CHAPTER-1 INTRODUCTION TO BEHAVIOURAL FINANCE

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Introduction

- Behavioural finance has emerged as relatively new body of knowledge which has taken its roots from psychology, finance, economics, and sociology. This field is the application of psychology to finance, with a focus on individual level cognitive biases.
- Behavioural finance explains the irrationality in financial decision making by individuals.

Behavioural Finance Defined

- Sewell (2005) defines “Behavioural finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets”.
- ‘I think of behavioural finance as simply "open-minded finance". Thaler (1993)
- Salsbury (2004) says “Behavioural finance also referred to as behavioural economics, combines economics and psychology to analyse how and why investors make their financial decisions. The field of behavioural finance, which has much in common with the field of cognitive psychology, offers a theoretical explanation for the sometimes irrational or emotional choices and actions of investors”.

Behavioural finance revolves around an investor

- Meir Statman of Santa Clara University has said that “people in standard finance are rational, whereas people in behavioural finance are normal”.

Applications to portfolio management

- Behavioural finance is an academic field and can work as “welfare portfolio management approach” (Stewart, 2006).

Market inefficiencies/ anomalies are explained by behavioural finance

- Modern finance assumes that markets are efficient and that agents know the probability distribution of future market risk (Markowitz, 1952; Merton, 1969).

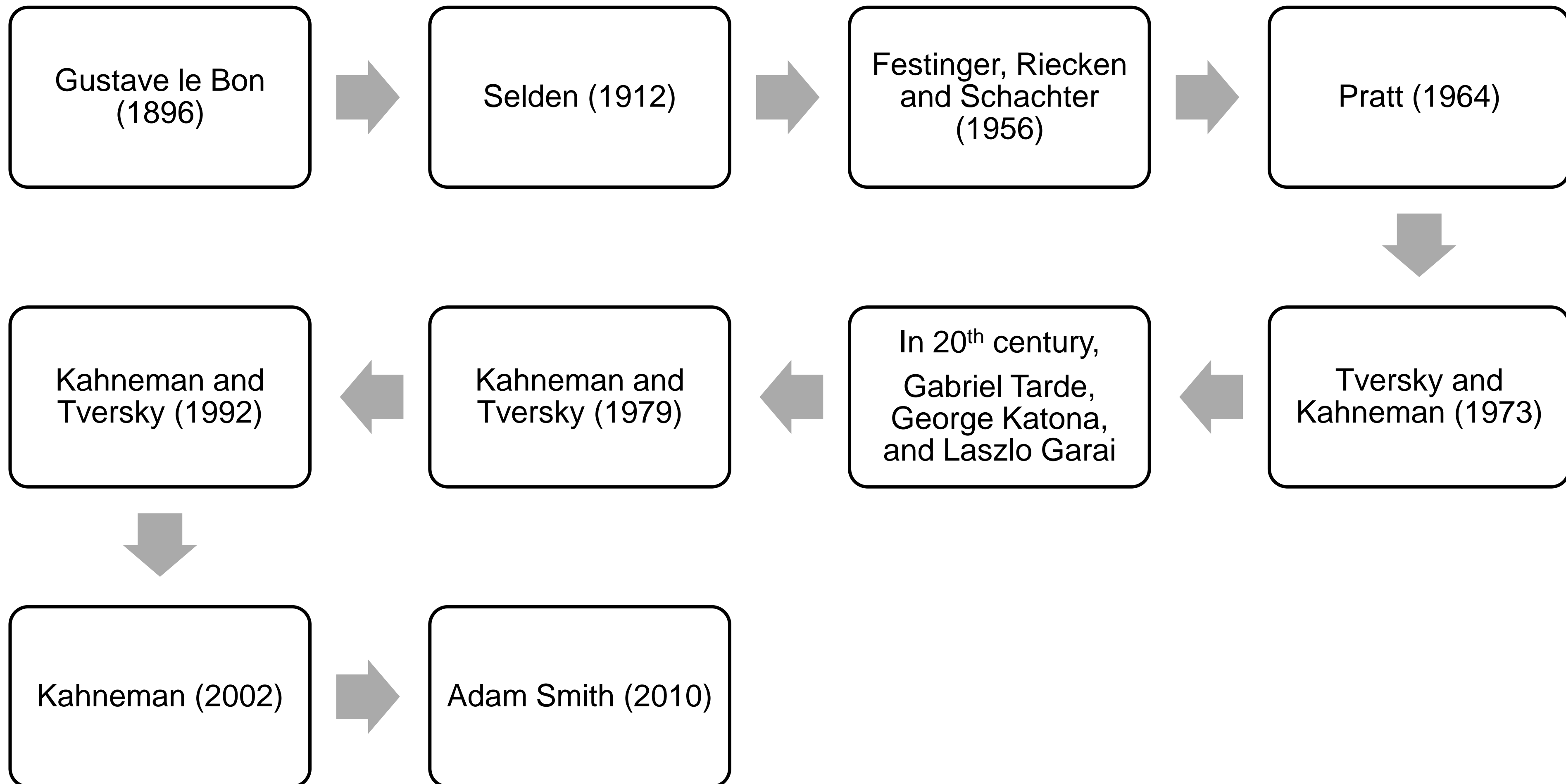
CLASSIFICATION OF BEHAVIOURAL FINANCE

- Behavioural finance classifies the market into micro and macro level.
  - Behavioural Finance Micro (BFMI) is that branch which examines *behaviours or biases of individual investors* that distinguish them from the rational actors envisioned in classical economic theory. (Pompian, 2006)
  - Behavioural Finance Macro (BFMA) detects and describes *anomalies* in the efficient market hypothesis that behavioural models may explain. (Pompian, 2006)

IMPORTANCE OF BEHAVIOURAL FINANCE

- Behavioural finance is about making right decisions which are free from biases or errors.
- It helps us understand investor behaviour better.
- Study of behavioural finance will help improving financial capability of individuals in an economy.
- It helps design wealth management strategy as it help us avoid emotion driven decisions which lead to losses.
- It covers individual biases, emotions, and group behaviour in the market. It brings together all academic fields of study for the purpose of decision making.

HISTORY OF BEHAVIOURAL FINANCE



IMPORTANT CONTRIBUTORS

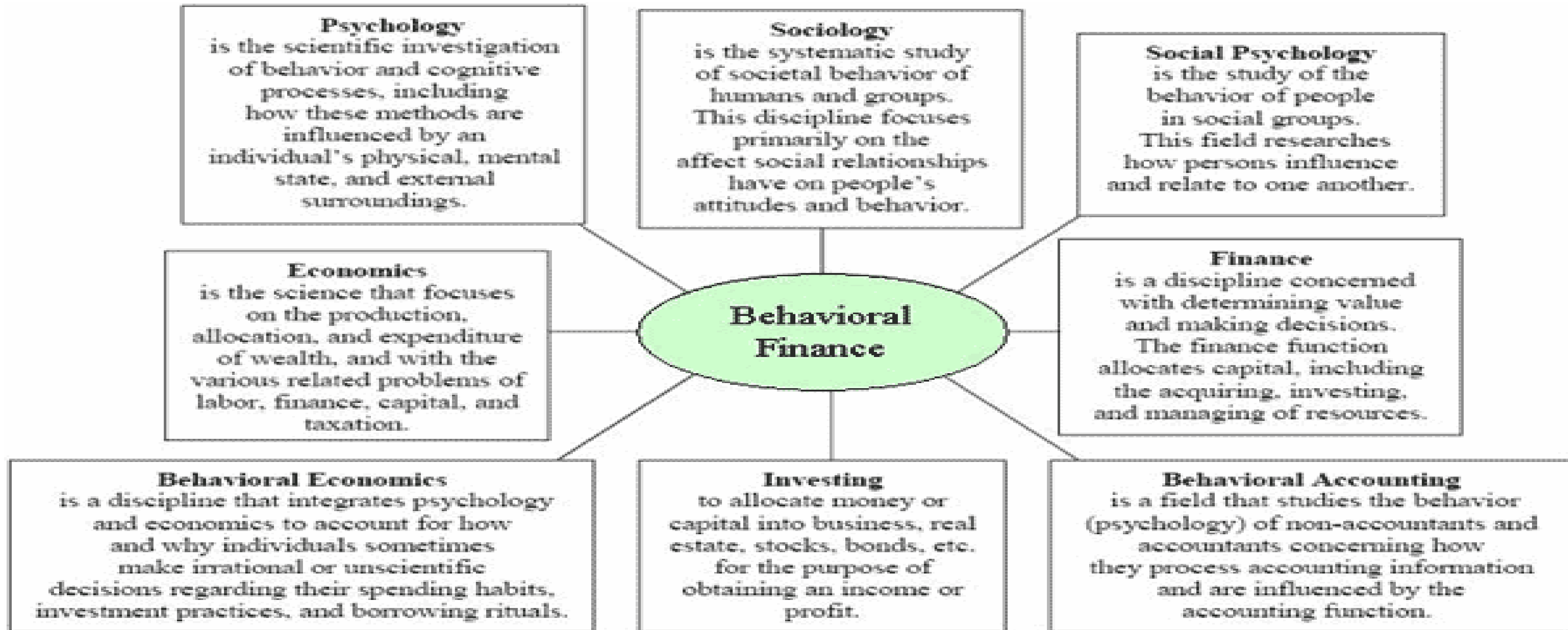
- *Daniel Kahneman and Amos Tversky* – They published about 200 papers/ articles since their collaborations in the late 1960s, most of which relate to psychological concepts with implications for behavioural finance.
- *Richard Thaler*- He understood the limitations of the conventional theories as they ignore behavioural aspects.
- *Baker and Wurgler*- They proposed model for behavioural finance which has two assumptions i.e. investors are subject to sentiments and betting against their sentiments can be costly and risky.

COMPARISON BETWEEN BEHAVIOURAL FINANCE AND STANDARD FINANCE

Behavioural Finance and Standard Finance can be differentiated on the basis of,

- **Risk**
- **Risk and Return**
- **Rational Behaviour**
- **Decisions**
- **Utility theory**
- **Limits to Arbitrage**
- **Underlying theories**
- **Subjective Expected Utility**
- **Predictable pattern of stock market**
- **Information dissemination**

COMPONENTS OF BEHAVIOURAL FINANCE



CLASSIFICATION OF BEHAVIOURAL BIASES

- ***Heuristics***
- ***Overconfidence***
- ***Mental Accounting***
- ***Framing***
- ***Representativeness***
- ***Conservatism***
- ***Confirmation Bias***
- ***Negativity Bias***
- ***Bandwagon Effect***
- ***Loss-Aversion Bias***
- ***Endowment Bias***
- ***Sunk cost fallacy***
- ***Availability bias***
- ***Ambiguity Aversion***

INVESTOR MODELS USED

Barnewall Two-Way Model

- Barnewall distinguished between two relatively simple investor types: passive investors and active investors. Barnewall defined “Passive investors” as those investors who have become wealthy passively. “Active investors” are those individuals who have earned their own wealth in their lifetimes.

Bailard, Biehl, and Kaiser Five-Way Model

- The Bailard, Biehl, and Kaiser (BB&K) model explains some principles of the Barnewall model and this has been done by classifying investor personalities along two axes—level of confidence and method of action.

BEHAVIOURAL FINANCE AFTER GLOBAL FINANCIAL CRISIS

- Behavioural finance has grown tremendously after the global financial crisis. As in 2008 after the crisis there was a demonstration of irrational behaviour of consumers and traders.
- Global crisis of 2007 which started with subprime mortgages happened because of overestimating one's ability to pay a loan, overconfidence, wrong assessment of trends. Behavioural finance studies can be useful in understanding and identifying financial crisis.

MANAGEMENT IMPLICATIONS OF BEHAVIOURAL FINANCE

- Behavioural finance helps comprehend the emotional side of human beings and the biases, errors in judgement they are affected by. For managing client's behavioural biases professionals can use two core tools, namely, moderating the client or adjusting the portfolio.
- Behavioural finance can help identify motivation of client to invest and his expectations more clearly which will make the relationship work successfully.
- Behavioural finance can help develop trust and confidence in client advisor relationship, which will not be affected by ups and downs of the markets.

Thank You

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  MARKET ANOMALIES

Continued…