

Behavioural Finance: A Review

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ABSTRACT

This study traces the growth of behavioural finance over the course of financial history. Early symptoms of anomalous stock market behaviour have been discovered in this investigation. Traditional financial assumptions are examined to determine if they can withstand further scrutiny. Financial behaviour and the unique role it plays in linking real-world events and established ideas are also underlined in the study.

Keywords: behavioural finance; behavioural anomalies; traditional finance theories; rational decision; market efficiency; behavioural biases

INTRODUCTION

Financial decision-making is heavily influenced by investors' emotions. There is no denying that emotions have the potential to influence a person's judgments and actions. Ineffectiveness and illogicality might lead to stock market calamities if these decisions are made. One of the worst examples of this sort of disaster in recent times is Hurricane Katrina [1]. It's his belief that in the 1700s, there were three bubbles: the Tulip bubble, the South Seas business bubble, and the Mississippi Corporation bubble. Most people are familiar with the tulip bubble, also known as tulipomania. This rare and exotic flower made its stock market debut during the Dutch Golden Age. The well-to-do immediately learned to associate this flower with social achievement. There has been an explosion in tulip cultivation and sales since that time. People in the Netherlands began buying tulip-related stocks as the mania grew. The cost of this flower has gone up since it was first introduced. A single bulb used to cost 10 times the annual wage of a skilled employee." The Dutch stock market crashed when investors realized how much money they had spent in a low-value item like tulip flowers. As a result of this realisation, tulip prices plummeted, resulting in substantial losses. Mania over Tulips strains the rationality of investors. In an ideal world, the market would be information-efficient if this technique were to be implemented. A flawless world isn't possible, and markets tend to be inefficient the vast majority of the time. Decision-making on the stock market is more complicated than that of a calculated, cold-blooded sensible individual. Forerunner of behavioural finance is the study of these abnormalities and human judgment errors.

Research into how people's psychology affects their financial decisions, and how that affects stock markets, is a relatively young field of study called "behavioural finance." [2]. Decision-making is

heavily influenced by psychological biases, as well as the specific behaviours they cause. Behavioural experts have identified overconfidence [3], self-attribution bias [4], and herd behaviour [5-6] as contributory reasons. It's thus more crucial than ever before that we understand behavioural finance.

Traditional finance versus behavioural finance

Early in the 18th century was regarded to be the beginning of conventional ideas [7]. The anticipated utility hypothesis was the most widely discussed of them. In this case, utility was defined as the degree to which a product or service satisfies an individual's needs [8]. As early as 1844, [9] proposed the idea of a rational economic man, often known as a homo economics, who seeks to maximize his happiness (or utility) within the limitations he is faced with. Complete self-interest, immaculate logic, and perfect information are the foundations of this agent's approach. As a result, the conventional financial framework was developed [7]. Achieving a reasonable solution, according to [10], requires the accomplishment of the two tasks listed below. They need to keep abreast of new developments in the industry and apply what they learn to better serve their consumers. This field has yielded a number of famous concepts, some of which are included in Table 1.

Table 1: Traditional Financial theories

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

Anticipated Utility Theory states that market participants consider the expected utility values of the various options before making a decision [8], [17]. Making hazardous decisions has long been based on this idea and modifications like the subjective expected utility hypothesis [18]. The portfolio selection model is originally introduced in [11]. Portfolio construction is illustrated by using an asset class that is both free of volatility and capable of mitigating volatility. Markowitz's portfolio theory, which forms the basis of the capital asset pricing model, is a key asset pricing model in finance (CAPM). CAPM has been developed by [13–15] during the past several years. The asset's predicted return and risk are explained here. In certain cases, investment returns are used as a proxy for the deal's profitability [19]. [20] The CAPM was replaced by a three-factor model since it showed anomalies inconsistent with market efficiency [21]. Since the introduction and explanation of [16], the assumption of market efficiency has been used as the basis for many asset pricing models. He says that an effective financial market is one in which the price of an asset always completely

reflects the information that is currently available. [16] When old information is divided into three categories, a market with weak, semi-strong, and strong efficiencies results. In its initial decade of existence, the EMH was a spectacular success in terms of empirical research. There is a lot of thinking put into the basic financial theories. Despite this, they were unable to pinpoint the reason of the stock market's catastrophe. Bubbles, over or under reactions, momentum and market reversals are examples of anomalies in the market. Because of the necessity to explain these outliers, behavioural finance was developed. The pioneering work of psychologists has a lot to do with behavioural finance [22]. In order to better understand how people make decisions in risky situations, they developed prospect theory in 1979, which became the cornerstone of behavioural finance. In the prospect theory, the value function takes the role of the utility function from the anticipated utility theory. You may see how much individuals value their gains and losses by using this feature. Some benefits and losses are felt more strongly than others, according to the function's explanation. In certain cases, the agony of a loss outweighs the joy of a gain of the same amount. It's characterized as "loss aversion" since losses seem to outweigh the potential benefits. As a result, the prospect theory makes the following three main claims: Individuals, according to the first proponent, do not all have the same attitude toward risk. As a result, the value function has a "S" shape to it.

In other words, profits are concave, whereas losses are convex. According to the second proponent, individuals evaluate a prospect's value by comparing it to something else. Because of their position or wealth, individuals are more likely to succeed or fail in a possible opportunity. The third argument is that losses are more important than profits (loss aversion). As a general rule, people have a strong desire to avoid losing money more than they do to obtain it. When it comes to understanding biases such as loss aversion, framing and the disposition effect in behavioural finance, prospect theory is essential. According to the above-mentioned literature, in the late 1970s and early 1980s, behavioural components of classical theories gained in favour. In contrast to the predicted utility theory, [22-25] Offer an alternate perspective [21] Stock market bubbles can only be better understood by looking at expected returns from a certain moment in time using CAPM models. Like the behavioural asset pricing model, which was introduced by [26], (BAPM). In the context of the market, informational and noise traders interact. [26] The behavioural portfolio theory is an alternative to Markowitz's portfolio theory (BPT). Markowitz's approach of mean variance portfolio construction helps investors optimize their risk/return tradeoff. With respect to behavioural investors, the BPT looks at portfolios that are built one asset at a time, each with a distinct purpose and risk tolerance.

In the 1990s and 2000s, a number of researchers, including those named [27-28].

[27] Stock index returns, stock price bubble persistence, and the 1998 failures of some well-known hedge funds may all be explained by behavioural theories of value investing. These findings further destabilize the EMH [28-29]. To paraphrase, stock prices were significantly more volatile in 1981 than conventional financial theories can explain. [28] An emphasis on the psychological and cultural factors that contribute to stock market bubbles is made. Additional evidence for momentum is shown in a second study [30]. According to their findings, there is a substantial link between historical stock price fluctuations and the way prices will go in the future. Findings like this go against even the most flimsy notions of market efficiency.

Table 2: Behavioural Finance Theories

Researcher Name	Year	Theory/ Concept/ Model
“Herbert Simon”	1955	“Models of bounded rationality”
“Festinger, Riecken and Schachter”	1956	“Theory of cognitive dissonance”
“Tversky and Kahneman”	1973, 1974	“Introduced heuristic biases: availability, representativeness, anchoring and adjustment”
“Kahneman and Tversky”	1979	“The prospect theory, introduced loss aversion bias”
“Tversky and Kahneman”	1981	“Introduced Framing Bias”
“Richard Thaler”	1985	“Introduced mental accounting bias”
“De Bondt and Thaler”	1985	“Theory of overreaction in stock markets”
“Barberis, Shleifer and Vishny”	1998	“Investor sentiment model for underreaction and overreaction of stock Prices”
“Meir Statman”	1999	“Behavioural asset pricing theory and behavioural portfolio theory”
“Andrei Shleifer”	2000	“Linkage of behavioural finance with efficient market hypothesis to find that stock markets are inefficient”
“Barberis, Huang and Santos”	2001	“Incorporation of prospect theory in asset prices”
“Grinblatt and Keloharju”	2001	“Role of behavioural factors in determining trading behaviour”
“Hubert Fromlet”	2001	“Importance of behavioural finance. Emphasis on departure from ‘ <i>homo economicus</i> ’ or traditional paradigm to more realistic paradigm”
“Barberis and Thaler”	2003	“Survey of Behavioural Finance”
“Coval and Shumway”	2006	“Effect of behavioural biases on stock prices. The price reversal for biased investors is quicker than unbiased investors”
“Avanidhar Subrahmanyam”	2008	“Normative implications of behavioural finance on individual investors and CEO’s”
“Richard Thaler”	2008	“Impact of mental accounting on consumer choice behaviour”
“Robert Bloomfield”	2010	“Compares the behavioural and traditional finance approach in explaining market inefficiencies”
“Parag Parikh”	2011	“Practical implications of behavioural finance and investor sentiments in value investing”
“Uzar and Akkaya”	2013	“Explores the evolution of behavioural finance”

		from traditional finance”
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Conclusion

Behavioural finance studies how investors make financial decisions and how their psychology influences their choices. This school of finance differs from conventional financial thinking in that it emphasizes the influence of an investor's own personal biases on the decisions they make. Predispositions might cause people to make ill-advised choices in the workplace. Large-scale market disruptions induced by these sorts of acts are referred to as "market anomalies." Individuals' and the country's financial well-being are at stake if these anomalies don't occur. Practitioners must become more aware of their own psychological and behavioural constraints if this is to be avoided. A comprehensive analysis of this issue has never been more critical.

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