Behavioral Finance

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What is Behavioral Finance?

Behavioral + Cognitive Psychological + Economics + Finance = Irrational Financial decisions

When did it all start?

- The thought of Behavioral Finance goes back to 1776 when Adam Smith wrote books on *Wealth of Nations and Theory of Moral sentiments.*
- The impact that people's sentiments had on their decisions. Additionally, ideas like bounded rationality began to reveal how limited our rationality and thinking is, which leads to irrational decisions.
- Amos Tversky, Daniel Kahneman, and Richard Thaler are called the fathers of Behavioral Finance

Why does Behavior Finance matter?

Aspects of Behavioral Finance

Behavior of an investor

Behavior of the market

Scenario

Theories of Behavioral Finance

- Prospect theory
- Regret theory
- Anchoring
- Over and under reaction

Which situation would you choose?

Situation 1:

a. A sure gain of Rs. 2000

b. 25% chance to gain Rs. 1000 and 75% chance to gain nothing

Situation 2:

a. A sure loss of Rs. 7500

b. 75% chance to loss Rs. 10000 and 25% chance to lose nothing

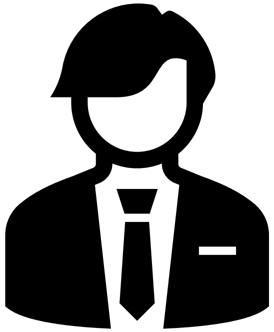
Prospect theory

- People respond differently to equivalent situations depending on whether it is presented in the context of a loss or a gain.
- Investors are risk hesitant when chasing gains but become risk lovers when trying to avoid a loss

Regret theory

- Investors will feel regret if a wrong decision is made and will thereby consider this regret when making decisions
- The fear of regret alters an investor's risk profile, causing them to be more risk-averse or risk-seeking than they normally would be.
- Regret theory can alter an investor's risk profile, causing them to be more risk-averse or risk-seeking than normal.

Example:



Conservative investor

~~RISK~~

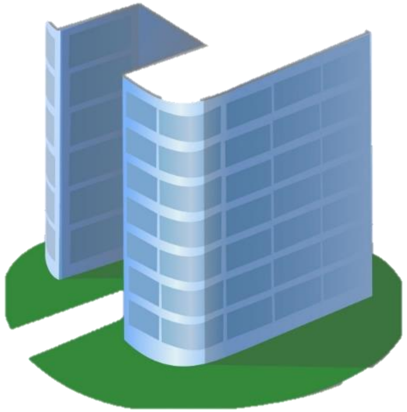
FOMO

Anchoring

- Absence of better information, investors assume current prices are about right
- In the absence of any better information, past prices are likely to be important determinants of prices today. Therefore, anchor is the most recently remembered price

Illustration: XYZ Corp.

$25 to $80



Major cust. did not renew

$80 to $40

Over and under reaction

- The most robust finding in the psychology of judgment needed to understand market anomalies in overconfidence.
- People tend to become more optimistic when the market goes up and more pessimistic when the market goes down

Situation in 2008

- In May 2008, when the Sensex had crossed 20000 mark, the investors were predicting that it will touch 25000 or 30000 without realizing it was the extreme situation.
- Investors were putting too much weight on current situation and became optimistic
- Instead, by the end of 2008, the Sensex was trading at 9176

Behavioral Finance in the Stock Market

Why is Behavioral Finance important?

- Learning to Recognize Mistakes
- Understanding and Utilizing Others' Decision-Making Processes
- Evaluating Market Trends
- Facilitating the Planning Process
- Understanding the Impact of Events on the Market

To sum up

- Behavioral finance is an area of study focused on how psychological influences can affect market outcomes.
- Behavioral finance can be analyzed to understand different outcomes across a variety of sectors and industries.
- One of the key aspects of behavioral finance studies is the influence of psychological biases.
- Some common behavioral financial aspects include loss aversion, consensus bias, and familiarity tendencies.
- The efficient market theory which states all equities are priced fairly based on all available public information is often debunked for not incorporating irrational emotional behavior.

Sources

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thank you