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Review on the Role of Behavioural Finance in Determining Investors' Preferences towards Financial Avenues

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Abstract: ***The study attempts to explain role of Behavioral Finance in determining the behavior of the investors towards a particular financial avenue. Traditional finance theory states that investors think rationally and make conscious decisions based on various evaluations or using economic models. However various researchers have revealed a large amount of evidence of irrationality and repeated errors in judgment. There are certain psychological traits such as loss aversion, herd behaviour and overconfidence, etc. make individual preferences irrational at times. The paper explains the evolution of Behavioral finance over a period of time. The field of "behavioral finance"help better understand and explain how emotions and cognitive errors influence investors and the decision-making process. The paper also attempts to identify various factors affecting perception of investors regarding investment in the various financial avenues. The study reveals that major factors that affect the preference are safety of principal risk tolerance and herd behavior. The findings help to create awareness regarding the preference of investors for a particular investment avenues. It will be useful to design and develop financial product/ avenues that caters to the need of the investors.***

Keywords: Behavioral Finance, Investment preferences, Finanacial market, Financial Avenues, Herd Behaviour

1. Introduction

Behavioral Finance plays a very important in determining the behavior of the investors towards a particular financial avenue. All the investors invest their surplus money in the various financial avenues based on their risk taking attitude, intuitions, and habits, cognitive or emotional biases. Besides, some psychological traits such as loss aversion, mental accounting and herd behaviour and overconfidence, etc. make individual preferences irrational at times. Traditional finance theory states that investors think rationally and make conscious decisions based on various evaluations or using economic models. However various studies revealed that human decisions often depend on their risk taking attitude, habits and psychological traits.

According to Shefrin "Behavioural finance is the study of how psychology affects financial decision making process and financial markets. Since psychology explores human judgment, behaviour and welfare, it can also provide key facts about how human actions differ from traditional economic assumptions.

2. Evolution of Behavioral Finance

The financial theory based on Modern Portfolio Theory (Markowitz, 1952) and Capital Asset Pricing Model (Sharpe, 1964) has long shaped the way in which academics and practitioners analyse investment performance. The theory is based on the notion that investors act rationally and consider all available information in the decision- making process, and hence investment markets are efficient, reflecting all available information in security prices. However, researchers have uncovered a surprisingly large amount of evidence of irrationality and repeated errors in judgement. The field of "behavioural finance" has evolved that attempts to better understand and explain how emotions and cognitive errors influence investors and the decision-making process. Kahneman and Tversky (1979), Shefrin and Statman (1994), Shiller (1995) and Shleifer (2000)

The study of "Behavioural Finance" has evolved to better understanding and explaining how emotions and cognitive errors influence investors in the decision-making process. Kahneman and Tversky (1979) and Later on Shefrin and Statman (1994), Shiller (1995) and Shleifer (2000) have established the theories which explain many stock market anomalies, bubbles and crashes.

Till date, much is not known about human psychology and investor's irrational behaviour that influences investors and their decision-making process.

The objective of this paper is to study the evolution of behavioural finance theory and to determine the factors affecting investor's preferences. The study explains the factors that lead to unusual preferences of the investors which were not explained completely by 'Traditional Finance' theories. The paper is structured as follows. First, the literature on behavioural finance based on theories developed will be studied. Later factors affecting investors preferences wil be considered. Next, the psychological theories used in behavioural finance. The results of some observed studies about individual investor behavior are given below:

"Prospect Theory" was described by Daniel Kahneman and Amos Tversky (1979). He originally described and established that individuals were much more distressed by prospective losses than they were contented by corresponding gains. A few economists have argued that to the investors usually the loss of $1 is two times more painful in comparison the pleasure received from same amount of gain. Individuals will respond in their own way to corresponding situations depending on whether it is presented in the backdrop of losses or gains..

Langer (1983) suggests that when these preferences are based on choices, there is more ego involvement and attachment to the preferences, suggesting heightened level of preference bias. This phenomenon is consistent with the prediction from Cognitive Dissonance theory of Festinger (1957).

Ippolito (1992) says that fund/scheme selection by investors is based on past performance of the funds and money flows into winning funds more rapidly than they flow out of losing funds.

Bikhchandani.S, et.al., (1992)attempts to study why people conform and why convergence of behavior can be peculiar and brittle. The model explains individuals rapidly converge on one action based on very little information. If even a slight new information arrives, explaining that a different course of action is most favorable, or if people guess that underlying circumstances have changed (whether or not they really have), the social equilibrium may completely shift. The paper is based on model of informational cascades, explains not only conformity, but also rapid and short-lived fluctuations such as fads, fashions, booms and crashes. It also throws light explaining that small shocks lead to big shifts in mass behavior only if people happen to be very close to the borderline between alternatives. It explains that informational cascade occurs when it is optimal for an individual, having observed the actions of those ahead of him, to follow the behavior of the preceding individual without regard to his own information.

Banerjee. A (1992) in his paper "A Simple Model of Herd Behavior"explains a sequential decision model in which every decision maker seeks the decisions made by previous decision makers in taking his/her own decision. This is rational as these other decision makers may have some information that is significant for him/her. The paper explains that the decision rules that are chosen by optimizing individuals will be characterized by herd behavior; i.e., people will be doing what others are doing rather than using their information.

Robert J. Shiller (1993) reported that many investors do not have data analysis and interpretation skills. This is because, data from the market supports the merits of index investing, passive investors are more likely to base their investment choices on information received from objective or scientific sources.

Phillip (1995) reported that there is a change in financial decision-making and investor behavior as a result of participating in investor education Programmes sponsored by employees.

Berhein and Garnette (1996) affirmed Philip's findings and further stated that a serious national campaign to promote savings through education and information could have a measurable impact on financial behavior.

Alexander et al., (1996) reported that only 18.9% of respondents could provide an estimate of expenses for their largest MF holding. 57% stated that they did not know what the expenses were even at the time they made the MF purchase. This suggests insensitivity to costs and many investors do not use fund costs as an evaluative criterion in making investment decisions.

Madhusudhan V. Jambodekar (1996) conducted a study to measure the awareness of MFs among investors, to identify the information sources influencing the buyer decision and the factors affecting the choice of a particular fund. The study revealed that income schemes and open-ended schemes are preferred over growth schemes and close-ended schemes during the prevalent market conditions Investors look for Safety of Principal, Liquidity and Capital Appreciation in order of importance; Newspapers and Magazines are the first source of information through which investors get to know about MFs / Schemes and the investor service is the major differentiating factor in the selection of MFs.

Goetzman (1997) states that there is evidence that investor psychology affect fund/scheme selection and switching.

Barber and Odean (1999) highlighted two common mistakes investors make: excessive trading due to over confidence and the tendency to disproportionately hold on to losing investments while selling winners to avoid regret . It is found optimism and and overconfidence leads to Risk taking . Those investors who are risk taker generally prefer to invest in the avenues that yield high returns inspite of high risk.

Hirshleifer (2001) categorized different types of cognitive errors that investors make i.e. self-deception, occur because people tend to think that they are better than they really are; heuristic simplification, which occurs because individuals have limited attention, memory and processing capabilities; disposition effect, individuals are prone to sell their winners too quickly and hold on to their losers too long.

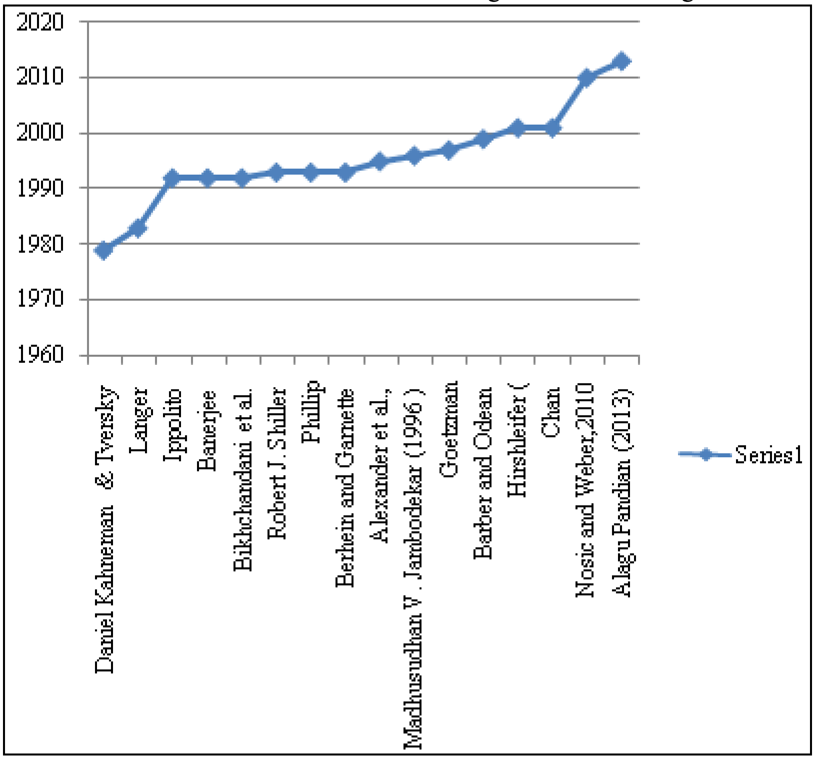
Nosic and Weber, 2010 state that in order to measure risk tolerance we should also measure optimism and overconfidence in the investors.

Alagu Pandian (2013) This paper studies investors preference towards various investments avenues in dehradun district. The study throws light on various investment avenues available such as shares, bank, companies, gold and silver, real estate, life insurance, postal savings and so on but the investor need to make the decision of how much to invest and where to invest. To choose wisely, we need to know the major features of an investment i.e safety of principal amount, liquidity, income stability, appreciation and easy transferability.

Table 1.1: List of Authors contributed to the evolution of Behavioral Finance

Names of Authors	*Year*
Daniel Kahneman & Tversky	1979
Langer	1983
Ippolito	1992
Banerjee	1992
Bikhchandani et al.	1992
Robert J. Shiller	1993
Phillip	1993
Berhein and Garnette	1993
Alexander et al.,	1995
Madhusudhan V. Jambodekar	1996
Goetzman	1997
Barber and Odean	1999
Hirshleifer	2001
Chan	2001
Nosic and Weber	2010
Alagu Pandian	2013

Table 1.2: Evolution Of Behavioral Finance In Determining Factors Affecting Investment Preferences



Factors affecting Investors Preferences towards Financial Market Avenues;

There various factors that affect the behavior of the investors towards different financial avenues. Investment opportunities for investors exist in different types of securities, each having their own risk return pattern. The investor has to choose proper avenues from among them, depending on his specific need, risk preference, and return expectation and financial awareness. Some of the major factors are discussed below:

Safety of Principal

This is one of major factor on which preferences of the investor depends. As we have studied Investors have fear of losses and therefore they always look for those avenues that are safe and provide constant returns. **Shiller (1995)** revealed that Human beings have the tendency to feel the pain or the fear of regret at having made errors. Therefore, to avoid the pain of regret, people are likely to alter their behaviour, which may end up being irrational at times. Their preferences for choosing a particular financial avenue largely depends upon Safety of principal amount.

According to **Madhusudhan V. Jambodekar (1996)** income schemes and open-ended schemes are preferred over growth schemes and close-ended schemes during the prevalent market conditions as Investors look for Safety**.** **Alagu Pandian (2013)** concluded that investors prefer Bank Deposits more than any other avenues as it is one of the safest avenues to Invest. **Prabhu G** reveals that investors prefer Mutual fund because of its feature of Diversification of portfolio that reduces the losses and provides safety to some extent.

Risk Tolerance

Risk Tolerance depends upon the level of risk that an investor is willing to take. Studies show that most of the people are Risk Averse they avoid losses and therefore have difference in preferences of financial avenues. **Barber and Odean (1999)** highlighted two common mistakes investors make: excessive trading due to over confidence and the tendency to disproportionately hold on to losing investments while selling winners to avoid regret. It is found optimism and and overconfidence leads to Risk taking. Those investors who are risk taker generally prefer to invest in the avenues that yield high returns inspite of high risk. It is also found people who are over confident they tend to take high risks. **Nosic and Weber (2010)** state that in order to measure risk tolerance we should also measure how optimistic and how overconfident people are .**Eckel and Grosmann (2002); Merrill Lynch (1996)** Assumption of risk, found differ greatly by gender. Women generally are more prudent when making investment decisions; as a result unlikely than men, they prefer less risky products. As to psychological traits, optimism and overconfidence lead to upward biased forecasts and hence to more risk taking. This implies that in order to measure risk tolerance weshould also measure how optimistic and how overconfident people are (Nosic and Weber, 2010). It is found people or investors prefer those avenues that generally are less risky.

Herd Behaviour

Let them alone: they be blind leaders of the blind. And if the blind lead the blind, both shall fall into the ditch." Matthew 15:14

Herding results from an apparent intention by the investors to copy the behaviour of other investors. **Boortz.C, et al. (2013)** states that Herd behavior among investors is often viewed as a significant threat for the operation of financial markets. The distorting effects of herding on financial markets range from informational inefficiency to increased stock price volatility, or even bubbles and crashes. The theoretical literature on the causes and consequences of herd behavior was initiated by the seminal work of **Bikhchandani et al. (1992)** and **Banerjee (1992).** Their concepts were put into a financial market context by **Avery and Zemsky (1998),** where herding is defined as a switch in traders' opinion into the direction of the crowd. It is found that most of the investors took decision based on their predecessors decision. Their preferences were affected by the choices of others regarding the investment.

3. Conclusion

The paper concludes that preferences of the investors are not rational. At times they behave irrationally; there are certain factors that explain us the reason why do investors prefer particular investment avenues to park their savings. The investors cannot avoid risk but to minimise the risk they select particular avenues. It is also found that people take decisions based on the decisions of others . The literature available on behavioural finance helps us to better understanding of evolution of behavioural finance and also throws light on various factors on which preferences of an individual investors depend.

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