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Behavioural Finance: A Review

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Abstract

The present study chalks the developments in behavioural finance through the course of financial history. It provides the earliest evidences of behavioural anomalies reported by researchers in the stock markets. It starts the discussion with traditional finance followed by the analysis of traditional theories in situations where they are deemed insufficient. The paper then throws light on the significance of behavioural finance and its unique position in bridging the gaps between real life situations and traditional theories.

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1. Introduction

Behavioural finance relates to the psyche of investors and its role in financial decision making. We know that humans have emotions which can influence their decisions. Such decisions often tend to be inefficient and irrational and can lead to disasters in stock market. Perhaps the most historic incidence of such disasters is recorded by [1]. He gives an account of three occurrences namely the Tulip bubble in 1630's, the South Sea company bubble from 1711 to 1720 and the Mississippi Company bubble from 1719 to 1720. Out of these, the Tulip bubble, popularly known as the tulipomania is possibly the most cited accounts. It happened during the Dutch Golden Age when the exotic 'Tulip' flower was brought in the Dutch stock market for the first time. This flower became so popular in the upper circles that its possession became a status symbol. The cultivation and purchase of tulips started happening at a large scale. Soon the tulip frenzy caught over entire Netherlands and people even started investing in tulip stocks. Naturally, the price of this flower skyrocketed and at its peak, the selling price of one bulb was greater than 10 times the yearly pay of a skilled artisan. The Dutch stock market finally crashed when the investors felt that they have spent a considerable amount on a commodity having very low utility like tulip flower. This realization led to steep fall in tulip prices which resulted in heavy losses. Events like tulip mania question the rationality of investors. In an ideal scenario where this approach is applicable, the market is informationally efficient. However, we do not live in such a utopian world and the markets are mostly inefficient. The presence of market anomalies like speculative bubbles, overreaction and

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underreaction to new information, are a proof that financial decision making process involves more than a cold, calculative rational agent. Thus, the need for understanding such anomalies and shortcomings of human judgment involved with them became the precursor of behavioural finance.

Behavioural finance is a relatively new school of thought that deals with the influence of psychology on the behaviour of financial practitioners and its subsequent impact on stock markets [2]. It signifies the role of psychological biases and their specific behavioural outcome in decision making. Behavioural experts have identified the role of psychological biases like overconfidence [3], self attribution bias [4] and herd behaviour [5-6] in fuelling such anomalies. This makes behavioural finance an extremely relevant topic in today's times.

2. Traditional finance versus behavioural finance

2.1 Traditional Approach to Investor Behaviour: The Rational Investor

Mid eighteenth century was considered to be starting point of traditional theories [7]. The premier concept amongst them was the expected utility theory. Here, utility was considered to be a measure of satisfaction of individuals by consuming a good or a service [8]. In 1844, [9] introduced the concept of rational economic man or *homo economicus* who tries to maximize his satisfaction (or utility) given the constraints he faces. The three underlying assumptions for this agent are; perfect rationality, perfect self-interest and perfect information. These assumptions became the basis of the traditional financial framework [7]. According to [10] arriving at rational solution means two things mentioned as follows. First, the agents should update their existing knowledge with new information correctly and second, using this knowledge to maximize their satisfaction. In this context, several traditional theories were developed that are summarized in Table 1.

Table 1. Traditional Financial theories

Author	Year	Finding
John Stuart Mill	1844	Introduced the concept of Economic Man or <i>homo economicus</i> .
Bernoulli	1738, 1954	
Von Neumann and Morgenstern	1944	Markowitz portfolio theory
Harry Markowitz	1952	
Treynor, Sharpe and Lintner	1962, 1964, 1965	
Jan Mossin	1966	
Eugene Fama	1970	Efficient market hypothesis

Expected Utility Theory [8], [17] states that the market participants make their decisions under risk by comparing the expected utility values of the available options. This theory along with its variants like subjective expected utility theory [18] was the most accepted theory for decades in financial literature for decision making under risk. [11] introduces the portfolio selection model. It describes the process of designing optimal portfolio of several risky securities and a risk free asset. Markowitz portfolio theory formed the basis of one of the most central asset pricing models in finance, the capital asset pricing model (CAPM). CAPM is developed by [13-15]. It gives the relationship that should be observed between the risk of the asset and its expected return. This return is considered an estimate of fair or benchmark return. [19]. However traditional theorists abandoned the CAPM in favor of [20] three-factor model when the CAPM produced anomalies inconsistent with market efficiency [21]. A great deal of asset pricing theories is based on the assumption of market efficiency which is introduced and explained by [16]. He defines the efficient financial market as one in which security prices always fully reflect available information. [16] categorizes the old information into three types which gives rise to three forms of market efficiencies: weak, semi-strong and strong. The EMH turned out to be enormous empirical success in the first decade of its conception.

2.2 Emergence of Behavioural Finance Approach from Traditional Finance

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