Essay about behavioral finance

Finance

One fundamental notion in thefinanceand economic fields with regards to decision making has always been based on the underlying assumption that individuals or decision making agents are rational and objective. However, in many cases, rationalistic explanations have failed to answer major financial occurrences in the past.

A good and simple example is given by Fromlet (2001), In 2001 the Swedish currency – the crown- was seriously undervalued in the foreign exchange market despite the fact that Swedish economy enjoyed a good economic growth record, had the lowest inflation rate among the 12 European Monetary union members, surplus government budget and a good, positive balance of payment position. Thus in this case all the rationalistic theories could not adequately explain the weakening of the crown given the fact that all economic indicators showed that it should be stronger.

According to many theorists, even though realism cannot be attained, a good theoretical model should include mechanisms that help in relaxing as much assumptions as possible to attain a near realistic empirically based theory. Most of the traditional and neoclassical financial theory such as the capital asset pricing model (CAPM) and expected utility theory (EUT) are based on the unrealistic assumptions that can be explained as:

• Representative agents and players in the financial market are rational therefore base their decisions with the objective of maximizing wealth therefore asset pricing reflect the real value of the asset at any particular time (Thaler, 1999). • The market given time will settle on an equilibrium point and that the equilibrium price reflects the real value of the asset that

can rationally be explained using traditional theories (Ideal or rationally explained equilibrium) (Thaler, 1999).

Behavioral finance is a relatively new field of study that has made tremendous progress in the attempt to answer these unrealistic assumptions and offer an alternative explanation of the financial market. Behavioral finance holds that the market is unrealistic due to the human element; therefore, in evaluation of financial market decision making and market condition, financial theories should recognize the role of human behavior in financial assets price determination.

The composition of financial investors is diverse from fathers and mothers, household, spouses, students, businessmen, government leaders etc. are all decision makers in the financial market thus the assumption of rationality as provided by these theories is unrealistic (Ritter, 2003). These paper is an in depth evaluation of the behavioral theory and its application in the financial market. The paper will look at the strength and weaknesses of behavioral finance in an attempt to show its applicability as a tool in the financial market.

Definition and description of behavioral finance. Behavioral finance is an empirically based theory, Behavioral finance theorists argue that to understand the performance and decision making in market, it important to integrate psychological and behavioral variables and classical financial theories in decision making and market atmosphere. According to this theory, the market is sometimes information inefficient and participants do not often make decision rationally.

Behavioral finance uses to main concepts namely cognitivepsychologyand limits to arbitrage. Cognitive psychology as applied in behavioral finance focuses on behavioral factors influencing investor's decision making or how people think; it postulates that investors make systematic errors in the manner they think and this contributes to irrationality in decision making. For instance, some investors might be overconfident and end up loosing due making investment decision based on this behavioral trait.

This cognitive biases lead to irrational decision and can explain the weaknesses of classical financial theories with regards to why the market fails to attain equilibrium or conceptual expectation of rational investor decision in the financial market. (Ritter, 2003). Cognitive biases. Cognitive psychologists hold that there several cognitive biases that affect investor's decisions in the market, as mentioned this biases lead investors to make systematic errors hence explaining irrationality in the financial market.

This paper will highlight the cognitive biases by combining some of the documented behavioral patterns in arguing the case and behavior finance model case in the financial market it should be noted that psychological patterns and behavior categories as presented are interlinked to the extent that an individual can make decisions due to several behavioral patterns (Fromlet, 2001): 1/n Heuristics or rule of thumb. Heuristics or the rule of thumb is one common behavioral technique applied in decision making.

According to the definition (as quoted in Fromlet, 2001), " heuristic means ' use of experience and practical efforts to answer questions or to improve performance. " Heuristics mean fast, selective interpretation of information, determined to a high extent by intuition--taking into account that the

conclusions may not give the desired results because of the velocity and/or the incompleteness in the decision-making. "

This technique makes it easier for investor's since information in the market usually spreads faster, changes often and has become more complicated to interpret. Therefore, given various options many investors use the 1/n rule by spreading their funds equally or proportionately on the available options since it is easier than choosing the rational option based on the information hence introducing irrationality in the market in terms of decision making.

A good example is if in a given financial market six different economic indicators are published, economists and investors have to assimilate and use the information as fast as they can to take advantage of the market, some result to heuristic approach. This sometimes leads to suboptimal results and explains the difference between the ideal classical financial market of a rational investor and the real world. (Fromlet, 2001 and Ritter, 2003).

Thaler (1999), argue that from empirical evidence collected in their research most individuals investing for retirement have little or no knowledge of the financial market hence uses the rule of thumb or 1/n heuristic approach to make decisions on where to put there retirement savings. Overconfidence and preference for certain information. Another pattern that manifests itself and lead to irrationality in decision making in the financial market is overconfidence.

Ritter (2003), notes that entrepreneurs tend to be overconfident and hence invest too much in stocks or options that they are familiar with. This can be

termed as an irrational tendency to the extent that it leads overconfident entrepreneurs tend to limit their options by not diversifying their portfolio hence irrational since they tie up their assets (for example real estates) to the company they are familiar with partly due to the fact that they would feel in control of local familiar stocks compared to high returns stocks that are outside their control, this is referred to as control illusions.

A good example world over is the fact that most workers tend to invest too much in the company they work for and this has led to loss of entire savings to many of the companies in the event of insolvency (see Ritter, 2003 pg. 434 for examples). Furthermore, it was noted that generally, men are more overconfident than women and this behavior extends to investment decisions. It was found out in a research by Bernard and Odeon (2001 as quoted in Ritter 2003) that the more men on average perform worse than women and this is partly attributed to the fact that they are overconfident than women.

Given the fact that some people are overconfident and tend to invest in familiar business stocks there is also another pattern or behavior that compounds the problem of irrationality. Analysts found out that investors make decisions based on information and familiarity of the business, however, due to attachment and preference new information that might make a rational investor change his decision does not make many investors in the real world do so.

It is less and less likely for investors to change their position in light of new information due to attachment to the current stocks or business preferences especially where unimportant information emerges with regards to the old

news or supporting their current position (Fromlet 2001, p4). Interpretation of information. Information from the efficient market hypothesis point of view is assimilated immediately and is reflected in the current prices.

However, this notion might not be true since: Individuals tend to be slow in picking up is and analyzing information due to a conservative wait and see approach, thus given change people might under react in the short run due to the conservatism bias thus introducing irrationality. In addition different people interpret information differently even among analysts and this contributes to irrationality and sub optimal decision making in the market.

And thirdly, information in the real market does not reach all players at the same time, it might just be available to a few, moreover not all players in the market can interpret the information thus cannot capitalize on the information when it comes to decision making (Fromlet, 2001 & Ritter, 2003). Framing. Another behavioral pattern that has a fundamental influence on human behavior in the financial market is framing. It refers to the manner in which information is presented to individual decision makers.

Cognitive researchers hold that people tend to react more to information that is attention grabbing and more salient thus framing of information can easily lead investors to make irrational decisions. For example if relevant information is framed in an unappealing manner while on the other hand obsolete or useless information is framed or presented in a captivating manner, investors will tend to react to the captivating news in decision making.

Another example is the technique used by salesmen; say a product A's actual price is $5, salesmen tend to make more if they use the strategy of buy one product at $10 and get one free. Limit to arbitrage On the other hand limit to arbitrage is concepts refer to the conditions when holds arbitrate forces will be effective and under what circumstances it will not. The arbitrage theory is based on the standard asset pricing model and holds that stock prices will always tend to equilibrium position that reflect their real value.

Therefore, in the event where financial assets are overvalued or undervalued arbitrageurs believe that it is possible to make profits from this anomaly-by shorting overvalued stocks or buying undervalued stocks - in the market since given time, prices will readjust themselves to their real value (assuming a rational market). However, empirical evidence has shown that there is a limit to this theory since the market is irrational.

According to Thaler (1999), the underperformance of arbitrageurs in the market proves that equilibrium position based on rational " textbook theories" – As referred in his text – prove that the there exist limits to arbitrage since the market is irrational, information inefficient and the equilibrium position cannot adequately be explained by standard model theories (Thaler, 1999 & Ritter, 2003).

The arbitrage theory holds that these hedge funds are important in that they shield market against undervaluation and overvaluation of assets thus contributes to restoring an efficient market to equilibrium position by avoiding further under/overvaluation situations in the market. A lot of scholars have produced findings showing that there is a limit to the ability of

a few investors with huge sums ofmoneyto control the market through hedging.

Behavioral scientists also argue that limit to arbitrage connotes that the market is not efficient as arbitrageurs would like to believe, a good example is one of the largest arbitrage firms in America (long term capital management LTCM) which had been successful for four years was liquidated after loosing $4 billion in the market and as it turned out in, the long run based on ex post financial analysis they were right. This can only be interpreted as inefficiency in the market since the market or investors did not act rationally forcing the arbitrageurs out of business.

Furthermore, it shows that there is a difference between unpredictability of the market and irrationality in the market. Fromlet argues that a rational decision might not bear fruits due to unpredictability of the market. Eugene Fama held that the stock market development cannot be forecasted by professional analyst based on public information therefore it is hard for fund managers and other analysts to successfully out shine the stock market as a whole based on public information.

These notions makes the capital asset pricing model (CAPM) and other financial theories unrealistic and partly explain the demise of LTCM since it is impossible to consistently out perform the market based on rational decision (Fromlet, 2001 & Ritter, 2003). Application of behavioral finance. Richard Thaler and Terrance Odeon are among the pioneers of behavioral finance and have done extensive research on the application of the theory, though the theory has not yet fully been accepted as a tool in financial market.

Thaler (2001) postulates that the theory has the potential to answer or explain some of the unexplained market occurrences in the past and in determining aggregate investors behavior and reactions in relation to decision making. Behavioral finance theory is a fundamental complementary theory that can help explain market occurrences when classical financial models assumptions are relaxed and hence should be used as an analytical tool together with ' textbook theories. '

Applying the theory on aggregate investor behavior and analysis of the market has enabled behavioral finance experts come up with strategies to avoid making irrational decisions. Behavioral finance model is important in that it helps differentiate between what people do and what ought to be done. Biases, decision traps (like those presented in framing) over and under reaction can be used by experts to formulate strategies of avoiding these cognitive behavior thus leading to better decision making.

A practical example is that it was found out that investors tend to be less risk averse if they have had consistently high returns to investment in the financial market. According to Thaler's example (1999), if a gambler is playing using house money he tends to be sloppier if he/she continues to win. Therefore, in advising an investor who has had luck of maintaining a streak of high returns one should take this into accounting while evaluating his portfolio (Fromlet 2001, p5 & Thaler 1999). Behavioral finance has also a big role in explaining past occurrences in the market over and above the rational based models.

There are some anomalies in the market that clearly call for the application of alternative models and behavioral finance has the potential of explaining

this phenomenon. For instance, rational models more particularly the expected monetary hypothesis stipulate that prices changes in light of fresh information in the market however, researchers have noted that the degree of volatility and fluctuation of asset prices in the world cannot entirely be explained by changes in real prices as induced by information in the market.

In addition to volatility, the volume traded in the real world is not in agreement with a rational market. For example, in a rational market the selling a volume of 700 million might be unrealistic to the extent that a rational buyer (assuming one buyer and one seller) would wonder what information you have that I don't.

Therefore, behavioral finance can be applied in explaining these anomalies in the market hence help analysts understand the market better and develop strategies to deal with such occurrences in the future (Thaler, 1999). Lastly, besides analyzing past and future human behavior influence and aggregate behavior in the market, behavioral finance can play an important role in analyzing areas and even markets where arbitrage can be applied and where they cannot.

Behavioralsciencehas made it obvious the extent that price-to-book ratios and other mechanisms used in by arbitrageurs to determine overvaluation and undervaluation of asset does not apply in the real world. Thus the same mechanism can be used by fund managers to analyze the market in terms of asset pricing, offer insights in portfolio management and hence improve market analysis for fund managers and other experts at large with regards to asset pricing and investment portfolios. (Fromlet, 2001 & Thaler, 1999).

To simply summarize the application of behavioral finance as a tool in the market, the fact that stock take a random walk as postulated by the efficient market hypothesis can be compared to a drunkard walking in a field, though there is no rational explanation on the direction he will choose (unpredictability) behavioral finance can be applied in studying how the drunkard navigates through the field thus can help in explaining possible steps that are likely to be taken by the drunkard and thus complements financial theories which seek to explain the direction.

(See Thaler, 1999). Conclusion. Behavioral finance is an important contribution to the financial market field. The theory does not per se contradict classical financial theories but complements them by focusing and adequately answering the anomalies presented by standard models and relaxing the assumptions presented by them.

It involves the integration of psychological aspect of human behavior as the driver of decision making and postulates that inclusion of human behavior with regards to how it affects decision making is vital and can explain many of the unexplained market occurrences in the past, help in analysis of future decision making and market performance and in creating a basis for further research and formulation of better financial models and macroeconomic theories.

Behavioral finance holds that the real world financial market is irrational and sometimes is information inefficient and thus dismisses fundamental assumptions used in classical financial models applied in the market. The model is based on two distinctive approach namely the cognitive biases model and the limit to arbitrage approach. The cognitive approach

postulates that investors who are subject to human behavior extend this patterns to investment decision and thus on aggregate how people think affects the performance of the market due to systematic errors induced by behavioral patterns.

This paper has shown that psychological findings show that individuals tend to be overconfident and controlled with illusions, there are elements of wishful thinking and attachment to assets, others tend to be conservative and apply different interpretative tools that adversely affect decision making and introduce the element of irrationality in the market.

With regards to limits to arbitrage, there certain market where this theory can be applied and others where it can't. The notion that one can profit from overvaluation and undervaluation in the market is not entirely true or al least not sustainable since the market is not rational and thus adjustment to a set equilibrium based on rational objective development in the market is not realistic.

Moreover, unpredictability is apparent in the market thus fund managers cannot consistently out perform the market by making abnormal profits. Therefore, given the obvious irrationality and unpredictability aspects of the financial market, it is necessary to integrate the current financial theories with behavioral finance in an attempt to come up with a holistic approach in dealing with the financial market.

The theory has vast application including studying the individual decision makers patterns to the extent that it influences decision making and devise measures to avoid errors and irrational tendencies in decision making,

Applying cognitive bias model to analyze the aggregate investors behavior and performance in the market in an attempt to understand the current financial market performance and devise correctional strategies if need be and lastly, to help in analyzing limits to arbitrage and explaining past performance in the market.

Given that the theory is still new in that has not been fully incorporated in financial market analysis and studies need to be conducted extensively on its potential and application in the financial and economic sectors at large, the discoveries and contribution of behavioral finance cannot be questioned. Therefore researchers and other players need to come together and facilitate the maturity and extensive application of behavioral finance as a financial analytical tool as a complementary theory in the market.

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