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A Review Study on Behavioral Finance

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Abstract

Behavioral finance is a relatively new but rapidly evolving field that explains economic decision-making by cognitive psychology, conventional economic and financial theory. Behavioral finance searches the influence of psychology on the behavior of financial practitioners and the subsequent effects on the financial markets. The purpose of the paper is the behavioral research aspects of financial decision-making as they help explain why and how markets might be inefficient. Hence, it becomes necessary for researchers to study the various available literatures on Behavioral Finance and its determinants that are useful to understand the better understanding of behavioral finance for the researchers and users. The paper reviews the comprehensive literature on behavioral finance and comes out with research gaps to further explore this emerging field having lots of research potential.

Keywords: Behavioral Finance, Financial Theory, Financial Markets, Financial Planning.

Introduction

Behavioral finance is a new concept in the contemporary philosophy of finance that aims to appreciate and expect psychological decision-making to have a systemic financial market impact. Behavioral finance is an analytical discipline that applies portfolio investment to behavioral principles. It is an interdisciplinary approach that incorporates insights from economics, psychology and sociology. There is mainly two theories relating the investors' behavioral aspects:

1. Standard finance/Expected utility theory
2. Behavioral finance/Prospect theories.

A prescriptive theory developed in 1952 by Markowitz is everyday finance theory. Standard finance is the body of information founded on the foundations of Miller and Modigliani's arbitrage principles, Markowitz's portfolio principles, Sharpe, Lintner and Black's capital asset pricing theory, and Black, Scholes, and Merton's option pricing theory. The standard view of finance is designed to provide mathematically, elegant explanations of sometimes complex financial problems. Such methods consider that markets are practical and highly rational and highly analytical.

Prospect theory is a mathematically constructed complement to the maximization of anticipated utility theory. The utility theory provides a concept of genuinely rational conduct under certainty. Investors are risk-averse, according to the predicted principle of utility. Aversion to risk is equal to the concavity of the utility function, that is, a decrease in the marginal utility of wealth—any normative. And the principle focuses on the maximization of capital—less valuation of the extra wealth unit than the previous equal rise in wealth. Despite the apparent appeal of this predicted utility principle, it has long been recognized that, at least in some cases, the theory has systematically failed to predict human actions.

The focus of the present study is to provide extensive literature reviews done on the behavioral finance world over and in India. The current research also focuses on emerging trends, issues, and challenges in behavioral finance. The paper starts with defining key terms in behavioral finance and covers topical literature reviews, and finally ends up providing research gaps and giving suggestions and conclusion.

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Literature Review

Kim & Nofsinger (2008) explained that how agents behave and their behavior affected financial markets. The research on behavioral finance possesses many challenges and hurdles, and they successfully addressed those challenges.

Alquraan *et al.* (2016) suggested that behavioral finance factors (Loss Averse, Overconfidence, and Risk Perception) have a significant influence on individual investors in Saudi Stock Market, while Herd has an insignificant effect.

Huang *et al.* (2016) evaluated the contribution of individual researchers and institutional contributors to behavior finance research from 1995 to 2013. According to the SCI / SSCI citation review, they also measured the influence of unique papers and individual authors.

Costa *et al.* (2018) the focus was on studying judgment errors and decision-making features in financial investments. Besides, it is concluded that the Behavioral Economics area is broader than the Behavioral Finance field since the latter is a by-product of Behavioral Economics. Finally, a conclusion is drawn, which shows that the Behavioral Economics and Finance fields have become a significant area of study.

Metawa *et al.* (2018) found that investment decisions are significantly affected by investor sentiment, over-reaction, and under-reaction, over-confidence, and herd behavior. Age, gender, and the degree of education also have significant positive effects on investor investment decisions. Experience does not play a significant role in investment decisions, but investors neglect emotional considerations when they accumulate experience.

Valaskova (2019): Fuzzy logic is valid when addressing financial management issues and financial decision-making problems. The urgency of the application of fuzzy logic to administrative and economic decisions should be stressed. Research in this field suggests that, in some situations, fuzzy logic is often more effective than the use of other approaches, as in the case of behavioral funding.

Antony (2019) found that by combining the behavioral biases, researchers have developed the behavioral portfolio model, which is a prescriptive model. The model was created as an extension of the model of capital asset pricing. The behavioral portfolio model illustrates why investors invest in various goals, such as potential family needs, retirement savings, and emergency response funds. Through designing the best portfolio and strategies to reduce risk by managing investors' emotions, the application of behavioral finance can assist in the policy-making process.

Upadhyay & Shah (2019) The significant effect on the decision-making process of individual stock market investors of some behavioral finance principles such as over-confidence, interpretation, representative, anchoring cognitive dissonance, Regret Aversion, narrow framing, and mental accounting have been discovered.

Bortoli *et al.* (2019) shown in their financial asset investment decisions, they explored the four paradigms of the risk profile manifested by investors. Prospect theory, investor profile analysis (IPA), the Big Five Personality Test, and the Cognitive Reflection Test (CRT) were the paradigms used to describe this profile. The proxy option for a typical investor's risk preferences (face) has been described by simulating investments in a laboratory setting. The findings were analyzed using ordered logistic regression. They showed that in their investment decisions, individuals who have greater risk tolerance according to IPA, who violate prospect theory, and who have a high degree of openness to experience are more likely to take higher levels of risk. Higher numbers of accurate answers in this test have an inverse relationship with risk-taking concerning the CRT.

Sharma & Kumar (2020): It helped to consider the problem of market efficiency and to shift the nature of the approach to asset pricing. This is done by identifying the holes in the philosophy of market efficiency and also suggesting how a superior strategy, such as behavioral finance, can bridge these gaps. The paper also points out differences and how they can be abridged by further discussion of current developments in behavioral finance so that behavioral finance is recognized as a standard alternative solution to EMH.

Königstorfer & Thalmann (2020): It has been shown that AI can be used in commercial banks in all core business areas. AI can be used to make accurate forecasts using previously unused data types in the context of lending. Credit risk models are more reliable, revenues can be improved, and new kinds of customers can be serviced by analyzing these new data types. Using AI for fraud detection and money laundering will make payment processing safer for consumers.

Kwatra (2020) proposed that, considering the recent economic down-turn, the existence of over-confidence and optimism bias provides sufficient evidence for growing markets. It also shows that behavioral psychology may have played a significant role in the selling of panics, which inevitably contributed to the worst market collapse in history (The Black Monday). It also highlights the role of Excessive Exuberance in building up major financial crises, in particular the Global Financial Crisis (2008-09).

Research Gap

The various past studies done on behavioral finance were more conceptual and theoretical, and some empirical research studies related to behavioral finance were done with the help of multiple models. These models help in analyzing factors influencing the finance decisions. Many authors have focused on conceptual work on behavioral finance, and thus, literature revealed that tiny empirical job was done on behavioral finance and its related aspects.

In light of relevant literature on behavioral finance, there is a significant gap found in the contextual studies as per the Indian sub-continent. The existing literature, specifically in behavioral finance is minimal, which leads to the need for research studies that contribute to the relevant literature. Another gap has been found for future research showing the effect of demographics (Gender, Age, Education, Income, Occupation, etc.) on the use of behavioral finance. Along with the conceptual and theoretical studies, there is a need to conduct more empirical studies in developing countries like India to generate mass knowledge about behavioral finance that can be meaningfully used by researchers, users, and banking industries for promoting excellence in the competitive business environment.

Conclusion and Suggestions

Behavioral finance proposes hypotheses based on psychology to describe financial market anomalies, such as extreme stock price increases or falls. The aim is to recognize and understand why investors make such financial decisions. Within behavioral finance, the structure of knowledge and the characteristics of market participants are believed to systematically affect the investment decisions of individuals as well as market performance. Accepting behavioral concepts, financial decision-making teaches investors to make effective choices to improve performance and meet strategic organizational objectives. To understand how investors manage the data and take action, behavioral finance also incorporates psychology, sociology, and other empirical approaches to studying investment behavior.

It is suggested that researchers find out various features and factors that lead to the increased utilization of green banking. Further, exploring factors affecting users' opinions about green banking will also contribute to today's competitive world. Many banks, corporate and government agencies can be highly benefitted from the findings of such researches; therefore, researchers may conduct the study on behavioral finance in their further studies.

Systematic risk is beyond the control of investors and financial institutions. COVID-19 was a major factor affecting investor perspective before the outbreak; Household income level, demographic convenience associated with the investor, risk associated with security, type of security, other investment options available in the market. Liquidity is the driving force for investors because the bird is better at hand than the bird later.

With the outbreak of COVID-19, individual investors suffered the most. Investors' wealth collapses due to the volatility of market conditions. Stock market indices are low all the time in the COVID period. Household income has dropped so they couldn't invest the same anymore. Companies will have to reduce their operations which leads to sporadic increases, the wages of employees were reduced at the time of COVID. People engaged in non-essential activity lose jobs for a certain period of time. The tourism industry and related industries suffered the most.

Among those who ate the most traps by the internment were regular wage earners, followed by casual employees and employees of their own accounts. Rumors of a decline in the earnings of families thanks to the Internment (CMIE); In such homes, people who are fascinated by the source of income are very grateful for the internment. On the contrary, the relationship continued to earn WHO who were salaried workers and would work from home.

Gold can be a relatively safe investment given the volatile market conditions and uncertain returns. In times of financial crisis the value of relevant, risky money assets goes down comparatively, at the same time

because the decline in costs in one market is contaminated in different markets, and investors have a pastoral behavior that ends up filling the step.

It is believed that e-Gold is a safe investment in times of political and monetary expectations. He has thought about the hedge against inflation and currency depreciation. It takes care of intensive stimulation processes (*Economic Times*, June 25, 2020). Gold is a collaborative quality that seems ready to rise in price even in precarious and difficult times. With domestic gold spending record highs, analysts examine the upward momentum for brass. Throughout COVID-19, the mad cow disease Sensex jumped to twenty-five, 981 points, from its peak of twenty-two, 320 points in March 2020. While the mad cow disease has since improved significantly, it still needs its previous high level. However, gold traded up about 20 pc in March. Has surpassed all optional quality categories since, and has produced fifty PCs in the last one year. 49,000 in the domestic market (ET markets).

The main reasons behind declining investment are reduction in unit financial gain and keeping money for crisis. Alternative reasons cited by respondents include a decline within the stock exchange (Nifty Fifty and Sensex down 38%-40%); Mutual funds gave negative returns during the Great Depression.

The reason behind the decline in investment was mainly due to the reduction in business financial gains due to the interment measures implemented by the central government.

In the previous crisis, the cost of gold had risen to nineteen crores. However, our respondents rumored that thanks to the measures of internment and social distance, all gold outlets have closed and they are not ready to buy physical gold. It was found that the respondents were not warning for Gold ETFs, i.e., Exchange Listed Fund Corporations. However, his choice to speculate in gold—a safe haven—was expressed by many investors.

The COVID-19 incident has significantly reduced the economy. Given the large population of the economy and the problematic circumstances, the financial sector in particular and the internment and social gaps have been tested to uncertainty. The steps taken by the government to unveil COVID-19 of the Internet and the stock exchange crash, the tendency of individual investors to speculate in mutual funds and the stock exchange being negatively overtaken. At the time of the gift, investors appear to have the specialty of additional risk, and the choice of comparatively safer investments than the medium offering returns with less risk. Investors need to be educated about gold ETFs, time to get in and out of stock exchanges and fund schemes. It jointly throws a little light on the fact that funding organizations and policy-makers should campaign in smaller cities to accelerate money acquisition of individuals.

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