Role of Behavioral Finance in Financial Market: An Exploration of Personalities of Retail Investors

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ABSTRACT

In the epoch of 21st century financial decision making has changed its parameters in all aspects. Earlier, they were only based on financial indicators and people invest blindly by making them as a basis of their investment. But, now days in addition to financial indicators, non-financial indicators also play an imperative role in financial decision making. This paper provides an overview of theories that seek to explain how one of the non-financial indicator i.e. personality of investor affects its financial decision making choice. This includes personality characteristics of individuals as well as the social environments in which decisions are made.

Keywords:
Behavioral finance, traditional theories, modern portfolio theories, personality, psychology.

1. INTRODUCTION

An individual's investment decisions would basically be in the form of two types: Subjective risk criteria and Objective risk criteria. Traditional finance, theories such as Modern Portfolio Theory (Markowitz, 1952) and Capital Asset Pricing Model (Sharpe, 1964) rely on the assumption that investors behave rationally. Investors absorb the all the new information available and update their beliefs accordingly. Hence investment markets are efficient, reflecting all available information in security prices. Barberis and Thaler (2003) suggest that rationality is a very useful and simple assumption, which means that when agents receive new information, they update their beliefs and preferences instantaneously in a coherent and normative way such that they are consistent, always choosing alternatives which maximize their expected utility.

Contrary to traditional finance, behavioral finance assumes investor to be irrational and there are repeated errors in their judgments. Behavioral finance attempts to understand and explain how emotions and cognitive errors influence investors and the decision-making process.

"Behavioral Finance is, in general, the application of psychology to the field of finance."Behavioral finance closely combines individual behavior and market phenomena and uses knowledge taken from both financial theories and psychological field.

2. LITERATURE REVIEW

The following works have been important milestones for behavioral finance in the 20th century; Gabriel Tarde's (1902) "Psychologie Économique" (Psychology of Economy) [3], G.C. Selden's (1912) "Psychology of the Stock Market" [4], George Kantona's (1960) "The Powerful Consumer: Psychological Studies of the American Economy", John W.Pratt's (1964) "Risk Aversion in the Small and in the Large" [5].

Alex Wang (2011) using survey data revealed that knowledge, experience, and income are important factors that influence younger generation's investing behaviors in mutual funds. Moreover, gender emerges as the most important factor that differentiates younger generation's investing behaviors in mutual funds. The findings point out challenges for younger women's wealth management, as they tend to exhibit fewer investing behaviors in mutual funds than their counterparts do.

Hoffmann, Shefrin and Pennings (2010) analyze how systematic differences in investor's investment objectives and strategies affect the portfolios they select and the returns they earn. The analyses in this study draw on transaction records of a sample of clients (65,325 individual accounts with over nine million trades from January 2000 until March 2006), from the largest online broker in The Netherlands. The data were obtained through an online questionnaire. It is found that investors who rely on fundamental analysis have higher aspirations and turnover, take more risks, are more overconfident, and outperform investors who rely on technical analysis.

Murat Kıyılar, OkanAcar(2009) in the analysis of concept of behavioral finance, the aim was to explain that individuals do not always act rationally in their financial decisions and that their behaviors cause them to make different choices about their financial decisions.

Cianci (2008) in her study conducted an experiment with 78 graduates as substitutes for real investors and results suggested that investors made higher relevance ratings and

lower investment attractiveness ratings while provided with simultaneous negative information in comparison with sequential negative information. The study categorized investors as current and prospective.

Doukas and Petmezas (2005) find support for the self-attribution hypothesis in the market for corporate control. Specifically, they find that managers earn successfully smaller returns in each successive acquisition, suggesting they become more and more overconfident with each successful acquisition.

Hirshleifer and Shumway (2003) confirm self-attribution hypothesis evidence across a number of international markets. This suggests that investor mood affects the stock market.

Goetzmann and Kumar (2003) show those individual investors who are young and less wealthy hold more under-diversified portfolios, suggesting that they may exhibit stronger behavioral biases.

Scheinkman and Xiong (2003) analyzed the interaction of overconfidence and short sale constraints. They show that agents with positive information may be tempted to buy overvalued assets because they believe they can sell that asset to agents with even more extreme beliefs. With short-sale constraints, negative sentiment is sluggish to get into prices, and this can lead to asset pricing bubbles.

Several studies have examined the link between gender and behavioral finance biases; of these, Barber and Odeanis perhaps the most important and comprehensive. Barber and Odean (2001) link certain biases with gender, trading behavior, and investor type, to date no study examines the link between personality measures, gender, and investor biases recently documented in the behavioral finance literature.

The study concludes that men are more subject than women to the overconfidence bias reflected in trading behavior. The researchers found that, over a six year period, men on average traded 45% more than women. And single men on average traded 67% more than single women. They provide interesting evidence on investor profits and performance by arguing that women outperform men in their individual stock investments. They attribute this to the notion that men tend to be more overconfident than women. The allusion is to an evolutionary rationale where men, as hunter-gatherers, are required to be overconfident to take risks for the purposes of hunting in order to acquire food, an essential need for survival.

Hong and Stein (1999) explain patterns using overconfidence and self-attribution. Overconfidence about private signals causes overreaction and hence phenomena like the book/market effect and long-run reversals.

3. RESEARCH SIGNIFICANCE

The concept of behavioral finance has emerged due to the difficulties faced by the traditional theories of finance. The following points support how behavioral finance is far wider than traditional theories.

- Financial theories assume that investors make rational decision. However most studies conducted, revealed that investors don't act in a rational manner.
- Behavioral Finance filled an important gap and tried to understand and explain how emotions and comprehension errors affect investors and decision making process.
- As per MeitStatman from Santa Clara University in standard finance "individuals are rational" however, for behavioral finance, individuals are considered to be "normal", and has criticized the notion of "rational individual behavior" as covered by traditional finance.
- Theories of behavioral finance are structured upon the experimentally supported knowledge from social psychology but traditional finance theories are mere own assumption of researchers and this type of market does not exist in real life.
- Behavioral finance supports cognitive psychology and the biases that arise when people form beliefs, preferences and the way in which they make decisions.
- Behavioral biases are so deep-seated that, in short, some investors may need to be "saved" from their poor decision-making, which makes it a significant part of financial decision making.

4. PROPOSED METHODOLOGY

The aim of this paper is to study the relation among personality traits and investment decisions. The present study is practically aimed and the data is gathered descriptively and correlatively.

4.1 Population and sample: Population includes retail investors. Determining sample numbers has been done through 200 samples was chosen through simple random sampling.
4.2 Data gathering tools: For gathering data questionnaire method is used. A questionnaire is be formulated and distributed among the clients of a brokerage firms and their investment decisions and effects of behavioral factors on it will be studied. The focus is on individual investors as they are more likely to have limited knowledge about

application of traditional theories in decision-making and hence are prone to making psychological mistakes.

4.3 Validity and reliability of inquiry: For validity and reliability of inquiry financial and behavioral expert's ideas and any vagueness of the questions have been removed and corrected.

4.4 Data analysis: The method of descriptive and correlation is used for analyzing the data. For describing the population research variants we have used methods of descriptive statistics like amplitude and rate and diagram, for examining the research hypothesis we have used exploratory factor analysis and spearman's correlation analysis.

5. FINDINGS

1. The Innocent: It was observed that innocents often live in disagreement. They are easily overwhelmed by financial information and rely heavily on the advice and opinions of others. They tend to be the most trusting because they generally don't see people or situations clearly – which leaves them open to bad decisions and frauds.
2. The Victim: Victims are people who tend to live in the past and blame their woes on outside factors and situations they claim they can't control. These people may have been abused, betrayed, or have suffered some great financial loss, but they generally see life as a self-fulfilling prophecy that they can't change.
3. The Warrior: These are successful persons in the business and financial worlds, they will listen to advisors, but they make their own decisions.
4. The Martyr: These people generally put other people before their own financial health. They use their money to rescue others based on their high expectations for themselves and the people they're rescuing, but these decisions may be costly in the long run.
5. The Fool: They are combination of the Innocent and the Warrior because they have no clue about what they're doing but they'll act fearlessly. They are financially adventurous and they act on impulse.

6. CONCLUSION

From the above study it is concluded that there is a strong relation between the investor's personality and financial decision making. Five types of personality traits were discovered which shows that there is a very strong association between the personality of investor and financial decision making in market. The personality of retail investor is the main criteria of investing and losses incurred and profit earned by him/her mostly depend upon their personality.

So it is suggested that there should be a transparency in order to safeguard the stake of individual investor. It will reduce the errors in the stock market and help the investors to make the best decisions. To safeguard the stake of investor in financial market the following measures can be adopted:

1. There should be transparency of work between the depository participant and investor.
2. The investor should be reported with mails, SMS's, telephone etc. before making any new move in the market.
3. The personality of investor is to be judged carefully and after that choice of investment alternatives is to be done.
4. The portfolio of investor should have right combination of securities, according to nature and level of confidence of investor and how much amount to be invested in market.
5. SEBI guidelines regarding the various aspects of market should be made clear to investor so that he/she can exercise its right whenever required.

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