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CONTEMPORARY PROBLEMS IN BEHAVIORAL FINANCE

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Abstract

Behavioral finance research is still in its infancy. In an attempt to comprehend why people make illogical financial decisions, this integrates behavior and cognitive psychology principles with traditional and emotional finance ideas. Human behavior, sociology, and economics and finance are the three disciplines that make up behavioral finance. It is the study of how individuals recognize their feelings in social situations. According to conventional financial theories, individuals make rational investment decisions after carefully considering pertinent factors in an effort to maximize profits and reduce losses. This article talks about common emotional mistakes that investors make when making decisions. To conduct the study, researchers have collected 546 observations. To ascertain, statistical techniques like factor analysis and multivariate regression are applied. Researchers discovered a strong correlation between mental accounting, remorse, availability, anchoring, and representative biases as well as herd behavior.

Keywords: herd behaviour, mental accounting, biases, behavioural finance, irrational financial decisions.

Introduction

According to conventional finance, investors have proven over the past 50 years to be informed, cautious, dependable, and not very difficult to make financial decisions for themselves. Furthermore, the theory states that investors are not influenced by feelings or perplexed by the manner in which information is conveyed to them. The actual situation deviates from these assumptions. Emotional and psychological factors may also influence investing decisions, according to behavioral finance. Behavior finance considers an individual's behavior when making investments, in addition to the traditional financial paradigms that center on rational investment decision-making. HH. Shefrin (1988) stated that behavioral finance studies looked at how psychology affected financial markets and decision-making. The underlying premise of conventional financial theory is that individuals are rational agents who base their decisions on a deep understanding of the market and the dynamics of risk and return. More research on financial decisions, however, is showing that human intents, feelings, instincts, and routines all influence financial decisions. Individuals make investing decisions due to a variety of psychological aspects that conventional financial theories were unable to account for. One comparison between

behavioral finance and behavioural economics is that the former integrates psychology and economics. In order to understand why people make irrational choices when it comes to spending, saving, and investing, we attempted to offer an alternative theoretical framework in this study for the hypothetical behavior of investors. This essay aims to clarify how and why reason is so heavily influenced by irrationality that it nearly eradicates it in the stock market.

Objectives of Research:

1. To comprehend the reasons behind illogical financial decisions made by individuals.
2. How behavioral biases affect investors' decision-making when making investments.
3. To determine the extent to which other behavioral biases and investor herd behavior are related.

Literature Review

The first to draw attention to the influence of human behavior on the performance of financial markets was Seldon (1912). He maintained that the psychological makeup and attitudes of the investing community have an impact on stock price volatility. Later research by Pratt (1964) focused on helping traders understand the dangers involved and make judgments based on how much they trade compared to the total amount of money they make. The study comes to the conclusion that investor trading volume is determined by internal fears and perceived risks rather than market risk. The concept of heuristic judgment was initially introduced by Tversky and Kahneman (1973) and dubbed "heuristic availability" since it allowed humans to assess their own existence. Depending on whether people rely more on their psychological reasoning than market performance indicators to make decisions, this leads to systematic bias.This demonstrates that people don't always make well-informed decisions or utilize all the facts at their disposal. The prospect theory, which was developed by Kahneman & Tversky in 1979, challenges the theory of utility, which holds that people value losses differently than gains. Moreover, the theory of application is unable to explain why investors are drawn to both gambling and insurance at the same time. Researchers have found that people tend to make decisions based more on perceived gain than perceived loss. This means that if someone is presented with two options, one of which is presented in terms of potential benefits and the other in terms of potential loss, they will choose the option that is presented in terms of potential benefits even though both options offer the same utility. The idea also emphasizes the disposition's result, which holds that people hold equities they lose and sell those they profit from. This behavior implies that losing stocks are sold to avoid losses and winning stocks are sold for maximum returns. Tversky and Kahneman (1981) discovered that how a choice is presented—as a win or a loss—affects how individuals respond to it. This alludes to independent research suggesting that people alter their opinions when the same issue is presented to them in various ways. It has been demonstrated that when given a sound framework, people do not take risks; yet, when given a poor framework, they expose themselves to danger. They made the point that how a question is posed or featured might influence how individuals respond to it, and that decisions can even be influenced by the quantity of options offered. Humans respond, according to Bondt & Thaler (1985), to unexpected situations They've

discovered that overreactions to these problems and occurrences cause market inefficiencies in the stock market. When human opinion needed to be changed, Samuelson &Zeckha user (1988)1conducted additional individual decision-making tests to ascertain the reasoning behind it. It has been discovered that bias does not cause people to change. Positive serial affinity for short-term benefits and negative negative serial affiliations over the long term were discovered by Poterba & Summers (1988). A revised version of the prospect theory known as the "cumulative prospective theory" was introduced by Tversky and Kahneman in 1992. The distribution function of increasing opportunities is used in this model to apply weights to gains and losses. Lakonishok, Shleifer, and Vishny (1994) provide a value proposition pertaining to the investing life cycle that involves purchasing stocks at a discount to earnings and other fundamental value estimations. This will enable the investor to profit more from the transaction. Al (1998) introduced a model that reflected investor attitudes. It displayed disproportionate reactions to stock prices upon receiving positive or negative news, as well as under reactions of share prices to news pertaining to profit declarations. Hong, Lim, and Stein (2000) examine the relationship between firm-specific information and stock returns, arguing that any direct corporate information is widely known to the public and causes volatile stock returns; positive news is positively correlated with returns, and negative news is negatively correlated with stock returns. Shefrin (2002) examined and distinguished three areas of financial ethics:

(A) Heuristics advise individuals to base their choices on the sixth law.

(B) Framing: How a situation is presented to a decision-maker affects how that decision-maker responds to it.

(c) Market inefficiency: denotes irrational behavior; stock prices do not accurately reflect the information that decision-makers have access to, including the perplexing returns. Five biases that generally influence stock market participants' behavior were discovered by Mercer Consulting (2006);

Research Methodology:

The goal of this study is to learn more about the psychological and emotional factors that influence investors' judgments. The question of how and why a logical investor makes an irrational financial decision has been attempted to be answered. Researchers have utilized descriptive analysis to determine how investors' psychological factors cause them to become disengaged from reason.

Research Design: The purpose of this study was to investigate how behavioral biases affect the investing choices made by individual investors in Lucknow.

Hypothesis: The hypothes is for the study was suggested as follows:

H0: There is no significant1relationship b/w Herd Behaviour & other Biases.

H1: There is a significant1relationship b/w Herd Behaviour & Representative Bias.

H2: There is a significantrelationship b/w Herd Behaviour & Mental Accounting.

H3: There is a significant1relationship b/w Herd Behaviour & Anchoring Bias.

H4: There is a significant1relationship b/w Herd Behaviour & Loss Aversion Bias.
H5: There is a significant1relationship b/w Herd Behaviour & Availability Bias.
H6: There is a significant1relationship b/w Herd Behaviour & Cognitive Dissonance.
H7: There is a significant1relationship b/w Herd Behaviour &Regret Bias.

Sources of Information: Data has been collected through a questionnaire. Data from 546 respondents were taken for the study.

Mean, Standard deviation

Items	Observation	Mean	Standard deviation
Gender	546	0.401	0.490
Age	546	2.857	0.707
Qualification	546	1.996	0.535
Occupation	546	1.573	0.893

Lables	N	Sign	Inter Test Correlation	Inter Rest Correlation	Inter Item Covariance	Alpha
If you have lost your previous investment in the stock market, would you like to	546	+	0.4374	0.3919	0.162204	0.8706
If you have made a profit on your previous investment in the stock market, would	546	+	0.5761	0.539	0.159448	0.8682
If you have been lossed in the stock market and currently you are seeing good opportunity	546	+	0.6131	0.5781	0.158564	0.8675
Your investment decisions is based on companies fundamentals such as dividend pa	546	+	0.5883	0.5525	0.159331	0.868
You want to invest in stocks that are constantly advertisedin news	546	+	0.6074	0.5708	0.158371	0.8675
You buy undervalued securities and sell overvalued securities	546	+	0.6266	0.5926	0.158337	0.8673
Before making an investment you do a risk return analysis	546	+	0.6573	0.6244	0.157336	0.8666
You don't sell a losing stock with the hope that stock price will rise again	546	+	0.5955	0.5598	0.15909	0.8679
While making an investment decision you consider potential gain as the most important	546	+	0.6268	0.5928	0.158304	0.8673
My own skills and understanding have made my future investment successful	546	+	0.5337	0.4943	0.160389	0.869

You are likely to buy the stocks that have high trading volumes	546	+	0.6016	0.5657	0.158806	0.8677
When I think of investments with a risk component, I become pretty apprehensive.	546	+	0.5393	0.4953	0.159194	0.8686
If the value of your shares falls, you resist selling them.	546	+	0.5957	0.5598	0.159012	0.8679
You feel disappointed when you are unable to acquire or sell a share when an opportunity arises.	546	+	0.598	0.5624	0.159043	0.8678
When you don't have knowledge on a stock, you normally go with what the bulk of people do.	546	+	0.4503	0.3996	0.161037	0.8703
Do you feel that the decision you have taken will definitely make you profit, no	546	+	0.4135	0.3619	0.162047	0.8711
You feel that your loss in the stock market was due to your wrong decision?	546	+	0.3376	0.2843	0.164003	0.8724
If lost continue I don't want to buy stock ever again	546	+	0.3068	0.2503	0.164561	0.8731
I am looking forward my next opportunity to invest after a deep fall in the mark	546	+	0.5004	0.4576	0.160764	0.8695
If loss happens in my investment I will sell all my stock to avoid future loss	546	+	0.3305	0.275	0.164	0.8727
Do you invest based on expert's predictor (analyst)	546	+	0.3854	0.2879	0.158557	0.8757
You are more upset about holding losing stocks for an extended period of time than you are about selling winning stocks.	546	+	0.5584	0.5181	0.159322	0.8684
Can you take high risk for high return in stock market?	546	+	0.4992	0.4558	0.160693	0.8695
Suppose the stock of ABC Company has outperformed (better) the market for past s	546	+	0.4624	0.4159	0.161325	0.8701
You purchase hot companies and avoid stocks that have underperformed in prior years.	546	+	0.4918	0.4492	0.161092	0.8696
You believe that a stock's future trend may be forecast based on its price history.	546	+	0.4815	0.4366	0.160976	0.8698
You are confident in your abilities & expertise to outperform (bet).	546	+	0.4538	0.4063	0.16142	0.8703
If all of your coworkers start purchasing o, your attitude toward stock will alter.	546	+	0.4222	0.3718	0.161963	0.8709

I'm searching for a high rate of return on my investment. I am willing to consider the possibility of	546	+	0.48	0.4356	0.161125	0.8698
Suppose you are hear about a great stock tip from your friend who has a good sto	546	+	0.3306	0.2788	0.164335	0.8725
You invest in market where gain and loss have same chance	546	+	0.4883	0.4442	0.160902	0.8697
I believe the stocks that I own will never move in favor because of confused mar	546	+	0.374	0.3238	0.163349	0.8717
At which rate do you want your investment to grow?	546	+	0.1354	0.1106	0.16942	0.8741
At what particular time do you invest?	546	-	0.068	0.001	0.170499	0.8783
Assume you have some money to invest and a choice b/w two investment products.	546	+	0.1469	0.1195	0.169205	0.8741
Imagine that stock market drops after you invest in it then what will you do?	546	-	0.0538	0.0198	0.170257	0.8752
What percentage of your income do you invest?	546	-	0.0451	0.0018	0.170495	0.876
Even if there was danger involved, I would go for the highest potential return.	546	-	0.2022	0.1432	0.167102	0.8751
How would you describe your normal demeanour while making major financial decisions?	546	+	0.083	0.0187	0.170047	0.8777
What is the time period you prefer to invest?	546	+	0.1366	0.1057	0.169208	0.8743
If you chose an investment with the potential for significant rewards but also the danger of loss,	546	-	0.0929	0.0278	0.169804	0.8776
What kind of investments you have made so far	546	+	0.0704	-0.0385	0.172193	0.886
Are you aware of the concept- Behavioral finance	546	+	0.3477	0.3175	0.166289	0.8722
You feel happy when your investment starts making profit	546	+	0.6245	0.5913	0.158674	0.8674
Mean					0.162775	0.8739

The Cronbach Alpha was found to 0.87. Thus suggesting the item have high correlation between themselves. The alpha value > 0.7, thus can be used further for statistical test.

Factor	KMO	X2	df	p
Mental Accounting	0.735	15	470.38	0.000
Herd Behaviour	0.760	15	507.50	0.000
Anchoring Bias	0.808	10	716.78	0.000
Representative Bias	0.500	1	132.56	0.000

Loss Aversion Bias	0.546	3	111.50	0.000
Regret Bias	0.500	1	74.41	0.000
Availability Bias	0.594	3	139.55	0.000
Cognitive Dissonance	0.607	3	121.27	0.000

There is a significant degree of correlation between the data for every variable, as shown by KMO values >.5 and p <.05. proving that the sample is sufficient.

Principal component analysis was used to conduct factor analysis. Mental accounting and the latent variable Herd Behavior produced two factors, of which factor 1 was taken into consideration for the investigation. Just one component was produced by the remaining latent variables.

Herd Behaviour	B	e	t	p
const	4.508	.027	0.000	1.000
Representative Bias	0.080225	0.039538	2.03	0.043
Mental Accounting	0.333896	0.041607	8.02	0
Anchoring Bias	0.337168	0.04314	7.82	0
Loss Aversion Bias	0.021742	0.029132	0.75	0.456
Regret Bias	0.08732	0.035932	2.43	0.015
Availability Bias	0.084925	0.034751	2.44	0.015
Cognitive Dissonance	-0.00611	0.033561	-0.18	0.856

Findings:

1. The researchers discovered that the expected value of herd behavior changes by 0.08 units for every unit change in representational bias. Given that the p value is.043, which is less than the 0.05 significance level, herd behavior and representational bias have a positive and significant association.
2. Because p values (000) are less than the significance level, it has been shown that a one-unit change in mental accounting is related with a 0.33-unit change in the anticipated value of herd behavior and has a positive significant association with the herd behavior.
3. A one-unit change in anchoring bias has been found to be correlated with a 0.33-unit change in the expected value of herd behavior. Given that the p value is 000, it can be concluded that anchoring bias and herd behavior are positively correlated.
4. Because p 1value (.456) is more than significance1level (0.05), researchers discovered that a one-unit change in loss aversion bias is linked to a 0.02-unit change in the expected value of herd behavior, with no correlation between them.
5. There is a positive and statistically significant correlation between herd behavior and regret bias, with a one-unit change in regret bias being correlated with a 0.08-unit change in the projected value of herd behavior. Less than 0.05 is the justification for the significance threshold of 0.015.

Conclusion:

To achieve the goal of explaining why irrationality gives way to rationality in personal financial decision-making, researchers have conducted studies to ascertain the nature of the relationship and quantify the degree of relationship between behavioral biases and investor herd behavior. Through research, we have demonstrated that loss aversion bias and cognitive dissonance, two of the seven independent components, have no discernible relationship to herd behavior. However, the other three—representative bias, mental accounting, anchoring bias, regret bias, and availability bias—all have a strong and positive correlation with herd behavior when it comes to investors' financial decision-making about investments..The two factors that have the biggest positive impacts on herd behavior for investors are mental accounting and anchoring bias. The highest positive connection between mental accounting and the reasons for the biggest positive relationship between herd behavior and anchoring bias could be explained by investors purchasing high-volume equities and holding onto their holdings when volume declines. The financial decisions made by investors can be supported by these facts.

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