

Market Minds: Understanding Behavioral Finance Concepts

OPEN ACCESS

Volume: 11

Special Issue: 1

Month: January

Year: 2024

E-ISSN: 2581-9402

Received: 11.11.2023

Accepted: 15.12.2023

Published: 27.01.2024

Citation:

Subashree, S. "Market Minds: Understanding Behavioral Finance Concepts." *Shanlax International Journal of Management*, vol. 11, no. S1, 2024, pp. 162–68.

DOI:

<https://doi.org/10.34293/management.v11iS1-Jan.7159>

S. Subashree

*Assistant Professor, Bachelor of Business Administration
Faculty of Management, SRM Institute of Science and Technology
Vadapalani Campus*

Abstract

The topic of behavioural finance is challenging the traditional notion of rational decision-making in the ever-changing financial markets. This paradigm shift examines the interaction between psychology, cognitive biases, and financial decisions, offering insights into market anomalies and behaviours that contradict conventional economic theory. Behavioural finance is an interdisciplinary field that combines psychology, cognitive science, economics, and finance. Its purpose is to connect economic theory with actual financial behaviours seen in the real world.

Keywords: Finance, Perception, Decision Making.

Introduction

Within the complex framework of financial markets, the long-standing assumptions on logical decision-making are being challenged by the rapidly growing subject of behavioural finance. This paradigm shift signifies a deviation from the traditional belief that economic actors are rational individuals who continually aim to maximise their wealth and optimise their overall welfare. As we explore this developing field, the interaction between psychology, cognitive biases, and financial choices becomes a central focus for comprehending market anomalies and individual behaviours that challenge conventional economic theories.

The financial domain has traditionally been governed by ideas based on rationality and logic, shown by models such as the Capital Asset Pricing Model (CAPM) and the Efficient Market Hypothesis (EMH). These traditional frameworks operate on the assumption that market players behave with flawless rationality, promptly analysing all accessible information to make choices that optimise their wealth. Nevertheless, the practical situations seen in financial markets often diverge from these assumptions, exposing an intricate interaction of emotions, biases, and psychological variables that impact decision-making.

Behavioural finance is an emerging discipline that aims to connect classic economic theory with the actual behaviours seen in finance. It adopts an interdisciplinary methodology, combining knowledge from psychology and cognitive science with the fundamental concepts of economics and finance. The fundamental concept of behavioural finance is that the arrangement of information and the attributes of market players have a systematic impact on both individual investment choices and overall market results.

In order to fully understand the intricacies of behavioural finance, it is crucial to go into its historical development. The phrase “behavioural finance” represents a deviation from traditional or “modern” finance, which is based on rational and logical ideas. The deviation from classical assumptions becomes apparent when we compare them to the principles of behavioural finance. In this text, we explore the historical development of behavioural finance, which has arisen as a powerful force that challenges the established norms of conventional finance.

The challenge of the Homo Economicus assumption, a fundamental idea in classical economics, is a central theme in the story of behavioural finance. This assumption suggests that people are rational agents who are persistently motivated by the goal of maximising their wealth. They are mainly unaffected by emotions or other external influences. Nevertheless, the actual dynamics of making financial decisions in the real world sometimes include a wide range of illogical behaviours that are not accounted for by the Homo Economicus model. The recognition of these irregularities triggered a fundamental change in perspective, prompting scientists to investigate cognitive psychology as a framework for comprehending the irrational and illogical behaviours that conventional finance found difficult to account for.

As we explore the field of behavioural finance, it is crucial to familiarise oneself with the pioneers who have influenced its theoretical framework. Within this group of distinguished individuals, the names Daniel Kahneman, Amos Tversky, and Richard Thaler hold a significant position. Kahneman and Tversky, cognitive psychologists, are widely recognised as the pioneers of behavioural economics/finance. Their extended cooperation since the late 1960s have established the groundwork for this field. Their groundbreaking studies, which delve into prospect theory and loss aversion, serve as a fundamental basis for comprehending the cognitive biases and heuristics that give rise to unforeseen and often illogical financial behaviours.

Richard Thaler, an economist, enhanced the psychological ideas of Kahneman and Tversky, connecting the fields of economics, finance, and psychology. Thaler cooperated with cognitive psychology experts to bring innovative notions like as mental accounting, the endowment effect, and numerous biases, acknowledging the constraints of traditional economic models. These contributions serve as the foundation on which behavioural finance has constructed its framework, enhancing our understanding of financial decision-making in light of human irrationality.

In the following sections, we will explore in further detail the fundamental principles that characterise behavioural finance. Prospect theory and mental accounting both reveal the complex connection between human psychology and financial decision-making. Our objective in this investigation is to provide a thorough comprehension of behavioural finance, illuminating its importance in unravelling the enigmas of financial markets and forming a more nuanced viewpoint on economic decision-making.

As we begin our intellectual exploration of behavioural finance, we encourage readers to question established norms, challenge preexisting beliefs, and delve into the complex web of human behaviour that influences the financial sector. This investigation not only aims to enhance our comprehension of financial markets but also to provide vital insights into the reasons and peculiarities that underlie the actions of market players. Welcome to “Behavioural Finance: Concepts and Conventions,” a platform that explores the intersection of cognitive complexity and financial market nuances, leading to a novel understanding of economic behaviour.

Review of Literature

Hirshleifer (2001) explores the correlation between investor psychology and asset price. This study examines the psychological aspects that affect investing choices and how they influence the value of assets. The extensive investigation covers several facets of investor behaviour,

demonstrating how psychological biases might result in market oddities. Olschewski, S., Rieskamp, J., & Hertwig, R. (2023) examine the complex relationship between cognitive capacities and risk preferences, with a particular focus on the influence of assessment techniques. The research emphasises that the connection between cognitive skills and risk preferences depends on how they are assessed, offering valuable insights into the complex interplay between cognitive functions and risk-taking. Benartzi and Thaler (1995) address the stock premium question by examining it from the perspective of myopic loss aversion. The study examines how people's tendency to focus on short-term outcomes and their fear of incurring losses contribute to the perplexing phenomenon of equity premiums. The results provide a behavioural rationale for the observed occurrences in financial markets. Mellers, B. A., and Yin, S. (2023) Enhance comprehension of variations in risk preferences by using Reference-Point Theory as a framework. This study investigates the process by which people build reference points, which in turn shape their attitudes towards risk. This study illuminates the psychological elements that influence the differences in risk choices across people. Kahneman and Tversky (1982) The groundbreaking study conducted by Kahneman and Tversky investigates the examination of statistical intuitions and cognitive biases in the process of decision-making. This research examines the cognitive processes involved in people's construction of intuitive judgements about statistical information. It specifically focuses on identifying and analysing the systematic mistakes and deviations from rationality that often arise throughout this process. The authors identify many cognitive heuristics and biases that impact statistical reasoning, establishing the foundation for the subject of behavioural economics and making substantial contributions to our comprehension of human decision-making. Vevek, S., and Selvam, D. M. (2021) Vevek and Selvam's study focuses on the modelling of the Nifty's volatility, which is a significant macroeconomic indicator in India. The paper uses empirical methodologies to investigate the relationship between market volatility and Indian macroeconomic parameters, making a valuable contribution to the subject of behavioural finance. The results provide valuable insights into the intricate relationship between economic data and market behaviour, elucidating the potential impact of psychological variables on volatility in the Indian financial markets. Vevek, S., Selvam, M., and Sivaprakash, S. (2022) Vevek, Selvam, and Sivaprakash conducted a study on the long-lasting nature of fluctuations in the Nifty 50, providing a comprehensive examination of market dynamics. The paper analyses the consistent patterns of volatility in the Indian market and adds to the existing body of knowledge in behavioural finance. It investigates how investor emotion, cognitive biases, and other psychological variables may lead to extended periods of market volatility. Vevek, S., Selvam, M., and Kirithiga, S. (2017) This study conducted by Vevek, Selvam, and Kirithiga examines the impact of foreign exchange (FX) and automobile volatility on the returns of the Nifty index. The research offers useful insights into the interrelationships between various sectors of the market. This research enhances the comprehension of behavioural finance by investigating the potential effect of external variables, namely those associated with currency and the automobile sector, on investor behaviour and their impact on returns in the Nifty. The results enhance our understanding of market dynamics, which are shaped by a combination of economic and behavioural variables. Trutmann, K., Heinke, S., and Rieskamp, J. (2023) examine how time delays and limited decision possibilities affect the development of beliefs in investing choices. The research offers valuable insights into the impact of temporal aspects on the cognitive processes that drive investment decisions, so enhancing our knowledge of decision-making in financial circumstances.

Objectives

To Explore Behavioral Finance key components like Investigate anchoring, mental accounting, confirmation bias, hindsight bias, the gambler's fallacy, herd behavior, overconfidence, overreaction and availability bias.

Data Collection

The current research relies only on secondary sources for data collecting, including newspapers, books, journals, periodicals, reports, theses, and digital resources.

Important Concepts of Behavioral Finance

This section will examine many key aspects recognised by pioneers in behavioural finance that lead to illogical and often detrimental financial decision-making.

- **Anchoring:** Anchoring is the cognitive process of attaching ideas to a reference point, regardless of their logical significance to the choice being made. Contrary to expectations, anchoring is widespread in settings that include fresh and innovative ideas.
- **Diamond Anchor:** Anchoring, as shown by the widely-known two-month wage guideline for diamond engagement rings, may result in illogical decision-making. This industry-established standard functions as a yardstick, yet it is a nonessential point of reference that often leads to financial burden. Empirical research substantiates the robustness of anchoring, even in scenarios involving arbitrary reference points, as shown in Kahneman and Tversky's seminal study conducted in 1974.
- **Academic Evidence:** Research has shown that the anchoring effect remains strong, even when the anchor is given randomly. The 1974 research conducted by Kahneman and Tversky, titled "Judgement Under Uncertainty: Heuristics and Biases," demonstrated the significant influence of apparently random anchor values on the replies of participants.
- **Investment Anchoring:** Investors in the financial realm experience frustration due to anchoring, which occurs when they make judgements based on irrelevant numerical values. Investors may fixate on a recent peak in stock prices, supposing that a substantial decline in price indicates a favourable moment to make a purchase. The occurrence emphasises how the cognitive bias of anchoring may lead to misguided investing decisions.
- **Avoiding Anchoring:** To reduce the impact of anchoring, it is crucial to engage in thorough and rigorous critical thinking. Prudence should be used when using metrics to assess the potential of a company. Effective investors avoid depending just on one or two benchmarks. Instead, they evaluate each firm from several viewpoints to gain the most precise representation of the investing environment.

Key Concepts in Behavioral Finance

In this part, we explore many key principles uncovered by pioneers in the subject of behavioural finance that greatly contribute to illogical and frequently harmful financial decision-making.

- **Anchoring:** The anchoring idea arises from the tendency to connect thoughts to a certain point of reference, even if it lacks logical significance to the current choice. This effect is especially common in settings involving innovative and unfamiliar notions.
- **Diamond Anchor:** This exemplifies the irrational display of anchoring, as shown in the well known two-month income guideline for diamond engagement rings. Although it functions as a standard for comparison, it is an inconsequential point of reference established by the jewellery business with the aim of maximising financial gains, rather than being a true assessment of love. Men often incur debt in order to achieve the goal of spending two months' worth of earnings, showing the influence of anchoring.
- **Academic Evidence:** Academic research demonstrate that the anchoring effect remains strong, even when anchors are randomly given, despite the first appearance of the two-month norm being reasonable. Kahneman and Tversky performed a research in 1974 called "Judgement Under Uncertainty: Heuristics and Biases," which demonstrated the significant influence of apparently random anchor values on participants' replies.

- **Investment Anchoring:** Investors in the financial industry find anchoring to be frustrating, since it often leads to judgements being made based on inappropriate data. Investors may fixate on a recent peak in stock prices, seeing a substantial decrease in price as a chance to purchase at a reduced rate.
- **Avoiding Anchoring:** In order to reduce the impact of anchoring, it is crucial to use rigorous critical thinking. Prudent consideration should be used when using metrics to assess the potential of a company. Skilled investors, rather than depending on a limited number of benchmarks, evaluate each firm from several angles to get the most precise representation of the investing environment.
- **Mental Accounting:** Mental accounting refers to the tendency of people to categorise their money depending on subjective factors, such as its origin and intended use. This approach, recognised by trailblazers in the industry, may result in illogical and harmful consequences in financial decision-making. The “Different Accounts Dilemma” illustrates how individuals may exhibit varying financial behaviours due to unanticipated situations, diverging from rational expenditure habits. Investors often diversify their portfolios to avoid risk, although this does not significantly affect their total net value. In order to avoid the negative consequences of mental accounting, it is crucial to understand that money is interchangeable and may be used for many purposes, regardless of where it comes from. By making well-informed choices that are in line with one’s overall financial objectives, one can navigate these potential pitfalls.
- **Confirmation and Hindsight Bias:** Examined within the framework of behavioural finance, these studies illuminate the inclination of humans to create biases while analysing information and events. The confirmation bias is a cognitive bias that causes people to selectively process and prioritise information that aligns with their preexisting beliefs, while dismissing contrary material. Within the domain of investment, this bias may lead to flawed decision-making since investors may exhibit a preference for information that supports their initial assumptions, so forming an inadequate comprehension of the issue. Hindsight bias, a prevalent cognitive bias, refers to the tendency to believe, in hindsight, that previous events were foreseeable, despite the fact that they were really unpredictable. This bias stems from our inherent inclination to seek patterns in the environment, which may result in simplistic and inaccurate explanations. To overcome confirmation bias, one must actively seek out opposing opinions in order to challenge preconceived notions and provide a more thorough assessment of facts.

The gambler’s fallacy, a cognitive bias examined in the field of behavioural finance, illustrates how a limited comprehension of probability may result in incorrect assumptions on the likelihood of random occurrences. This fallacy is characterised by the erroneous perception that the probability of a certain event occurring decreases after a sequence of events or incidents. Within the realm of investment, people may fall prey to this fallacy by making judgements predicated on the notion that a stock’s trajectory is prone to reverse after a series of successive trends. For example, some investors could decide to sell off a holding that has had a succession of upward moves, based on the belief that the chances of more gains have lessened. On the other hand, some individuals may choose to retain a deteriorating stock, considering further losses to be unlikely. To prevent falling into the gambler’s fallacy, it is crucial to understand that, in the context of independent events, the likelihood of a certain result stays unchanged regardless of previous occurrences. Investors should prioritise fundamental and/or technical research instead of giving in to illogical ideas about trend reversals influenced by recent market noise.

Herd behaviour, as studied in the field of behavioural finance, investigates the tendency of individuals to mimic the activities of a larger group, regardless of whether such acts are logical or illogical. This phenomena is driven by social pressure and the innate need for approval, as individuals instinctively comply to avoid being stigmatised as outsiders. Another factor contributing to herd behaviour is the belief that a sizable collective is improbable to make mistakes, hence instilling a

feeling of safety in conforming to the majority. The dotcom boom of the late 1990s is a striking illustration of investors rushing to internet-based enterprises, even though these companies had solid financial business models. This behaviour was fueled by the confidence gained by witnessing others engaging in the same investment activities. Even individuals in the financial industry may yield to herd behaviour, encountering scrutiny from customers as new investing trends arise. Nevertheless, engaging in such behaviour incurs substantial expenses, since transaction fees accrue due to frequent buying and selling, and the task of timing transactions becomes arduous. In many cases, investors that follow the herd tend to join the market at a later stage, resulting in financial losses as those who embrace new techniques early on move on to alternative approaches. In order to prevent the negative consequences of herd mentality, it is recommended that investors engage in comprehensive research prior to mindlessly adhering to popular trends. It is important to acknowledge that assets favoured by the majority might become overpriced due to excessive optimism rather than solid underlying fundamentals.

The phenomenon of overconfidence, as examined in the field of behavioural finance, uncovers a widespread tendency among people to overrate their skills or influence in a particular undertaking. In a significant 2006 study undertaken by researcher James Montier, a poll was conducted among 300 professional fund managers. Surprisingly, 74% of them believed that they had achieved work performance that was better than the norm. Remarkably, over 100% of the participants regarded their work performance as ordinary or superior, underscoring the unreasonable and pervasive prevalence of overconfidence among this particular group. This characteristic is not limited to fund managers, but is often seen in many competitive situations when people have a strong and unshakeable conviction in their chances of succeeding, even while the competition is intense. It is essential to differentiate between confidence and overconfidence, since the latter entails an excessively positive evaluation of one's understanding or authority over a given circumstance. Within the domain of investment, excessive self-assurance may have negative consequences, as shown by a research conducted in 1998 which revealed that overconfident investors engage in more transactions but ultimately generate poorer returns compared to their less confident counterparts. In order to prevent excessive self-assurance, investors should recognise the ever-changing difficulties of the market and the need of continuously improving their investing strategies, understanding that each deal has the possibility of a sobering realisation.

Overreaction: The occurrence of excessive response to new information in the stock market contradicts the assumptions of market efficiency, which dictate that new information should be promptly incorporated into a security's price. In contrast to this notion, participants often display foreseeable exaggerated responses to new information, resulting in sudden and significant fluctuations in prices, but these surges tend to decrease with time. In 1985, De Bondt and Thaler conducted a significant research called "Does the Market Overreact?" which examined the stock returns on the New York Stock Exchange. They noted that the collection of stocks with the lowest performance consistently achieved better results than the market index, while the collection of stocks with the highest performance regularly achieved worse results. The total difference reached an approximate 25% over a span of three years, indicating that the initial "winners" transformed into "losers" and vice versa as a result of investor overreactions. The availability bias is a cognitive bias that leads individuals to give excessive importance to current information while making judgements. In order to mitigate this bias, it is strongly advised for investors to retain a broad viewpoint, giving importance to comprehensive analysis and prioritising the long-term investing environment rather than being swayed by short-term market volatility caused by current events.

Prospect Theory: the assessment of options is thought to be influenced by the overall impact of advantages and disadvantages, where utility denotes pleasure or satisfaction. Nevertheless, the prospect theory proposed by Kahneman and Tversky in 1979 undermines the rational viewpoint by arguing that individuals evaluate gains and losses in distinct ways and base their judgements

on perceived advantages rather than actual losses. According to this notion, losses have a greater emotional effect than gains of the same magnitude. The evidence for irrational behaviour is obtained from studies in which participants made judgements between options that had potential costs and profits. Prospect theory, within the realm of finance, elucidates irrational behaviours such as the disposition effect. This impact manifests when investors retain underperforming equities for an excessive period and dispose of profitable stocks prematurely. To minimize the disposition effect, hedonic framing can be employed to alter the mental approach, emphasizing separate gains and losses rather than lumping them together. This approach aims to enhance positive utility and mitigate the impact of emotional responses to losses.

Conclusion

This comprehensive exploration of behavioral finance reveals the intricate web of psychological factors shaping financial decision-making. From the anchoring effect to prospect theory, recognizing and understanding these behavioral nuances is crucial for investors. By delving into the historical development, key concepts, and empirical evidence, this paper aims to provide a nuanced understanding of behavioral finance, enriching our comprehension of financial markets and economic decision-making. As we embark on this intellectual journey, challenging established norms, questioning beliefs, and unraveling human behavior in the financial sector, we aim to contribute to a more insightful and holistic understanding of economic behavior.

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