyzed and studied through Behavioural finance. Behavioural finance is regarded as the study of investor's psychology. Investors are the best assets of a company and the nature of their investments is parallel to their behaviour. The behaviour of an investor is not always rational, so it is deeply required to study the internal factors that may affect the rational behaviour of the investors towards the financial markets. Behavioural finance studies stress the fact that psychological propositions govern the perceptions and decisions of the investors. The investors react differently to different events and often frame decisions on their perceptions and emotions, rather than being strictly rational. The concept of Behavioural finance has made finance more prudent within the rational groundwork, this is undoubtedly a major reason that Behavioural finance studies and concepts have grown so rapidly in the former years and is advancing in the present as well.

The Behavioural finance studies have solicited to throw light upon the uncertainties, inefficiencies and biases prevailing in the financial markets since its inception in the early 1980s. At the beginning of the 1980s, many finance theorists came to the idea that the framework of the laws of financial investment is not as much clean as they were formerly theorized or predicted and were based on the efficient market hypothesis, and when these ideas cropped up in the economy it gave birth to a new field which was regarded as Behavioral Finance. The basic essence of Behavioural finance is the identification and explanation of mispricing and inefficiency in the financial markets by stressing upon the rationality and irrationality of the decisions framed by the potential investors. In the end, the basic reason for the evolution of a separate field of Behavioural finance is that every individual investor views different investment opportunities differently and perceives the same information contrastingly. Investors will grab information according to their own alignment of understanding and knowledge and all these issues are approached to Behavioural financing so that

market anomalies can be easily identified and abolished from the economy.

II. LITERATURE REVIEW

R. C. Hammond [1] (Behavioral finance- its history and its future) : "The field of behavioral finance has attempted to explain a litany of biases, heuristics, and inefficiencies present in financial markets since its creation in the 1980's. Apart from financial planning and advising, the largest application of behavioural finance in investing is in investment decision making and securities selection."

D. M. Misal [2] International journal of economics and business modeling (A study of behavioural finance and investor's emotion in Indian Capital market): "if we always assume that financial markets are efficient and investors are rational then why there are so many studies about investor's psychology? Investment managers always want to make money for themselves and for their clients. That is the reason they care about the 'psychology' factor of the financial market as well as investors."

Pavlo Illiashenko [3] (Behavioral finance: history and foundations): "behavioural finance substitutes normal people for the rational people in standard finance. It substitutes the behavioural portfolio theory for mean-variance theory and behavioural asset pricing models for the CAPM and other models where expected returns are determined only by risks."

Egidijus Bikas, Daiva Jureviciene [4] (behavioural finance: the emergence and development trends): "definition of behavioural finance supposes two important aspects – individual investors and the entire market. In other words, behavioural finance in a broad sense is divided into macro behavioural finance and micro behavioural finance. Behavioural finance is the result of the structure of various sciences."

Richard H Thaler [5] (advances in behavioural finance): "behavioural finance during most of its first decade was more finance than behaviour. In recent years that emphasis has begun to change as researchers have obtained data sets of actual behaviour by investors. Using such data researchers have been able to show that the same biases discovered by psychologists in laboratory experiments at low or zero stakes also emerge in the field of high stakes."

Dr L. J. Chaarlas, Albin D Robert Lawrence [6] (behavioural finance a boon to investors): "the efficient markets theory reached the height of its dominance in academic circles around the 1970s. Faith in this theory was eroded by a succession of discoveries of anomalies, many in the 1980s, and of evidence of excess volatility of returns. A survey was conducted among equity investors in Tamil Nadu (India) to trace the behavioural biases of investors."

Sudhir Singh [7] (investor irrationality and self-defeating behaviour: insights from behavioural finance): "the collapse of the dot-com era of the late nineties and the continuing present anxiety over stock market performance has had a sobering effect on investors and warranted a revising of the rules of investing. New attempts are being made to explain the behaviour of financial markets, one of the foremost of which is in the area of behavioural finance."

Nicholas Barberis, Richard Thaler [8] (a survey of behavioural finance): "behavioural finance argues that some financial phenomena can plausibly be understood using models in which some agents' are not fully rational. The field has two building blocks, limits to arbitrage and psychology which catalogues the kinds of deviations from full rationality we might expect to see."

A. Byrne and M. Brooks [9]The research foundation of CFA (Behavior finance: theories and evidence): "a key argument in behavioural finance is that the existence of behavioural biases among investors(noise traders) will affect asset prices and returns on a sustained basis only if limits to arbitrage also exist that prevent rational investors from exploiting short-term mispricing."

III. OBJECTIVES

The basic objectives to be fulfilled by this research are as follows:

- ✓ To screen out the emergence and development of behavioural finance.
- ✓ To synthesize the evolution of behavioural finance.
- ✓ Extract the important theories and foundation of behavioural finance.
- ✓ To draw an exclusive conclusion.

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IV. RESEARCH METHODOLOGY

The research is based on the qualitative study of literature and an in-depth understanding of the topic through various sources like journals, papers, magazines, articles etc. it is explanatory research truly based on secondary data. All the data is effectively and properly utilized for the research work. All the data is carved out through a comprehensive study of the field by various means.

V. HISTORY/EVOLUTION OF BEHAVIOURAL FINANCE

The progression of behavioural finance started when a need for the analysis and study of human behaviour emerged, for detecting and contrasting the market uncertainties and anomalies. Behavioural finance is an old field which emerged rapidly over the years and has now become a great part of financial investments. The emergence of behavioural finance studies has resulted in narrowing the bridge between substantial market conditions and the conventional financial theories and practices. The behavioural finance theories loomed in the economy and substituted the classical finance theories with more pragmatic behavioural theories to cope up with the ever-changing markets and recession.

The evolution of behavioural finance involves two approaches

THE TRADITIONAL APPROACH: the commencement of the traditional economics started from the mid-eighteenth century, with the birth of the utility concept in economics. The utility concept measured an individual's satisfaction through

the consumption of a good or service. Then, in 1844, a new development cropped up as the concept of rational economic man, depicting that an individual is perfectly rational and has perfect knowledge of the market. All these evolutions in the economy became the groundwork of the classical financial theories which were based on the principle of arbitrage. In 1970, the concept of efficient market hypothesis emerged as a breakthrough in the financial economy and turned out to be a great success in first the earlier decades on its transformation. The EMH model stressed that the financial investors are rational and value securities rationally, extracting all the important information. In the past years, these theories were considered to be an excellent explanation of the markets and the investor's behaviour, but, in recent times, with the growth and development of the investors and the financial markets these theories got violated in the actual market scenarios, as many researchers came to the point that these theories were based upon bygone and abridged assumptions. Hence, it gave rise to the behavioural approach toward finance.

Year	Concepts
1844	Concept of economic man
1944	The utility theory
1970	The efficient market hypothesis theory

Table 1

THE BEHAVIOURAL FINANCE APPROACH: the theories of behavioural finance evolved when the classical theories of finance were not able to give any explanation of the on-going market anomalies. The market participants were driving the prices of securities very above to their fair prices and therefore, were resulting in mispricing and uncertainties. The behavioural finance theories provided alternatives and solutions to these market blocks. It captured the psychology and the investor's side of decision making so that the market anomalies can be abolished from the economy. There are various theories of behavioural finance (discussed further) which proved to be a great boon to the financial managers. The theories of behavioural finance stated the fact that investors can never be fully or perfectly rational and they trade off noise and information; hence, they are decumbent to various market biases and reactions. Therefore, behaviour finance counters the predictions of the traditional approach and has proved to be of great significance in this dynamic economy.

VI. THEORIES OF BEHAVIOURAL FINANCE

Behavioural finance is based upon the theories of behavioural finance which concludes that the investors are prone to behavioural biases and their decisions cannot be perfectly ration. The various theories of behavioural finance are discussed further.

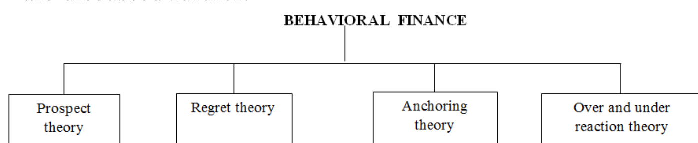

Figure 1

- ✓ *PROSPECT THEORY* – the prospect theory of behavioural finance states that financial investors react or acknowledge equivalent events or situations differently. This theory is fully based on the anticipations of the investors about the different situations that they are in, at the time of taking investment decisions. The investor's psychology depicts the nature of decisions that an investor takes in the context of risks and gains. An investor may behave like a risk lover when he or she is avoiding a loss and may become risk averter while chasing gains. According to this theory, the investor's decisions are based upon the context of situations as they are revealed to them.
- ✓ *REGRET THEORY* – the regret theory of behavioural finance is based on the emotional responses of the investor of making an erroneous judgment. According to the regret theory, the investor finds it easier and convenient to follow other people's investment decisions in order to avoid error judgments. For example, an investor may drop down the idea of selling an investment (stock) whose value has gone down in order to run away from the regret of making a bad investment decision. This theory particularly stresses the mental state of an investor while having a sense of regret about their judgments and choices.
- ✓ *ANCHORING THEORY* – anchoring is a worldwide phenomenon and is present in the financial markets too. Anchoring is prevalent in many situations. The best way an investor can be on the good side is taking a decision in reference to solid facts and figures which are correct and relevant in nature. Many times investors take a decision on the basis of some irrelevant facts and incur a loss. A wise means of avoiding anchoring is to practice critical thinking while investing in any stock. A wise investor is always at a brighter side.
- ✓ *OVER AND UNDER REACTION THEORY* – over and under reaction crops up when the investors put so much attention or stress on prevailing events and news at the loss of other vital data. Investors become more optimistic when the market prices hikes and become pessimistic when the market prices fall. The over and under reaction leads to extreme events as the prices may fall to a great extent on a piece of bad news and can rise to a great level on a piece of good news.

These theories are the key factors of behavioural finance studies and form a basis for various researches and studies.

VII. FOUNDATIONS OF BEHAVIOURAL FINANCE STUDIES

Same as economics and traditional finance fields are made up of two sections that are, micro and macro, the field of behavioural finance is also constituted by two sectors, namely, micro behavioural finance and macro behavioural finance. Miller suggests that the micro vein is a basis of individual decision making and the macro study is concerned with the asset prices of the market as a whole. To figure out the concepts of micro and macro behavioural finance we need to look into the roots of the foundation of this field.

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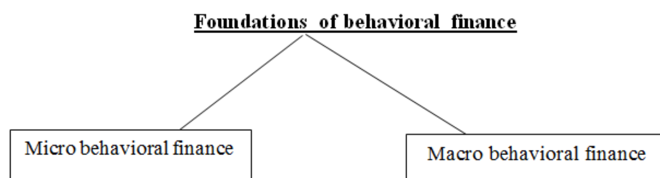

Figure 2

- ✓ *MICRO BEHAVIOURAL FINANCE* – micro behavioural study deals with the analysis of the behaviour of an individual investor. It concentrates on the decision making the prospect of a single investor and documents the behavioural biases that an individual investor may experience while making an investment decision. The micro behavioural finance study suggests that an individual investor should process the facts and information attentively, be ignorant about the inaccurate and irrelevant information and then take decisions. These behavioural studies have also shown that investors are affected by behavioural biases.

  The micro behavioural research also draws attention to the dual-process theory of decision making. This theory of decision making consists of two sub-sets, first, the system of influenced and effortless decision making and second, the system of logical and deliberate decision making. An investor encounters such situations in his or her decisions making processes and these two sub-sets works parallel to each other. The micro behavioural study further provides with the information that is relevant for the macro behavioural studies. The important conclusion is that the micro behavioural finance is concerned with an investor as a single entity (individual).
- ✓ *MACRO BEHAVIOURAL FINANCE* – macro behavioural finance is dependent on human behaviour which is depicted by the micro behavioural finance. Unlike, the micro theory the macro behavioural finance is not concerned with an individual investor, rather it is connected to the effects or influences that the decisions of an individual investor on the asset prices of the market as a whole. Macro refers to large; hence, the macro behavioural finance studies the market as a whole on the basis of decisions made by the investors at the micro level.

  Macro behavioural finance also leads to the conclusion that the homogeneity in the decisions of many investors may lead to changes in the entire market. Macro behavioural finance works in harmony with the micro level. The important conclusion is that the macro behavioural finance deals with the economy as a whole and stresses upon the idea that the individual decisions if combined, can make a big change in the asset prices of investments in the long run.

VIII. THE SIGNIFICANCE OF BEHAVIOURAL FINANCE IN FINANCIAL MARKETS

Behavioural finance is attracting more and more attention due to its importance in the financial markets. It has become a vital part of today's financial structure. The calibre of behavioural finance in the modern economy can be understood by the following text.

- ✓ Behavioural finance has bridged the gap between the traditional finance theories and the actual market conditions.
- ✓ Behavioural finance theories purely illustrate the practicality of the decision-making process of a potential investor.
- ✓ The behavioural finance studies have overcome the loopholes of the classical finance theories, such as the efficient market hypothesis theory.
- ✓ The studies of behavioural finance enable the managers to carve out better and logical strategies, by understanding the psychology of their investors.
- ✓ Behavioural finance studies assist in detecting and abolishing the market anomalies, like mispricing and uncertainties.
- ✓ The field of behavioural finance keeps an efficient check on the market movements, which are driven by investor's decisions.

In a nutshell, the behavioural finance studies are a boon to the modern economy and provide a number of alternatives to cope up with market inefficiencies and disturbances.

IX. CRITICISM OF BEHAVIOURAL FINANCE

As it is rightly said that, every coin has two sides, just like that, behavioural finance has also faced some decent criticisms in the long run. Behavioural finance faces criticism by many scholars and researchers on different grounds, some of which are drafted below.

- ✓ Behavioural finance proposes a cramped and bounded critique of the classical economic theory.
- ✓ Some researchers often argue that the subject matter of behavioural finance is stuck to pointing out failures of apprehension and calculations.
- ✓ Behavioural finance studies bear the consequences of neglecting other social sciences and the traditional finance theories.
- ✓ Behavioural finance sometimes comes out with contradicting findings which are difficult to reconcile.
- ✓ Behavioural finance has a narrow predictive power, that is, it mostly tells what an investor will not do, rather than what they will do.

The basic learning from all the criticisms of behavioural finance is that it is dependent on traditional theories of economics and finance and is still rigorously growing to be an effective tool for financial managers as well as others.

X. CONCLUSION

After going through a massive amount of information, we can conclude that behavioural finance has depicted a descriptive charm from its inception till present. Behavioural finance is a potent and productive study of social sciences like psychology and human behaviour for the betterment of the financial economy. It has exploded into massive popularity over the years since its birth in the late eighteenth century and

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is still growing and developing at a fast pace. Behavioural finance theories help in understanding how the money markets actually are and what are the perceptions and assumptions in the minds of potential investors while taking an investment decision.

Behavioural finance studies and theories are a boon to the financial markets. However, the field is not left alone of its criticisms, but just like any other matter of subject it is growing and overcoming every limitation. Behavioural finance helps in detecting the market abnormalities and provides alternatives for the same. For the closure, it is appropriate to say that, one day this field will shine into something truly astonishing and will provide numerous aids to the financial environment.

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