INVESTOR’S PSYCHOLOGY IN INVESTMENT DECISION MAKING: A BEHAVIORAL FINANCE APPROACH

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ABSTRACT
Worldwide the financial markets are influenced by several factors such as the changes in economic and political processes that occur in the country and the globe, information diffusion and approachability and so on. Yet, the foremost important factor is the investor’s reaction and perception. For an individual investor, decision making process can be perceived as a continuous process that have significant impact of their psychology while making investment decisions. Behavioral finance relies on research of human and social recognition and emotional tolerance studies to identify and understand the investment decisions. This article aims to report the research of individual investor’s financial behavior in a historical perspective. This article uncovers the investor’s psychology in investment decision making focusing on the investor’s rationality by explaining psychological and emotional factors that affect investing. The results of the study are revealed by means of Graphical visualization.

Keywords—Behavioral Finance, Decision Making, Investor’s Behavior, Psychology, psychological and Emotional Factors

I. INTRODUCTION
Investment behavior is an innovative sub-area of research in behavioral finance that explains exactly how the investors judge, predict, investigate and review the processes for decision making that includes investment psychology, information gathering, defining and understanding, research and analysis. This whole process is “investment behavior” (Slovic, 1972; Alfredo and Vincente, 2010). Much of the academic research in finance have considered the investor’s rationality and market efficiency as the main hypothesis in explaining the financial theories. The main assumption being considered was that investor’s decisions are all the time rational and that the markets are lined up with expected utility...
maximization. On the other hand, during the last few decades many research studies have indicated that the traditional theories of finance are not able to explain the irrationality of the investors in making investment decisions (Chang, 2008). In real-world circumstances, investors are not fully rational whereas they are induced by various behavioral biases that cause irrational behavior (Bondt & Thaler, 1985). Much of the research studies in behavioral finance confirm investment decisions are affected by the psychological factors of the investors. Unlike the assumptions of traditional finance which considers investors to be rational, behavioral finance believes that investors are not rational all the time and confirms investor to be irrational in investment decision making.

A. Statement of the Problem:
Recent global financial crisis reveals the importance of identifying the factors influencing the investor behavior in evaluating the individual investor’s investment decision making process. According to behavioral finance theory, understanding behavioral psychology deeply gives deep insight into the stock market anomalies and investment strategy selection. On the hand, better understanding of the investor’s psychology in investment decision making helps the investors to convert their behavioral biases into benefits (returns) which motivates them to invest further.

B. Objectives of the Study:
The basic objective of this research article is to analyze the research of individual investor’s investment behavior in a chronological viewpoint. This article reveals the aims of psychological and emotional factors on the market movements focusing on investor rationality to explain the psychological effects of investing.

The structure of the paper is prepared as follows. Section 2 explains about the research work carried out on investor’s financial behavior in a historical perspective. In section 3, the research methodology opted for the study has been discussed. In Section 4, the analysis and the main findings of the study has been outlined. Finally, Section 5 summaries and concludes the findings of the study through Graphical visualization.

II. INVESTOR’S FINANCIAL BEHAVIOR IN HISTORICAL PERSPECTIVE

In 1912, Selden wrote Psychology of the Stock Markets based upon the certainty that the movements of prices in financial markets are determined by the mental attitude of the investing and trading of investors to a very considerable extent. In the year 1956, the theory of Cognitive Dissonance was introduced by Leon Festinger. In 1964, Pratt worked on utility
functions and risk aversion. In 1968, Raiffa and Raiffa provided facts about how human actions differ from traditional economic assumptions. In 1973, Tversky and Kahneman presented availability heuristic, a judgmental heuristic in which a person evaluates the frequency of classes or the probability of events by availability i.e. by the ease with which relevant instances come to their mind.

III. Methodology
The present research article is basically a descriptive paper to explore the aspects related to investor’s psychology in investment decision making process which are often affected by the behavioral biases of the investors that deviates them from logical reasoning. To study the psychological effects of investors, methods of analysis and synthesis, description and comparison are used.

VI. Results and Discussion
Research studies in finance have explained the irrational behavior of the investors and focused on the cognitive or behavioral biases that have explained the anomalies and the mental errors of the investors in investment decision making. Behavioral finance is comparatively a new field of study that seeks to mix behavioral and cognitive psychological theory with standard economics and finance to produce explanations for why people build irrational financial decisions. The two main building blocks of behavioral finance are Cognitive psychology and the limits to arbitrage. Cognitive psychology states how people think. The limits to arbitrage refer to predict the possible ways of arbitrage circumstances forces will be effective and when they are not. It is a new field of study in finance that recommends psychology-based theories in explaining the market anomalies. As per the theories of behavioral finance, information structure and also the psychology based factors influence the investment decisions of the investors.

The factors that directly or indirectly impact the retail investor’s decision making seem to be under researched aspect across Indian perspective. The existing studies either focus on one or two aspects or simply ignore the cross factor linkages that collectively impact the pattern and the pace of the decisions made by the participating retail investors and their sentiments with regard to sense making with regard to gains from the stock market investments. The respective information processing has its impact on the market based participation at retail level. The attention allocation and rational decision making eludes the biased decision
making set up. The instances of bounded memory and biased assessment often lead to non-
satisfactory investment related decisions.

The existing theoretical literature with regard to behavioral finance reviews and categorizes
the actions as involving the aspects of heuristics, framing, emotions and market impact. In
theoretical terms, the concept of heuristics has been interpreted as acceptable rules of thumb
that seek to reduce the cognitive resources to solve a problem. Such rules of thumb seek to
facilitate the decision making with simplification of complex ideologies and methodologies.
The literature identifies the “investment related heuristics” as representativeness, anchoring
and adjustments, sense of over confidence, familiarity, conservatism, regret aversion, mental
accounting, ambiguity aversion as well as effect.
Psychology is related with understanding how the mind controls and determines behavior. Basic goal is to determine whether psychological biases play an important role in decision making and the relationship of behavior exhibited. In understanding the psychology of the investors in investment decisions, the attitudes and emotions, moods and sentiment, personality traits, perception towards investment making, feelings of the investors cannot be ignored. While investing, the psychological factors affect the logical thinking of the investors and are affected by biases as mentioned in the above figure no.1

Behavioral psychology comprises of heuristics biases (including representativeness, availability and anchoring,) and cognitive bias (over-confidence, over-reaction and herd
effect). In contrast to the traditional finance theories, psychological biases can provide explanations and solutions to the market anomalies to some extent. The evidence of behavioral finance theory supports in understanding behavioral psychology profoundly and provide further insight into stock market anomalies and investment strategy selection.

Akerlof and Shiller opined that our feeling determine psychic reality which affect investment judgment emotions and associated human unconscious needs, fantasies, and fears drive much decision of human beings. The choice of investment avenue, company amount and timing of investment are many times based upon our past experiences, fear and aspirations[1]. Martin David Hilbert documented about individual and retail investor’s investment decision making and concluded that they are influenced by behavioral biases such as herding, overconfidence and reinforcement bias etc., when compared to their institutional counterparts. They are assumed to possess formed trading decisions on psychological phenomena instead of rational disputes. They suggested that individual and retail investors are able to predict stock exchange movements better than the institutional ones [2]. Athar Iqbal and Sania Usmani carried out a study on the investment decision process to identify the factors influencing the individual investor behavior at the KSE on the economic perspectives in relationship between the lifestyle, demographic variables and also behavioral variables. Their study confined that the individual investors considered on the wealth maximization criteria in making their investment decisions [3]. Ahmed Ibrahim Mokthar studied how the behavioral theories confronts the psychological aspects in investor’s rational and irrational investment decisions. He concluded that cognitive errors and emotional biases have a significant impact in the investment decisions ensuing the irrational price performance and constant mispricing does not cover within the efficient framework [4].

Sindhu, Y Rama Krishna and Adavelli Sagar carried out a study on understanding the relationship between investor’s personal attributes and investment perceptions towards mutual fund investment and concluded that safety of investments of the investors is related with the age of the investors [5].
Psychological biases display the irrational characteristic in investment decision making. Cognitive bias, over-confidence, self-attribution bias and herd affect are four main psychology biases according to the research. These biases are more noticeable among investors implying the psychology biases cannot be corrected or eliminated by learning and accumulating experiences.

V. Conclusion

The present paper has made a synthesis of investor’s financial behavior in a historical perspective. The psychological effects of investing are being studied to describe the investors’ psychology in investment decision making of the individual investors. The investor’s mood and sentiment cannot be ignored in predicting the market movements as much of the empirical studies have supported experimented and concluded the same. Understanding the investment behavior of the investor enables to convert the psychological biases into financial benefits to the retail investors. The errors in judgement making of the retail investors can be rectified with an in depth insight into investment decision making.
References


