ABSTRACT

Behavioral finance integrates psychology and economics in finance theory. It is a new paradigm of finance which seeks to supplement the modern theories of finance by introducing behavioral aspect to provide explanation for why investors make irrational decision. Efficient market hypothesis has been the most important theory that explains the behavior of agents in the financial markets. But it neglects the impact of any human behavior in investment process. The purpose of this study is to identify behavioral factors which have influence on investment decision of the investor.

KEY WORDS: Behavioral Finance, Investment decision, Behavioral factors.

INTRODUCTION:

Behavioral finance is the study of the influence of the psychological factors on the development of financial markets. In other words, financial markets inefficiency is analyzed in the light of the psychological theories and perspectives. Behavioral finance is a relatively recent and high impact paradigm which provides an interesting alternative to classical finance. It is very popular in stock market across the world for investment decisions.

TRADITIONAL FINANCE VS BEHAVIORAL FINANCE:

In traditional theories of finance investment decisions are based on the assumption that investors act in a rational manner. This means that they behave rationally so they earn returns for the money they put in stock markets. To become successful in the stock market it is essential for investors to have rational behavior patterns. Rational behavior is also required to overcome tendencies.

Modern theory of investors’ decision-making suggests that investors do not act rationally at every time while making an investment decision. They deal with several cognitive and psychological errors. These errors are called behavioral biases and are exists in many ways. Behavioral finance has been growing specifically over the last two decades as we find difference between the assumptions made in traditional finance theory and actual behavior of investors.

LITERATURE REVIEW:

Chaudhary (2013) studied how behavioral finance provides explanations for why investors make irrational financial decisions. The study demonstrates how emotions and cognitive errors influence investors in the decision making process.
The study shows that various causes that led to behavioral finance are anchoring, overconfidence, herd behavior, over and under reaction and loss aversions. Chandra (2008) explored the impact of behavioral factors and investor’s psychology on their decision-making. The research was based on the secondary data. The study concluded that retail investors do not always take rational decision. The decision of investment is influenced by many behavioral factors such as greed and fear, cognitive dissonance, mental accounting, heuristics and anchoring etc. The study focuses that these behavioral factors must be considered while taking the investment decision.

Jay R Ritter (2003) has given a concise introduction of behavioral finance published in Pacific Basin Finance Journal. In his research article, author rejected the traditional assumption of expected utility maximization with rational investors in efficient market. The study shows that the two dimensions of behavioral finance are cognitive psychology (How People Think) and the limit of arbitrage (when market will be inefficient).

OBJECTIVES:
• To understand behavioral finance as new paradigm of finance.
• To know the difference between traditional finance and behavioral finance.
• To identify various behavioral factors influencing the decision of investor in stock market.

VARIOUS BEHAVIORAL FACTORS WHICH AFFECTS THE DECISION OF INVESTORS IN STOCK MARKET:
Some of the behavioral factors which affect the investment decision of investors in stock market are as mentioned below.

1. OVERCONFIDENCE:
Psychologists are of the opinion that overconfidence causes people to overestimate their knowledge, underestimate risks and exaggerate their ability to control events. A common trait among investors is a general overconfidence of their own ability when it comes to picking stocks and to decide when to enter or exit a position. An overconfident investor makes too many trades and takes too much risk. They do not diversify their investment.

2. REPRESENTATIVENESS:
It is the tendency of investors to associate new event with a purpose of knowing the event and through which only they make investment. If a company makes some announcement, the investor will correlate that announcement with the past announcements and makes decision on the basis of that past announcement without considering the fact that past announcement may not represent the present one so far.

3. HERDING:
This is the common mistake where investors tend to follow the investment decisions that taken by the majority. As a result of this investor will not buy or sell a stock even if that decision is supported by technical or fundamental analysis. Investor is pressurized by the influence by the peers. They are more concerned about what others think of their investment decision. As a result of herding behavior, investors lose their own individuality in the decision making process.

4. ANCHORING:
Anchoring is a psychological situation exists when investors give unnecessary importance to statistically random and psychologically determined ‘anchors’ which leads them to investment decisions that are not essentially ‘rational’. After considering the estimation of good price for buying the share the investor will begin such process by using initial value called ‘Anchor’ and may be by considering the 52 weeks low of the stock then investor adjust such ‘Anchor’ up and down to reflect their analysis or new information but studies have shown that this adjustment is insufficient and ends producing results that are biased.

5. COGNITIVE DISSONANCE:
Cognitive Dissonance can be defined as the mental conflict that people experience when they are presented with evidence that their beliefs or assumptions are wrong. As a result of this conflict, the investor ignores new information that contradicts known beliefs and decision. This behavior of investors leads to reduction in their ability to make rational and fair investments.

6. REGRET AVERSION:
Regret Aversion is a psychological error that arises out of excessive focus on feelings of regret at the time of decision making, which turned out to be poor, mainly because the outcomes of the alternative are visibly better for the investor to see. The root cause of this type of error is the tendency that individuals hate to admit their mistakes. Because of such tendency investors may avoid taking decisive actions for the fear that whatever decisions they take will be sub-optimal in Hindsight. Because of unwillingness to admit and rectify mistakes in a timely manner could lead investors into holding
7. MENTAL ACCOUNTING:
Mental Accounting is the set of cognitive operations used by individuals and households to organize, evaluate and keep record of financial activities resulting in a tendency for people to separate their money into separate accounts based on a variety of subjective reasons. Individuals tend to assign different functions to each asset group, which has often irrational and negative effect on their consumption decisions and other behaviors. Mental Accounting refers to the codes of people use when evaluating an investment decision resulting in low or no diversification of investment.

8. HINDSIGHT:
Hindsight bias can be defined as the tendency to think that one would have known actual events that were coming before they happened. As a result of hindsight bias investors usually take wrong decision or pretend that the outcome of their decisions was known by them very earlier. If investor have loss on particular stock then too they will pretend as if they knew it earlier that they will loss, as a result of this they don’t learn lessons from their wrong decisions and such decisions may be taken again in future also.

9. AVAILABILITY BIAS:
The availability bias suggests that the recent memory i.e., the available example influences more on investor’s decision of investment i.e., if investors have recently seen huge loss in one investment avenue then he will not invest in that avenue. Investors are more likely to be fearful of stock market if they have recently seen any stock market crisis.

10. CONSERVATISM:
Conservatism represents that the investor takes decision on the basis of his past information although faced with the new information or investor only partially adjust their view in the light of new information i.e., investors who buy shares in a high profile company may be slow to adjust their view of the company’s prospects even after the company’s profitability deteriorates.

CONCLUSION:
The conclusion can be drawn that investors not always act in a rational manner due to the cognitive and psychological errors they have to deal with. The behavioral factors are important in financial markets because they influence the investors who make the financial decisions. Busenitz and Barney (1998) state that if the environment is uncertain and complex, biases and heuristics can be an effective and efficient aim for decision making. Under these circumstances a more comprehensive and careful decision making is not possible. Behavioral finance highlights the psychological edge of investment decision making process in strong contradiction to the Efficient Markets Hypothesis. It is obvious that the separation of an investor’s personality and their investment decisions making is not possible. There fore, it cannot be ignored the importance of understanding of the individual financial behavior of capital market investors. Behavioral finance represents a revolution in financial theory. The combination of financial theory with other social sciences resulted into the appearance of behavioral finance. This is a relatively young and promising field of modern finance which has registered remarkable progress in the last decades.

BIBLIOGRAPHY:
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