

Behavioral finance critical essay

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Behavioral finance is a study which involves the influence of psychology on the attitudes and behavior of investors and its subsequent effects on the markets. Behavioral Studies is still in its development stages, but it is instrumental in determining/ explaining as to why or how markets might be inefficient. The difference between traditional finance and behavioral finance is that traditional finance is based on the following concepts: - Investors have rational behavior - Capital Asset Pricing Model (CAPM) - Markets are efficient

Behavioral finance on the other hand says that, the psychological forces interfere with these concepts. It says that there are both internal and external behavioral obstacles towards the value creation of any company. In practical terms it brings forward the errors in judgments made by both individual investors and fund managers and the various biases to which we as humans are prone. Analyzing this will place us in a position to make decisions which avoid errors/mistakes committed in the past . INVESTORS: Individual investors: An individual investor is a person who purchases small amounts of securities for him/herself.

He is not professionally involved in investment services and whatever purchases he/she makes are on an arm's length basis. Individual investors are highly regulated because they are thought of as amateurs with little or no knowledge. An individual investor is also known as retail investor or small investor . Professional investor: These investors are usually all those businesses which are involved in giving investment services either directly or indirectly for example, investment companies, mutual funds, investment banks, brokerage houses etc.

Besides them professional investors could also be individuals which are professionally involved in giving investment services. Professional investors are also known as institutional investors. These investors are subject to fewer regulations probably because they are perceived as having superior knowledge to individual investors . Behavioral biases: Individual and Institutional investors are both prone to almost similar biases, because institutional investors are although organizations in their own right but in actual are lead by a handful of managers.

Proponents of this study argue that humans are prone to bias in making their judgments no matter how qualified or experienced they may be. They say that humans make frequent use of heuristics, mental shortcuts/rules of thumb to simplify decisions and tasks that are complex. Availability heuristic: With availability heuristic it is believed that for humans the probability of an event occurring is dependent on how easily one can imagine that event happening. The more clear is the image the greater the probability.

A related concept is Illusory correlation which describes we imagine and hence interpret evidence. Although this bias is limited for retail investors since not only their investments are smaller but they also don't have various charts, patterns analyzing past year data at their disposal, as for institutional investors this bias is at a much more magnified level because many fund managers use charts and technical analysis which according to them helps in identifying various patterns and price/stock moments . Representativeness heuristic:

This concept says that humans are prone making judgments that involve consideration of stereo-types instead of the underlying features. For <https://assignbuster.com/behavioral-finance-critical-essay/>

example, while hiring the selection process takes into consideration the qualifications, relevant experience, personality etc. however this in no way can predict the future job performance of the individual. This also incorporates a related concept called Illusion of validity which puts forward that the confidence in one's judgment is primarily based on the representation of the situation instead of the characteristics.

However, retail investors are more prone to this bias as compared to institutional investors because they have the information that is available to the general public for example, commentaries from financial journalists, analysts which believe that well known companies are good stock-market investment options, but in reality these two factors are largely unrelated .

Anchoring and adjustment: This is another important heuristic according to which decisions made by humans are dependent on some key value/number.

There is no process or logic behind determination of this value/number it could be any random number. For example, budgeting which involves use of current figures to determine future estimates. Many fund managers use current year figures and current year industry averages to determine future estimates. This bias is a product of our inherent conservatism which leads to our under reaction to new information. Institutional investors are more prone to this bias as compared to small investors. Probably because the managers of investment companies actively use these techniques to draw conclusions.

Small investors would hardly be aware so these techniques however those with an accounting background could be an exception .

Loss aversion: It is also a key bias. It is based on the concept that humans find it very difficult to accept loss and the state of denial is such that we in fact believe that holding

onto it for longer periods of time would turnaround things some way or the other. This bias has some major consequences in financial decision-making. For instance, over the years it has been seen that many companies have kept running loss-making units and destroying shareholder wealth to the level at which it was irreparable.

The reasons behind the strength of this bias as scholars put it is the shame and regret and feeling the blame for the loss incurred. Individual investors are more prone to this professional investors, a study revealed that individual investors sell those stocks that start to perform well quite soon and hang on loss-making stocks for longer periods of time hoping that things might take a u-turn. This problem as professional traders put it is named get evenitis. Hindsight bias: It is based on the concept that humans are prone to that feeling “ I knew it all the while” or precisely hindsight bias.

To correct this bias is also very difficult because it’s natural for us to make differing conclusions regarding what happened in the past even though those decisions would have been correct according to the data and circumstances at hand then. For example, these days since the global economy is in recession even a layman is heard that this was inevitable. Individual investors are prone to this bias out of human nature, as for institutional investors they are less prone to this because they would be having greater access to information all the time .

Over-confidence bias: Humans are naturally over-confident about their abilities normally. This further leads to over optimism i. e. we normally feel that we can be successful in most of our endeavors or do the right thing in most of the situations. However in reality that is not possible. Moreover the <https://assignbuster.com/behavioral-finance-critical-essay/>

more information or data one gathers regarding a task, the more that person feels in greater control this is called Illusion of knowledge. Practically the biggest setback that one has to deal with results unfolds is that they are quite different than what was expected.

Individual investors are much less prone to this bias as compared to institutional investors which suffer a lot more, because the over-confidence of a team of managers would prove more lethal financially. For example, 3Com which acquired US Robotics in 2000 made an IPO of its division that made the famous Palm pilots. Although the share prices went as high as \$165 making 3Com the fourth largest technology firm then but announcement of a forthcoming product without the infrastructure yet in place saw its share prices dramatically fall to \$1.35 in 2001.

This financial blunder was a result of a combined over-optimism of the then senior management. INVESTMENT BELIEFS: Characteristics of the Individual investor's investment beliefs would be focused on limited aspects probably because they have limited knowledge of the market and they invest smaller amounts as compared to institutional investors. They would probably invest in companies that have good market reputation and which promise a good return within a short period of time. As for institutional investors their investment beliefs would be diverse since they are professionals.

It would be important for them to take measures to avoid conflicts of interest. It would also be important for them to develop a clear view of capital markets in order to invest in companies that are expected to yield good returns. CONCLUSION: Behavioral finance has therefore highlighted that financial decision-making of both individual and institutional investors.

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The errors/mistakes made in yester-years both at the individual and organizational level if taken care of in future could result in making sound long-term decisions. WORKS CITED: Blanco. A.

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