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ROLE OF BEHAVIOURAL FINANCE IN INDIVIDUAL INVESTOR INVESTMENT DECISION IN THE FINANCIAL MARKET

*** Naveed Jan**

Business School Shandong Normal University, Jinan China

Muhammad Adil

Muhammad Adil, Assistant professor, Department of Management Science and Commerce, Bacha Khan University, Charsadda

Dilkash Sapna

Miss Dilkash Sapna, Lecturer Department of Sociology and Political Science, Bacha Khan University, Charsadda

Uzma Haroon

Uzma Haroon Department of Management Sciences, Times Institute, Multan Pakistan

Email of the corresponding author: needo@yahoo.com

ABSTRACT

There are mainly two disciplines of financial market study viz. Conventional Finance and the recent development is known as Behavioural Finance. Conventional finance foundation is mainly based on an efficient market, Investor rationality, and the modern portfolio theory developed by Markowitz. But till 1990 the conventional finance theories were not so been challenged. But from the mid-90 researchers have shown many shortcomings of the existing theory and particularly challenged the investor rationality concept. As a result, a new paradigm known as behavioral finance has been developed. In this paper, an attempt has been made to highlight the shortcomings of the traditional finance theories as pointed out by behavioral finance supporters and also a discussion on the significance of behavioral finance.

***Keywords*:** Traditional finance, behavioral finance, behavioral biases, investor rationality, and stock market decision.

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INTRODUCTION

The place where the financial instruments or the financial assets are traded is called financial markets. Financial assets are primarily based on securities issued by companies mostly shares, stocks, debentures or bonds, etc. The study of financial markets has always been a center of attraction for researchers. Due to this inquisitiveness, various

developments have resulted at different stages in the evolution of behavioral finance. In this regard, numerous theories have also been established. These developments are essentially categorized into three specific categories:

- Traditional Finance theories
- Modern Finance Theories
- Latest addition is the Behavioural Finance theories.

Information is quickly reflected in the behavior and direction of stock prices in financial markets which have experienced extreme volatility globally since the 2008 global financial crisis as a result of anomalies that run counter to the logic of the rational expectations theory of investor sentiment, which is a major determinant of market movements. Many researchers are interested in studying the behavioral factors of investors. Financial markets play an important role in a country's economy, and this research explores the role played by behavioral factors (cognitive and emotional), such as fear, greed, excessive confidence, and other behavioral factors, in the formulation of investment decisions. Consequently, behavioral finance has become the specialized field in studying how psychological factors affect investment decision-making in case of uncertainty.

There are some limitations in traditional finance that are effectively explained by behavioral finance. Firstly, traditional finance is based on the assumption that investors are rational. However, numerous empirical studies have shown the theory's key limitations. Rationality implies that investors should make the best and most efficient use of the information in the stock market for rational investment decisions (Agarwal et al., 2017). Büyüközkan et al., (2018) have shown that investors are social beings if they have asymmetric information concerning stock market trading that leads to biased investment decision in the stock market. Investor irrationality has a direct effect on biased investment decisions in the stock market. Second, Conventional finance believes that most investors will truly care about the desired value they are willing to get from their investments using utilitarian characteristics of investments such as risk and return. However, behavior finance shows how an investor can optimize the expected return and reduce the inherited risk in their investments.

Third, the role of investors in stock market investment decisions is completely ignored by traditional finance. But investors are also normal people with perfect self-control and we cannot ignore the role of investors' perfect self-control in any investment decision-making process including the investment portfolio allocation in different sectors. Fourth, Conventional finance assumes that investors have immediate access to all available information and stock prices in the stock market. But in reality, it is not feasible for investors because at the same time all investors do not have access to all the available information in the stock market.

The investment sector consists of a huge database of all available information about historical and present stock prices, market movements, and prospects but it depends upon investor capabilities and how he interprets such information for rational investment decisions in the stock market (Pompian & Wood, 2006). In this article, the theoretical discussion will be presented to understand and analyze the emotional and cognitive biases that are specific to the decisions of investors in financial markets and how these biases

affect their investment decisions, resulting in irrational behavior dominating their investment decisions.

STATEMENT OF THE PROBLEM

Finance is the lifeblood of every business, organization, or firm. Business needs more resources to expand their operations in this competitive environment. Business growth is also important for the country's rapid industrialization and economic development and which ultimately depends on public shares that are the major source of financing for a business. However, attracting more and more investors to the stock market will not only improve the individual businesses' competitive position in the stock market but will also contribute to the overall national growth and development. As a result, investigating not only the stock market's movements but also the behaviors of investors that make these stock market movements seem valuable for financial market growth and prospects. In this paper, an attempt is made to explain the evolution of the new financial discipline known as behavioral finance.

Objectives Of The Study

The key objectives of the paper are to demonstrate the shortcomings of traditional finance theory and explore the significance of behavioral finance discipline in the development of financial market behavior of investors.

METHODOLOGY

This paper is primarily conceptual and descriptive and is based on the various research papers, journals, and various articles on behavioral finance available through internet-based sources. Moreover, the paper is also based on various books and journals that are available in physical form to develop the paper's foundation.

Importance Of Study

The importance of the paper is to identify the various shortcomings of traditional finance theory and behavioral biases that investor confronts during investment decision in the financial market. The financial decision couldn't be made in a vacuum an individual investor needs to make a comprehensive analysis like an efficient use of historical market information, his or her financial knowledge, and effective advice from friends or relatives to make a rational investment decision in the stock market.

LITERATURE REVIEW

Investing in financial markets from a normative point of view has been extensively studied over the past few decades with various theories being developed in terms of financial return and financial risk and both of these have been used together in the investment practices in the stock market. Most of the theoretical structures presented in the literature are based on the principal criterion of Individual rationality – the investor behaves in a certain way to maximize their desired benefit. In the financial context, he maximizes his welfare a concept that Von Neumann and Morgenstern were first introduced in 1947. Leung et al., (2012) suggested a quantitative structure for investment selection in financial markets – such structure became the basis for modern portfolio theory.

It represents a cornerstone of modern financial theory it provides investors with a means of structure modeling asset allocation within a portfolio for a given necessary risk and

return. Elbannan, (2015) developed the CAPM model which provides the investor with a certain level of risk and can be used in the investor risk-return asset model. However, both of these important theories along with other major studies in the literature on the financial markets are linked to investor rationality in stock market investment decisions. This intuition forms the basis for the efficiency in financial markets and stated that financial markets can disclose all available information to market participants so investors can make rational investment decisions in the stock market (Fama, 1970). However, human emotions and irrationality play their part in the activities of financial markets and were examined by different researchers from a psychological perspective starting in the 1970s. Singh, (2009) laid down the foundation of emerging fields such as behavioral finance under the prospect theory of investor investment decisions in the stock market. The history of financial market research both from a conventional and behavioral point of view is comprehensive and contributes to the current study of behavioral biases and investment decisions. Behavioral finance is a field that captures investor irrationality and different behavior biases that investors confront in the financial market during their investment decision. These cognitive errors are due to the inability of investors to know market movements for the upcoming different periods leading to biased investment decisions.

Such investment decisions are both poor and irrational for investors' future returns. The behavioral financial discipline emerged as a result of various limitations in traditional finance theory of stock market investment decisions. This development has highlighted the behavior of the stock market, various market securities, and market anomalies that were overlooked by the traditional finance theories of the stock market. However, it should be remembered that both efficient market theory and behavioral finance are interrelated with investor behavior, i.e. how investors make securities market investment decisions. We should anticipate that if investors avoid behavioral biases while making investment selections their decisions will be more productive and will increase their trust in investing in the stock market.

The stock market provides human interaction platform and plays a vital role in economic development (Akbar et al., 2016). It pools funds from individuals and institutions and directs tits toward businesses and industries. Individual investors play the most important role in the market and their behavior is examined for both academic and professional purposes. Individual investors may obtain information from friends, relatives, coworkers, print media, and electronic media and invest in the stock market. In addition, bankers, brokers, and financial planners can provide useful information to an investor for rational investment decisions in the stock market.

Behavioral Biases In The Financial Market

Behavioral biases have significant potential impacts on financial market participants' behaviors and their decisions. However, by identifying behavioral biases participants in the financial market can be able to reduce or respond to such biases and thus increase their require financial outcomes. These biases are classed as cognitive biases and emotional biases. The kind of bias influence identifies whether the impact is low, moderate, or high.

- Cognitive biases in the stock market arise from basic statistical, information-processing, or memory errors from an individual investor in the stock market.

- Emotional biases in the stock market arise from impulse or intuition; emotional biases result from reasoning influenced by individual investor feelings in the stock market.

Types Of Cognitive Biases In The Financial Market

Pompian, (2011) describes the first types of biases which are seen as the most important.

Over-Confidence Bias

This is one of the cognitive prejudices possessed by people and is believed to be one of the most prominent features of success and excellence in many decision-making areas. It also refers to confidence and confidence in language means a person's sense of certainty. It may also indicate the accuracy in the expression and persuasion of something (Al-Dahan et al., 2019). The person who possesses this bias tends to exaggerate their cognitive abilities and skills in the investment field because they believe they possess more knowledge and insight than others when making a decision. The first to describe excessive confidence in the field of psychology was (Oskamp, 1965).

Psychologists believe that a person with excessive confidence over-estimates events and how to control them, and reduces the time required to assess risk; this also means over-estimating a person's own ability to perform certain tasks and showing more confidence in making decisions (Seppälä et al., 2009).When deciding to buy and sell securities, the presence of an over-confidence bias leads to heterogeneity in the decisions of the dealers in securities (Scheinkman & Xiong, 2004). When investors in the markets and decision-makers are characterized by excessive confidence, it leads to excessive trading. People who experience this bias fail to understand information or make an effort to obtain it (Schwartz & Brownell, 2007).

Securities are generally bought at a high price and sold at a low price due to excessive confidence. This cycle leads to losses for the investor and bubbles in the financial markets (Charles & Kasilingam, 2014).

Representativeness Bias

This cognitive bias means people try to fit a new and unknown event into a current event. The nature of people is to judge something according to their ideas and what their memory retains. (Busenitz & Barney, 1997) were the first scholars to describe this bias, which manifests when people prefer to generalize a phenomenon based on previous experience. This means that they depend on the similarity between the event and a similar previous event, and on the mental image generated, by allocating more weight to the latter phenomenon without taking an average of the phenomenon in the long term (Kubilay & Bayrakdaroglu, 2016).Thus, they ignore the random nature of events by linking current analysis periods with previous periods (Chang & Chen, 2008). This in turn leads to inaccuracies in investment decision-making because of the inaccuracy of the decision-maker in selecting the sample (Bodie et al., 2013).

Availability Bias

Another important cognitive bias that appears when decisions are made based on memory is estimating the probability of the latest event by adopting a mental event retrieval formula to increase the probability of event retrieval (Aren & Hamamci, 2021). This provides a

rapid evaluation of the event for easy retrieval leading to speed decision-making (Riaz et al., 2020).

Illusion of Control Bias

This bias means a person thinks they are capable of controlling the consequences of events, whereas they don't possess that ability. It reflects negatively on their future decisions (Chira et al., 2008). Such bias affects the relative importance of skill, the role of luck, and the incentives a person has to control the investment environment of the financial market.

Confirmation Bias

Trading requires the availability and collection of information about the current assets and their basic characteristics and anticipation of what other investors in the market will do to make a correct estimate of assets in the future. This bias leads to a tendency for investors to focus on information that agrees with their views, preventing them from responding to any other information this can lead to the creation of bubbles in financial markets (Walenchok, 2018).

Hindsight Bias

Hindsight bias is a cognitive bias that makes a person convinced that the circumstances of an event after the occurrence of the event were expected based on historical data. There is a belief in predictability, which is seen as an ability to make investment decisions (Suresh, 2021).

Types of Emotional Biases In The Financial Market

Loss Aversion Bias

It is human nature to want to avoid loss, and this can play a big role when making an investment decision. Yet this bias can lead to irrational behavior. This will affect the investment decision because investors retain investments to avoid loss when they should exit the market. Numerous psychological studies have shown that individuals do not view the results as the ultimate state of wealth or well-being, but rather as gains and losses relative to a particular reference point, usually the status quo (Moshinsky & Bar-Hillel, 2010).

Endowment Bias

The cost of giving away anything from a person's property is seen as a loss and the opportunity cost (not buying a commodity or financial asset) is seen as a prior profit. The first should be given greater weight, as investors resist change when they own security. Pompian, (2011) states that this bias: 1. Affects investors in holding onto the securities they have inherited regardless of whether it is financially wise to do so 2. Results in investors holding the securities they have purchased, which is often the result of a decision deficit 3. Results in investors retaining the securities they have inherited or bought because they do not want to bear the transaction costs associated with selling securities 4. This leads to investors retaining the securities they have inherited or purchased because they are aware of the behavioral characteristics of these investments.

Self-Control Bias

Restraint bias can lead to many mistakes for investment and thus affect investor decisions and profits, and create bubbles in the market; this bias leads to investors spending more today rather than saving for tomorrow. Retirement can arrive so quickly that investors cannot provide enough; often, people assume an inappropriate degree of risk in their portfolios to make up for the lost time. People who do not plan to retire are less likely to invest in securities. Restraint bias can lead investors to overlook basic financial principles (Pompian, 2011).

Regret Aversion Bias

Emotional biases describe people feeling sad about doing something. Grief may result from comparing the actual result with an alternative result and feeling responsible or blaming oneself for the negative outcome of a decision. Avoiding remorse is a psychological theory that shows regret when people see that their decisions are wrong, even if they seemed correct originally. Regret is associated with a sense of responsibility for the option, so it differs from the frustration of placing responsibility on external elements for bad outcomes (Michenaud & Solnik, 2008).

Status Quo Bias

Individuals who face a range of options tend to elect an option that maintains the status quo, rather than alternative options that might bring about change. That is, they make the decision only because it maintains the current situation (Bostrom & Ord, 2006).This bias means that people tend to stay where they are, even if they have better alternatives (Burmeister & Schade, 2007). This bias may result from the search for comfort because people resist change and fear the remorse of change if they take effective steps to change the status quo (Ackert & Deaves, 2009). This means people tend to retain their existing alternative rather than change, which is linked to the researchers' view of ownership bias, but there is a difference between the two biases (Kahneman & Tversky, 1979).

CONCLUSION

Behavioral finance is the study of psychology on the behavior of financial practitioners and the subsequent effect on markets (Birău, 2012). It attempts to better understand and explain how emotions and cognitive errors influence investors. Much of economic and financial theories presume that individuals act rationally and consider all available information in the investment decision-making process. (P. Singh, 1997) notes that there is evidence to show repeated patterns of irrationality, inconsistency, and incompetence in the way human beings arrive at decisions and choices when faced with uncertainty. There is also emerging evidence that institutional investors behave differently from individual investors, in part because they are agents acting on behalf of the ultimate investors. Studies have shown that individual and institutional investors are affected by emotions and cognitive influences when making investment decisions. The literature has reviewed both cognitive errors and emotional biases that potentially influence individual investor decisions. It has discussed biases such as overconfidence, representativeness, availability, the illusion of control, confirmation, hindsight, loss aversion, endowment, self-control, regret aversion, status Quo biases, etc.

RECOMMENDATIONS AND FUTURE DIRECTIONS

There are some financial ideas and techniques to assist investors to avoid the most prevalent behavior biases in stock market investment. Most individuals do not begin savings and investments by developing a specific deadline. Many consumers buy stocks or mutual funds based on previous performance rather than studying what they will do in the future. Many investors do not focus on diversifying their holdings enough. Most individuals purchase stocks based on historical performance without anticipating their prospects in the stock market. However, many investors do not diversify its portfolio effectively in the stock market.

There are four basic rules before trading in the stock market. (1) Don't spend with the crowd (2) Conscious (3) Careful (4) benefit - don't give up. Evidence suggested that a large number of investors are overconfident. Even though historical information suggests that most investors believe they can outperform the market. One reason for investors' overconfident characteristics is the internet because the internet provides quick access to stock market information and motivates them to make an investment decision in the stock market. However, investor education, standardization of mutual fund advertising, disclosure standards, and reporting rules make financial reports transparent and easy to understand and can assist investors to make rational investment decisions in the stock market. It has been suggested that cognitive biases stem from faulty reasoning that can be corrected by education and advice.

However, this is not supported by empirical evidence. Instead, there exist contradictory literature which suggests that financially literate investors are not immune from the effects of the popular investing culture observed in individual investors, and many of the factors no doubt influence their thinking as well. However, emotional biases can be overcome by active monitoring of a portfolio is important for navigating the changing tides of financial markets.

Still, it is also essential for individual investors to manage the behavioral impulses of emotional buying and selling that can come from following the market's ups and downs. Indeed, investors seem to have a knack for piling into investments at market tops and selling at the bottoms because it is not uncommon to get entangled in media hype or fear, buying investments at peaks and selling during the valleys of the cycle. The key is to understand the motivations behind emotional investing and to avoid both euphoric and depressive investment traps that can lead to poor decision-making.

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