

A BEHAVIORAL APPROACH IN INVESTMENT PROCESSES

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Abstract: It cannot be denied that behavioral finances changed the way people think about investments. This paper aims to present the psychological factors and the biases that affect the capital investment decision. The expected result of the paper is to present the concept of behavioral finance that helps us recognize our natural biases which lead us into making illogical and usually irrational decisions when it comes to investments and finances. A full understanding of what behavioral finance means leads us closer to our own success.

Keywords: behavioural finance, overconfidence, over and underreaction, risk aversion prospect theory.

Introduction

The field of behavioral finance tried to explain the biases and the inefficiencies present in financial markets since its creation in the 1980s. Behavioral finances studies how the behavior of the investors in the financial market is influenced by psychological factors and how the resulting influence

on decisions made while buying or selling on the market affects the prices. Amos Tversky, Daniel Kahneman, and Richard Thaler, are considered today the founding fathers of behavioral finance. The modern portfolio theory shows how financial markets should work in an ideal world, while behavioural finance shows how they really work. Reality shows that people are not always rational, they are affected by their emotional state and other beliefs.

Factors influencing investment decisions

The theory underlying the behavioral finance is the Prospect theory and it belongs to Kahneman and Tversky (1980). The theory introduces concepts such as risk aversion and regret, anchoring effect, the adjusting effect, the herd effect, representativeness heuristic etc. Behavioral finance argues that poor performance is caused by psychological factors which influence the investor's decisions. The psychological factors that we consider the most relevant are:

a. *The herd instinct*

The herd instinct in financial markets is defined as an imitation. It represents the tendency of people to copy the actions of a large group instead of taking a decision individually. The herd instinct is a frequent mistake that the majority of people make. Very often investors have the tendency to omit important information, which usually leads to unfavorable results. They are subjective and make irrational decisions. An explanation of this mistake is that people are sociable and they tend to seek acceptance from the group, rather to assume their decision.

b. *Overconfidence*

Human beings are often overconfident about their abilities and knowledge. Greater overconfidence leads to greater trading and to lower expected utility. A research by Odean has revealed that the confident investors trade more than those who are less confident. The level of confidence is usually not reflected in the market success. An increased confidence can lead to poor or ineffective decisions. These decisions may refer to: buying investments with an increased risk, inability to diversify and finally an unprofitable transaction.

c. *Overreaction*

Thaler indicates several recent studies that demonstrate that people put too much enthusiasm in some opportunities, thinking they had identified a trend. Investors tend to fixate on the latest information received and extrapolate from it; last earnings report will become, in their minds, a signal for future gains. Then, believing that they see something that others do not see, they take hasty decisions because of superficial reasons. Overreaction is a consequence of having emotion in the stock market when a new information comes. According to efficient market hypothesis the new information should more or less be reflected instantly in a security's price. Overconfidence appears; people think

they understand better information than others, as they interpret it better. But it is more than that. Overreliance is extrapolated overreaction. Researchers learned behaviors that people tend to overreact to bad news and react more slowly to the good news. Psychologists call this "overreaction caused by the influence of factors". Thus, if the ratio of short-term gains is not good, the typical response of investors is steep, which has an inevitable effect on stock prices. Participants in the stock market predictably overreact to new information, creating a larger-than-appropriate effect on a security's price. Thaler describes this overreaction as an exaggerated emotionalism as a "myopia" of the investor and believes that it would be better if they do not receive information monthly.

d. *Emotional biases*

Behavioral biases can vary depending upon our personality type. The biases are cognitive and emotional. The cognitive biases illustrate a tendency to follow the rule of thumb. The rule of thumb is a general principle that gives practical instructions for accomplishing or approaching a certain task. The emotional biases is a tendency to take action based on emotions or feeling rather than facts. A study by H. Kent Baker and Victor Ricciardi presents eight biases responsible for investment decisions: anchoring or confirmation bias, regret aversion bias, disposition effect bias, hindsight bias, familiarity bias, self-attribution bias, trend chasing bias and worry. Brad Sherman (2016) makes the following chart



Figure 1: Emotional rollercoaster and how it impacts investment decisions

Source: Brad Sherman (2016)

Kahneman says that the concept of loss aversion is certainly the most significant contribution of psychology to behavioral economics. The concept resumed says that human tendency is not to give up the things already owned to an uncertain, potential future earning. Some investors believe that a low-risk investment is more favorable, but a greater risk may bring a higher gain. A higher gain is directly proportional to the risk that investor assumes. An investment made is a risk not to get the money back, but the investor expectations to make profit offsets the risk.

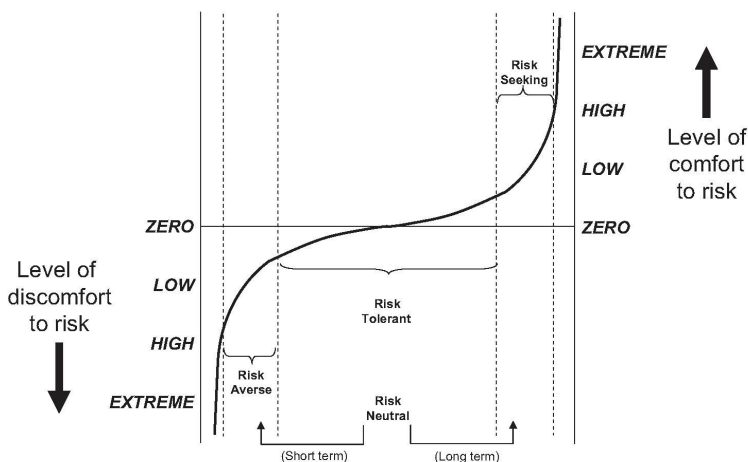
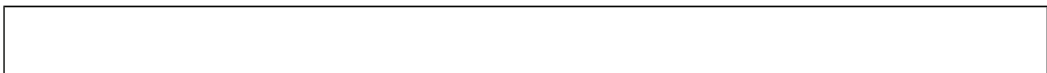


Figure 2: Risk attitude spectrum

Source: adapted from Hillson and Murray-Webster (2007)

There are two important elements to consider while we are evaluating risk: 1. the perception of risk and 2. the attitude against risk.



STRUCTURAL MODEL: THE CONTEXT OF RISK ATTITUDES

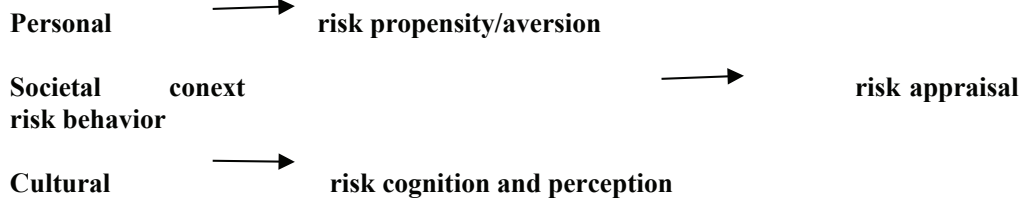


Figure 3: The potential role of risk attitudes
Source: Rohrmann B. (2005)

Prospect theory

Prospect theory presents the investors behavior in terms of gain and loss. It was found that people tend to make decisions based on the potential gains and losses or less take into account the finality of decisions on asset portfolio, giving importance to the likely results in favor of safer ones. Their decisions are being taken based on emotions. The theory talks about the framing effect treating identical situations differently. (Kishore, 2004). Framing effects express the incoherence in making decisions. According to the Prospect theory people feel more acutely the losses than they feel the gains. The emotional impact is higher. Based on this judgment it was created The Value function of Prospect theory. The function explains different emotions depending on where is the investment portfolio.

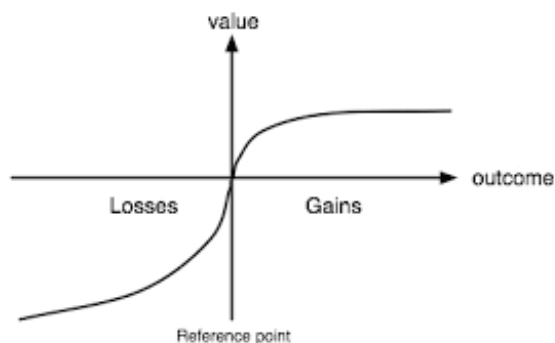


Figure 4: The value function
Source: A. Mitroi, Behavioural Finance (2014)

Conclusions

Behavioral finance intends an efficient administration of individual finances assessing and making balance between psychological factors that influence financial decision from the portfolio actively managed in relation to individual financial profile, taking into account the evolution and modification of the portfolio depending on personal, professional, economic circumstances and social rights of individuals. Behavioral finance adds a little more rigour to the traditional approach by outlining a more realistic model of individual psychological behavior. Behavioral research opens up new directions and options in order to explain the mechanisms of financial crises.

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