Behavioral finance assignment

Business

Introduction Traditional finance, market and price models assume markets are rational, it's further assumed that this rationality is reflected in the intrinsic value of the security. The whole concept of traditional finance revolves around assumption people are ' rational' be it efficient market hypothesis, Babes Theory, or what Margarita said. But how often do we use into these theories in real world, how many people actually use Babes Theorem to really update probabilities based on new information, probably very few.

The underlying premise of traditional finance " Man is a ration being" is a hypothesis that has been proved wrong on many occasions. Each person has their individual rationale in what they do and same is true in sphere of investing as well, so it's hard not to think of the stock market as a person as well: it has moods that can turn from irritable to euphoric; it can also react hastily one day and make amends the next. Can we understand the financial markets if it is not all that rational? Behavioral Finance attempts to fill the void that cannot be captured plausibly in traditional finance models based on perfect investor rationality.

Behavioral Finance Behavioral finance is about what people actually do I. E. Actual investor behavior, actual market behavior and try to explain that. It challenges the rational investor assumption; it also challenges the efficient market hypothesis. Behavioral Finance makes certain assumptions, few of them are – 1. Aversion to Loss Investors are strongly averse to risk and will only take them if expected returns are high and compensate them for the risk. Daniel Keenan and Amos Taverns came up with a study on how people react to risk called the Prospect Theory.

The theory outlines how individuals react differently n undertaking risk for gains and when they concern losses. Keenan explains this with an example. A group of Princeton students were asked to take a bet where if they tossed the coin and got heads they would lose $10, Just how much would the researchers have to pay for the student to take the bet? The amount he says is about $125. If a ratio were to be put on how much individuals are averse to losses more than they like winning is put at about 2 to 3. This is seen in the manner in which they would invest as well. . Overconfidence It is another characteristic used to explain pricing anomalies. Individuals who are overconfident will stop being rational and over-estimate their abilities to take risk and therefore take calls on securities that are not in their benefit. A group of such investors can lead to the security being misperceived. In the long run, prices will adjust but by then these over confident investors would have taken a hit on their investments. How individuals take risks and therefore their trading choices are explained by several behavioral models.

Some of them are, Narrow Framing sees investors seeing issues in isolation. Disposition effect explains that investors tend to want to avoid mistakes rather than making gains. Ђ Conservatism is the model that states that many investors tend to react slowly to new information about an asset. Mental accounting sees individuals maintaining separate mental accounts of their investments, rather than taking an organic point of view. Gamblers fallacy highlights how if an investor is on a winning streak, he wrongly assumes that the trend will continue and make investment assumptions accordingly. Ђ Representatives refers to when investors use current trends to predict probability of outcomes. All these theories point out that there is

no homogeneity in the way they ascertain the price of the asset. This leads to them exhibiting different investing methods, which can explain pricing anomalies to some degree. 3. Information Cascades Behavioral finance uses its models to understand how individuals invest and how the group impacts their behavior as well. Humans like other animals like cows, goats tend to seek strength in numbers and look for signs within the group to invest.

Recent examples of this behavior are the mortgage backed securities and the dotcom bubble. The pricing at the peak of these bubbles were not on account of fundamental strengths in the securities, but the sense that ' if everybody is investing in them so should I'. Once the bubble bursts and money is lost investors in retrospect wonder why they did what they did. This phenomenon is called herding. Information cascading is slightly less irrational. Market participants follow someone, but it is based on reported outcomes and data.

If an investor is making picks based on an analysts findings and outcomes and an exchange of such information spreads wider and wider in the investment circle we say the information cascade is strong. Why is behavioral finance gaining so prominence? It is because financial markets do not exist in nature no one has ever picked a perfectly ripe credit, or has unearthed just the right moist hedge fund, we dream them up and then abuse them and with behavioral finance we are attempting to understand the behavioral biases we snare which influence our financial decisions. We can classify them as follows, 1. I Can Change Them Bias" In a recent study people were asked to buy lottery tickets, in scenario 1 they were allotted tickets numbered 1 – 50 and were asked how much would they pay for it if

someone else chose the ticket for them, odds of winning being 1/50, they decided to pay 1. 97 dollars, in scenario 2 they were given the option to choose the ticket no. Of heir choice, the odds remained the same but they were willing to pay almost 9 dollars. Why is it that we are willing to pay 4 times? We think we can control the outcome, we think we can change the outcome if we exercise the choice.

Similar is thinking when it comes to making a financial decision; we tend to think if we are investing in a fund it is bound to do well, somehow miraculously. We are the only force standing between the particular fund and its financial ruin. 2. “ This Time is Different Bias” We have all had the experience of thinking that this time it will be different, this time it will be better. We think so and fail, because we do not completely analyze and adequately address the underlying issue of why it failed the first time, we have a tendency to rebound.

Even if nothing has changed about us since the last event, we believe that this time it is different. Psychologists call this “ New Era Thinking”. Similarly while making a financial call we think this time market is acting different and it won’t act like it did during the last collapse, and skip the homework and go with the gut. 3. “ Prince Charming Bias” Prince charming bias is the idea that a high impact low probability event will happen ND sweep us of our feet, will make all of our financial problems go away.

This bias is very much in play in our financial lives, particularly those who can least afford are most likely to be swept up in this bias I. E. The common investors. 4. “ L Just can’t Quit You Bias” This bias is based on the simple

notion that “ We Hate Losing”, we hate losing twice as much as we are happy about similar magnitude positive event and this play all the time in our economic lives. Consider a gambler who cannot quit the table because to quit would tantamount to giving up or consider someone who buys a stock for 100

Rupees could have sold it for 95 Rupees with but rides it all the way to the bottom because he can’t stand assured loss. In conclusion it can be said that behavioral finance aims at understanding why investors invest the way they do and thereby market pricing anomalies. How do investors view risk and how do they make decisions. It tries to explain why the emotional tail wags the rational dog Behavioral finance offers no investment miracles, it doesn’t tell people how to beat the market, but perhaps it can help investors train themselves how to be watchful of their behavior and, in turn, avoid mistakes that will decrease their personal wealth.