The Role of Psychological Factors in Financial Decision Making of Investors

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Abstract: Investment decisions are central for the development of the country’s economy. Investment decisions by investors go through a batch of assessments of various factors such as political factors, economical factors, company factors, market factors, technological factors and so on. Beyond these factors there are some individual internal factors that affect the investment decisions of the investors, aforesaid internal factors are known as behavioral factors or psychological factors of investors. The objective of this paper is to conceptually scrutinize the psychological factor’s role on investment decision making of the investors.

Keywords: investment decisions, external factors, behavioural factors, investors decision making process.

I. INTRODUCTION

Investors have various reasons for investing in stock market. Some people invest for good return, or to gain regular income with long term return, or to gain bonus shares, some investor are invest for the purpose of becoming the owner of the firm, some for taking dividend and some invest for capital gain etc. Investment decisions are mainly concerned with various rational and behavioural factors. The traditional theory of finance is based on the assumption that individuals act rationally and consider all available information in their financial decision making process. And this theory affirm that the financial markets are determined by many factors such as economic, political, industry, company, information technology factors etc; which takes place within the country or outside the country. Beyond these factors one of the most important factors are the people’s reaction and perception (psychology). Behavioural finance is the area which concentrates on the people’s reactions and perception toward stock markets.

“The ignorance of behavioral factors are very harmful for investment decision because when investor is rational, he takes the decision without acknowledge the behavioral factors like emotion and bias, in the end result he blames ourselves in case of loss.” (Kahneman and Riepe, 1998).

II. EMERGENCE OF BEHAVIOURAL FINANCE

During earlier period, investment was based on analyzing the various traditional factors such as political uncertainty, GDP, inflation rate, stock market conditions, dividends, rapid growth etc. Despite that, the results produces through these analyses is very low comparing to actual results. There is a huge gap between the calculated returns and actual returns. While searching into the reasons, the researchers identified that irrational behavior of investors and visualize the impact of psychology in investor’s decision making process. Then the researchers start analyzing about the field of Behavioural Finance to understand the psychological process of investors. Nowadays the field of behavioural finance is popular across the world stock markets. Yet, it is essential to study both market factors as well as behavioural factors to reach the financial goals with the right mix of investments. Many researchers conclude that the behavioral finance is a good concept to understand and define the emotions, feelings and other behavioral factors affecting investment decision making and performance.

III. ROLE OF PSYCHOLOGICAL FACTORS IN INVESTOR’S DECISION MAKING PROCESS

The psychological factors involve two important theories one is heuristic theory and second is prospect theory. Heuristic theory involves overconfidence, representativeness, anchoring, gambler’s fallacy and availability bias and prospect theory involves Loss aversion, regret aversion and mental accounting. These are the factors which involves in the behavior of individual investor and affect the performance and decision making of investor.
y representativeness, probability of certain future research gets more attention in finance literature.

Availability:
Based on the availability bias, people tend to react to changes or news and become less likely to make decisions like poor information’s, complex investing circumstances and market instability and so on.

d. Gambler’s Fallacy:
When an individual erroneously believes that the onset of a certain random event is less likely to happen following an event or a series of events. This type of thinking is inexact because past events do not change the probability of certain future events. Suppose you have flipped a coin and it has come up heads several straight times. The gambler’s fallacy is the belief that tails is more likely to occur on the next toss. The likelihood of heads or tails is 50/50 on every throw. Each toss is totally independent of the other tosses. Gamblers often base their theories on the incorrect assumption that something is “bound to happen”.

e. Anchoring:
Anchoring happens when investor cannot integrate new information into their thinking because they are too “anchored” to their existing views. They do not give new information its due, especially if it contradicts their previous views. By devaluing new information, they tend to under-react to changes or news and become less likely to act.

Heuristics can lead to things like stereotypes, prejudice, bias etc. Because people use mental shortcuts to classify and categorize situations, they often overlook more relevant information and create stereotyped categorizations that are not in touch with reality.

V. PROSPECT THEORY
Prospect theory was developed by Kahneman and Tversky (1979). In its basic form, it is interested in the behaviour of decision makers who have to make a choice between two alternatives.

Kahneman and Tversky started their research investigating apparent anomalies and contradictions in human behaviour. Subjects when offered a choice depicted in one way might display risk-aversion but when offered the same choice put in a different way might show risk-seeking behaviour.

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<th>GROUP</th>
<th>BEHAVIORAL VARIABLES</th>
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<td>- Overconfidence</td>
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<td>- Volume of stock to trade of other investors</td>
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<td>- Speed of herding</td>
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IV. HEURISTICS THEORY
Heuristics play a vital role in both decision making and problem solving. It involves simple experience-based techniques for problem solving, known as rules-of-thumb or a shortcut, which have been introduced to explain how investors make decisions, especially during periods when it is difficult to make decisions like poor information’s, complex investing circumstances and market instability and so on.

a. Representativeness:
Representativeness involves the making a decision by comparing the present situation with the most representative mental model. The definition of representativeness is explained by Tversky and Kahneman as quoted: “When judging the probability of an event by representativeness, one compares the essential features of the event to those of the structure from which it originates. In this manner, one estimates probability by assessing similarity or connotative distance” (Tversky and Kahneman, 1973). That is to say, representativeness is a process of overreliance on stereotypes. Similarly speaking, it is a decision making rule of thumb that people use to judge the similarity of something by how well it looks like a particular prototype. It makes people ignore useful information.

b. Availability:
Based on the availability bias, people tend to heavily weight their decisions toward more recent information, making any new opinion biased toward that latest news. For example, the stocks of corporations that get good press get more attention than companies that has less publicity. But in reality sometimes these “high-profile” companies may actual have worse earning than the less publicized companies.

c. Overconfidence:
It is a mental shortcut that affects an individual’s risk perception because there are many methods in which a person tends to be overconfident about his decision related to risk-taking behaviour. According to Daniel and Titman (2000), overconfidence is one of the most documented biases in the behavioural finance literature. Confidence can be described as the faith in oneself and one’s abilities with full conviction, whereas overconfidence can be taken a step further in which overconfidence takes this self-reliant behaviour to an extreme (Ricciardi and Simon, 2000a, p.13).

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For example, as Kahneman says, “people may drive across town to save $5 on a $15 calculator but not drive across town to save $5 on a $125 coat.” One very essential result of Kahneman and Tversky work is proving that people's attitudes toward risks related to gains may be completely different from their attitudes toward risks concerning losses. For example, when given a choice between getting $1000 with certainty or having a 50% chance of getting $2500 they may choose the certain $1000 in preference to the uncertain chance of getting $2500 even though the mathematical outcome of the uncertain choice is $1250. This is a perfectly reasonable attitude that is described as risk-aversion. But Kahneman and Tversky found that the same people when faced with a certain loss of $1000 versus a 50% chance of no loss or a $2500 loss do often choose the risky alternative. This is called risk-seeking behaviour. This is not necessarily irrational but it is essential for analysts to recognize the asymmetry of human choices - Kahneman and Tversky (1979).

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<th>GAINS</th>
<th>LOSSES</th>
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<tr>
<td>HIGH PROBABILITY (Certainty Effect)</td>
<td>95% chance to win $10,000</td>
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<td></td>
<td>Fear of disappointment</td>
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<tr>
<td>RISK-VERSE</td>
<td>RISK-AVERSE</td>
</tr>
<tr>
<td>LOW PROBABILITY (Possibility Effect)</td>
<td>5% chance to win $10,000</td>
</tr>
<tr>
<td></td>
<td>Hope of large gain</td>
</tr>
<tr>
<td>RISK-SEEKING</td>
<td>RISK-VERSE</td>
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Source: https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/prospect-theory/

a. Loss Aversion:
In respect to prospect theory, loss aversion means that people prefer to avoid losses than acquire gains. The theory was first introduced and postulated in 1979 by Daniel Kahneman and Amos Tversky, under the assumption that losses have a greater impact on preferences than that of the advantages of gains. Some studies assume that losses are as much as twice as psychologically strong as gains. Loss aversion is based on the idea that the mental penalty related to a given loss is greater than the mental reward from a gain of the same size.

b. Regret Aversion:
Regret aversion arises, when investors have the desire to avoid experiencing the pain of regret, resulting from a poor investment decision. For example, if an investor decided to sell a share and then it risen up. Here the investor might have felt regret from selling at that time but beware: the fallout could intensify the investor and he try to avoid such strain in the future. According to behavioural economists, the next time that investor considered selling or buying he might be biased. He might try to minimise regret by not acting. This tendency to avoid taking an action due to fear that it will turn-out to have been the worse option is known as “regret aversion”.

c. Mental Accounting
Mental Accounting bias was first explored by Professor Richard Thaler in 1980. According to Richard Thaler, people think of value in relative rather than absolute terms. Mental accounting refers to the tendency for people to separate their money into separate accounts based on a variety of subjective criteria. People usually classify their wealth into three as current income, current as assets and future incomes. As a result of mental accounting bias, people tend to behave differently depending upon the scenario. In other words, people treat money differently depending upon the source of money. For instance, if a person win a lottery of Rs.10000, he spend differently than the money earned by his monthly income.

To put in a nutshell, prospect theory describes the behaviour of people who accept gambles when they are less than their levels of aspiration but refuse such gambles when they are above their levels of aspirations.

VI. HERD BEHAVIOUR
Herd behaviour in investing is sometimes called the conformity trap or following the crowd. In other word, it is when investors copy each other (Banerjee 1992, Bikhchandani and Sharma 2000, Hwang and Salmon 2004). Herd investing is said to
have contributed too many dramatic movements in markets over hundreds of years. Among the most famous examples are the Dutch “tulip bulb mania” of 1630s, the “Japanese asset bubble” of the late 1980s, the “dot-com” boom in the late 1990s and the housing market dynamics that contributed the global financial crisis from 2007 onwards. On the stock market, herd behaviour is when investors follow others’ behaviours, even when their private information announces them to act another way.

VIII. CONCLUSION

There are various factors which influence investor’s decision making process such as demographic factors of investors, economic factors, social factors, market factors etc, among these one of the most important factor that influence investor decision making process is various behavioural and psychological factors. So it is important for the investors to get aware about these behavioural factors while making investment decisions, to achieve their financial and investment goals effectively.

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