Example of research paper on behavioral finance and its effect on housing market

Business, Marketing

Introduction

Behavioral finance is essential in the understanding and analysis of systematic market effects of psychological decision procedures. The concept of behavioral finance uses knowledge from anthropology, social sciences and cognitive psychology to analyze the behavior of investors. The theory of behavioral finance is based on the idea that investors act rationally by analyzing all possible or available information before settling on a given decision. Therefore, investment markets are assumed to be efficient, and they give a true reflection of the available public information of security prices. According to Minsky, capitalistic systems are always vulnerable to crises because financial innovation leads to high economic activity, which destabilizes an economy and leads to a crisis. The same idea is used in the analysis of the impacts of the financial crisis where the 2008 crisis. The concept involves free and efficient markets, bubbles and a link between the real economy and financial markets. The 2008 financial crisis is an effect of the mortgage securities innovations.

The housing bubble and market efficiency

According to Minsky’s argument, the housing bubble of 2008 was the main cause of the current crisis. The desire for people to own homes resulted in many people buying houses that they could not finance. Bankers and mortgage financiers willingly accepted to finance these deals blindly. The housing bubble was a threat to efficiency in the market. The theory of the efficient market was responsible for the inflation of the housing bubble. An efficient market is one where the value of a security equals its intrinsic value and that no investors can generate excess or negative returns. In an efficient market, there are no bubbles because there are no price deviations from intrinsic values of securities.

The psychological factors affecting investment decisions can lead to anomalies if wrongly interpreted. The housing bubble was caused by investors wrongly assuming that they could invest in new mortgages and mortgage securities at a gain. Mortgage financiers and banks also failed to observe the impact of the increased demand for mortgages among investors. This marked the beginning of the financial crisis because many financial institutions fell into trouble. Therefore, the impact of behavioral finance on the housing market was caused by psychological factors, which distorted investors' information hence; they inaccurate conclusions on investments in the housing market. There are several behavioral finance biases that can affect the housing market.

Emotional factors

In most cases, investors' emotions overrule their intelligence in decision making. Investors in the housing market may pay extra attention on agreeable aspects on an investment and ignore the minor but essential aspects simply because they fear regret. This leads to some investors choosing risky or losing positions for so long while hoping that at some point the situation will change. Overconfidence in the investors' abilities can result in losses. Some investors are overconfident of making profits that they assume minor details that could lead to losses. Conservative investors hesitate to act whenever there is a change in the market information.

Behavioral finance affects the housing market because some investors resort to emotions rather than intelligence when making financial and investment decisions. In the recent housing bubble, investors were overconfident in their investments that they ignored the aftermath of investing in large numbers. Mortgage financiers were also not keen on averting losses; they took the risk on providing mortgage securities to investors, some of whom did not understand anything about mortgages.

Misinformation

Market efficiency is dependent on the free flow of information in the market. In the housing market, not everyone has full knowledge of the market information, and if they did, they probably would make wrong decisions using that information. Behavioral finance could have affected the housing market in that investors and financial institutions made wrong forecasts. During the housing bubble, mortgage financiers and investors alike had forecasted massive returns. Some institutions ignored advice from risk assessment managers and went ahead to give mortgage security to many investors. Investors only focused on the benefits of owning new houses and not the risk aspect of such an investment. The forecasting errors resulted in the crisis of 2008.

Cognitive mistakes and bubbles

It is assumed that investors are not affected by emotions or cognitive errors in an efficient market. They are only impeded by the inability of the available information to reflect accurate share prices in relation to their intrinsic value. To illustrate this aspect, an asset pricing model is used to classify different kinds of investors. For example, there are optimists, pessimists and smart investors. The smart investor is not influenced by emotions and other cognitive mistakes. From the model, the weighted average valuation of each investor's wealth to the intrinsic value of the security is the equilibrium price. However, the model is a theoretical aspect that could not be applied in the housing market. Most investors did not analyze the mortgage market during the housing bubble. They were led by the market's euphoria hence making rush decisions that led to a crisis as explained by Minsky.

The housing bubble and the crisis

Behavioral finance is the basis of efficient markets. The financial crisis of 2008 serves as evidence to this claim because it shows that markets are not efficient. In cases where security prices equal share intrinsic value, there is usually no compensation for information digging costs that could uncover discrepancies between intrinsic value and share prices. Investors are said to have exhibited bias when valuing mortgage securities hence; it caused valuation inaccuracies. The American residential valuers did not follow the normative process during the valuation process during the house bubble. This resulted in wrong conclusions and expectations by investors, which turned out to be financial crisis thereafter.

The preference of investors to move from being risk averse to risk takers was one reason why there was a price boom in the property industry. It can be considered to be a speculative move that pushed up demand hence price increases. The price increases were not caused by market inefficiencies but the behavior of investors. The enthusiasm with which they invested without estimating the real value of the mortgages is the main reason why the crisis resulted from the housing bubble. This was demonstrated by the massive increase in the ration of loans to value and the reduction of cap interest ratios in the market during the housing bubble. The causes of this herd mentality by investors to flock the mortgage securities industry is explained by behavioral finance in terms of psychological knowledge. It is attributed to self-control, fear of regret, over confidence and overreaction.

Conclusion

The impact off behavioral finance on the housing market is clearly illustrated by the way investors abandoned rationality and resorted to behavioral bias in decision making. The housing bubble was sparked by speculative mentality in investors who overrated the housing market potential. On the other hand, financial institutions ignored advice from risk assessment experts and went on to lend out mortgage securities to many people. Some of the investors were so naive that they did not understand how the mortgage industry worked. What investors underrated was the future growth. These two factors led to price inflation in the housing market. The market perspective on bubbles and rational prices corresponds with the ideas of Keynes on economic downturns, expansions and financial crises. Keynes argues that psychological aspects such as confidence, optimism and sentiments are not rational when analyzing security prices and housing bubbles. According to Keynes, bubbles are characterized by optimistic objectives to achieve high returns.

Minsky’s blames economists for misunderstanding Keynes’s ideologies. He argues that economists only focus on the standard economic theory but ignore the relationship between real sectors and the financial sectors. There is instability in the concept of capitalism because of financial shocks and crashes where financial relations are broken. Therefore, behavioral finance has a strong influence in not only the housing market but all other financial markets. The housing market could not sustain the sudden increase in investments as a result of the housing bubble. The housing bubble was driven by enthusiasm and speculation rather than credible rational ideas hence; the bubble burst in the long run causing the financial crisis.

References

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