

The Study of behavioral financial effect on Investors Behavior

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ABSTRACT: Research in behavioral finance is relatively new. Within behavioral finance it is assumed that information structure and the characteristics of market participants systematically influence individuals' investment decisions as well as market outcomes. According to behavioral finance, investor market behavior derives from psychological principles of decision making to explain why people buy or sell stocks. The research we have done was on the topic "Factors Influencing the Individual Investor Behavior". The behavioral finance revolution in academic finance in the last several decades is best described as a return to a more eclectic approach to financial modeling. The earlier neoclassical finance revolution that had swept the finance profession in the 1960s and 1970s represented the overly-enthusiastic pursuit of only one model. Freed from the tyranny of just one model, financial research is now making faster progress, and that progress can be expected to show material benefits. An example of the application of both behavioral finance and neoclassical finance is discussed: the reform of Social Security and the introduction of personal accounts. The current state of research from the efficient market and behavioral perspectives therefore suggests that an inclusive and diverse approach in the choice of theoretical explanations of the behavior of financial markets will be the pragmatic response to the inconclusive results on either side of the debate. While, on the one hand, investors are not making large sums of money from market anomalies, not many people will disagree that the stock market bubble burst of 2000 or in 2008 is better explained by hubris and irrational exuberance grounded in behavioral finance than by the efficient markets theory.

Keywords: Individual investor, , Investor behaviour, Market, theories.

INTRODUCTION

Behavioral finance is the paradigm where financial markets are studied using models that are less narrow than those based on Von Neumann–Morgenstern expected utility theory and arbitrage assumptions. Specifically, behavioral finance has two building blocks: cognitive psychology and the limits to arbitrage. Cognitive refers to how people think. There is a huge psychology literature documenting that people make systematic errors in the way that they think: They are overconfident, they put too much weight on recent experience, etc. Their preferences may also create distortions. Behavioral finance uses this body of knowledge rather than taking the arrogant approach that it should be ignored. Limits to arbitrage refers to predicting in what circumstances arbitrage forces will be effective, and when they will not be.

According to economic theorists', investors think and behave "rationally" when buying and selling Stocks. Specifically investors are presumed to use all available information to form "rational Economy Expectations" about the future in determining the value of companies and the general health of the Economy. Consequently, stock prices should be accurately reflect fundamental values and will only move up and down when there is unexpected positive or negative news, respectively. Thus Economists have concluded that financial markets are stable and efficient, stock prices follow a "Random walks and the overall economy tends toward "general equilibrium".

In reality however, according to Shiller, (1999) investors do not think and behave rationally. To The contrary, driven by greed and fear, investors speculate stocks between unrealistic highs and Lows. In other words, investors mislead be extremes of emotion, subjective thinking and the Whims of the crowd, consistently form irrational

expectation for the future performance of Companies and the overall economy such that stock prices swing above and below fundamental Values and follow a somewhat predictable, wave-like path.

Behavior of investors is a part of academic discipline known as "financial-behavioral" which states how feeling and cognitive errors influence investors and their decision-making. It is long time that the behavior of individual investors is interested academias and managers of securities, but not investors because sometimes mentality of public dominates rationality. Behavior of people is caused by the involuntary intellectual interaction in individuals who react to others' behavior signals (Proctor, 1999).

Definition of financial-behavioral

Behavioral finance attempts to explain and increase understanding of the reasoning patterns of investors, including the emotional processes involved and the degree to which they influence the decision-making process. Essentially, behavioral finance attempts to explain the what, why, and how of finance and investing, from a human perspective. For instance, behavioral finance studies financial markets as well as providing explanations to many stock market anomalies (such as the January effect), speculative market bubbles (the recent retail Internet stock craze of 1999), and crashes (crash of 1929 and 1987). There has been considerable debate over the real definition and validity of behavioral finance since the field itself is still developing and refining itself. This evolutionary process continues to occur because many scholars have such a diverse and wide range of academic and professional specialties.

In reviewing the literature written on behavioral finance, our search revealed many different interpretations and meanings of the term. The selection process for discussing the specific viewpoints and definitions of behavioral finance is based on the professional background of the scholar. The discussion within this paper was taken from academic scholars from the behavioral finance school as well as from investment professionals (Ricciardi and Simon, 2000).

Standards of Finance

Current accepted theories in academic finance are referred to as standard or traditional finance. The foundation of standard finance is associated with the modern portfolio theory and the efficient market hypothesis. In 1952, Harry Markowitz created modern portfolio theory while a doctoral candidate at the University of Chicago. Modern Portfolio Theory (MPT) is a stock or portfolios expected return, standard deviation, and its correlation with the other stocks or mutual funds held within the portfolio. With these three concepts, an efficient portfolio can be created for any group of stocks or bonds. An efficient portfolio is a group of stocks that has the maximum (highest) expected return given the amount of risk assumed, or, on the contrary, contains the lowest possible risk for a given expected return. Another main theme in standard finance is known as the Efficient Market Hypothesis (EMH). The efficient market hypothesis states the premise that all information has already been reflected in a security's price or market value, and that the current price the stock or bond is trading for today is its fair value. Since stocks are considered to be at their fair value, proponents argue that active traders or portfolio managers cannot produce superior returns over time that beat the market. Therefore, they believe investors should just own the "entire market" rather attempting to "outperform the market." This premise is supported by the fact that the S&P 500 stock index beats the overall market approximately 60% to 80% of the time. Even with the preeminence and success of these theories, behavioral finance has begun to emerge as an alternative to the theories of standard finance.

The Performance of Individual Investors

In research published through the late 1990s, the study of investor performance had focused almost exclusively on the performance of institutional investors, in general, and, more specifically, equity mutual funds. This was partially a result of data availability (there was relatively abundant data on mutual fund returns and no data on individual investors). In addition, researchers were searching for evidence superior investors to test the central prediction of the efficient markets hypothesis: investors are unable to earn superior returns (at least after a reasonable accounting for opportunity and transaction costs).

While the study of institutional investor performance remains an active research area, several studies provide intriguing evidence that some institutions are able to earn superior returns. Grinblatt and Titman (1989) and Daniel, Grinblatt, Titman, and

Wermers (DGTW, 1997) study the quarterly holdings of mutual funds. Grinblatt and Titman concludes (p.415) "superior performance may in fact exist" for some mutual funds. DGTW, (1997) use a much larger sample and time period and document (p.1037) "as a group, the funds showed some selection ability." In these studies, the stock selection ability of fund managers generates strong before-fee returns, but is insufficient to cover the fees funds charge.

In financial markets, there is an adding up constraint. For every buy, there is a sell.

If one investor beats the market, someone else must underperform. Collectively, we must earn the market return before costs. The presence of exceptional investors dictates the need for subpar investors. With some notable exceptions, which we describe at the end of this section, the evidence indicates that individual investors are subpar investors.

To preview our conclusions, the aggregate (or average) performance of individual investors is poor. A big part of the performance penalty borne by individual investors can be traced to transaction costs (e.g., commissions and bid-ask spread). However, Transaction costs are not the whole story. Individual investors also seem to lose money on their trades before costs.

The one caveat to this general finding is the intriguing evidence that stocks heavily bought by individuals over short horizons in the U.S. (e.g., a day or week) go on to earn strong returns in the subsequent week, while stocks heavily sold earn poor returns. It should be noted that the short-run return predictability and the poor performance of individual investors are easily reconciled, as the average holding period for individual investors is much longer than a few weeks. For example, Barber and Odean, (2000) document that the annual turnover rate at a U.S. discount brokerage is about 75% annually, which translates into an average holding period of 16 months. (The average holding period for the stocks in a portfolio is equal to the reciprocal of the portfolios' turnover rate.) Thus, short-term gains easily could be offset by long-term losses, which are consistent with much of the evidence we summarize in this section (e.g., Barber, Odean, and Zhu, 2009).

It should be noted that all of the evidence we discuss in this section focuses on pre-tax returns. To our knowledge, there is no detailed evidence on the after-tax returns earned by individual investors because no existing dataset contains the account-level tax liabilities incurred on dividends and realized capital gains. Nonetheless, we observe that trading generally hurts performance. With some exceptions (e.g., trading to harvest capital losses), it is safe to assume that ceteris paribus investors who trade actively in taxable accounts will earn lower after-tax returns than buy-and-hold investors. Thus, when trading shortfalls can be traced to high turnover rates, it is likely that taxes will only exacerbate the performance penalty from trading.

Factors influencing investor behavior

Most financial theory is based on the idea that everyone takes careful account of all available information before making investment decisions. But there is much evidence that is not the case. Behavioral finance, a study of the markets that draws on psychology, is throwing more light on why people buy or sell the stocks they do - and even why they do not buy stocks at all. This research on investor behavior helps to explain the various 'market anomalies' that challenge standard theory. It is emerging from the academic world and beginning to be used in money management. There are some factor for influencing investor behavior (please see the diagram located below).

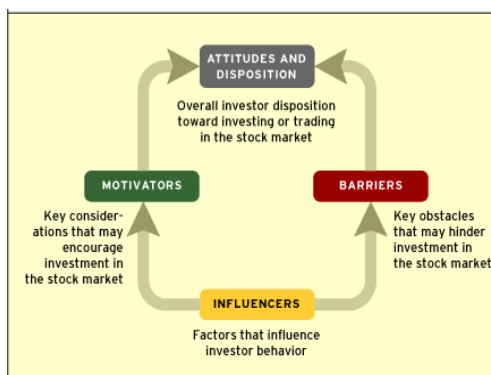


Figure 1. Factors influencing investor behavior

The Role of Behavioral Finance With Private Clients

Private clients can greatly benefit from the application of behavioral finance to their unique situations. Because behavioral finance is a relatively new concept in application to individual investors, investment advisors may feel reluctant to accept its validity. Moreover, advisors may not feel comfortable asking their clients psychological or behavioral questions to ascertain biases, especially at the beginning of the advisory relationship. One of the objectives of this book is to position behavioral finance as a more mainstream aspect of the wealth management relationship, for both advisors and clients. As behavioral finance is increasingly adopted by practitioners, clients will begin to see the benefits. There is no doubt that an understanding of how investor psychology impacts investment outcomes will generate insights that benefit the advisory relationship. The key result of a behavioral finance-

enhanced relationship will be a portfolio to which the advisor can comfortably adhere while fulfilling the client's long-term goals. This result has obvious advantages—advantages that suggest that behavioral finance will continue to play an increasing role in portfolio structure.

Modern Behavioral Finance

By the early twentieth century, neoclassical economics had largely displaced psychology as an influence in economic discourse. In the 1930s and 1950s, however, a number of important events laid the groundwork for the renaissance of behavioral economics. First, the growing field of experimental economics examined theories of individual choice, questioning the theoretical underpinnings of Homo economicus. Some very useful early experiments generated insights that would later inspire key elements of contemporary behavioral finance. Real investors are influenced by where they live and work. They tend to hold stocks of companies close to where they live and invest heavily in the stock of their employer. These behaviors lead to an investment portfolio far from the market portfolio proscribed by the CAPM and arguably expose investors to unnecessarily high levels of idiosyncratic risk.

Psychographic Models Used in Behavioral Finance

Psychographic models are designed to classify individuals according to certain characteristics, tendencies, or behaviors. Psychographic classifications are particularly relevant with regard to individual strategy and risk tolerance. An investor's background and past experiences can play a significant role in decisions made during the asset allocation process. If investors fitting specific psychographic profiles are more likely to exhibit specific investor biases, then practitioners can attempt to recognize the relevant telltale behavioral tendencies before investment decisions are made. Hopefully, resulting considerations would yield better investment outcomes.

Practical Application of Behavioral Finance

Almost anyone who knows from experience the challenge of wealth management also knows the potential for less-than-rational decision making in finance. Therefore, many private-client advisors, as well as sophisticated investors, have an incentive to learn coping mechanisms that might curb such systematic miscalculations. The overview of behavioral finance research suggests that this growing field is ideally positioned to assist these real-world economic actors. However, only a few of the biases identified in behavioral finance research today are common considerations impacting asset allocation. Why does behavioral finance remain underutilized in the mainstream of wealth management? First, because no one has ever contextualized it in an appropriately user-friendly manner. Researchers have worked hard to reveal behavioral biases, which are certainly usable; but practitioners would benefit not merely from an academic discourse on discovered biases, but also from lessons on how to go about detecting biases themselves and advising their clients on how best to deal with these biases. Second, once an investor's behavioral biases have been identified, advisors lack pragmatic guidelines for tailoring the asset allocation process to reflect the specific bias.

This book intends not only to familiarize financial advisors and investors with 20 of the major biases unearthed in behavioral finance research, but to do so in a lexicon and format that is applicable to asset allocation. This chapter establishes a knowledge base that serves in the following chapters, wherein each of 20 specific biases is reviewed in detail. The central question for advisors when applying behavioral finance biases to the asset allocation decision is: When should advisors attempt to moderate, or counteract, biased client reasoning to accommodate a predetermined asset allocation? Conversely, when should advisors adapt asset allocation recommendations to help biased clients feel more comfortable with their portfolios? Furthermore, how extensively should the moderate-or-adapt objective factor into portfolio design?

Financial-behavioral theories

There is huge psychology literature which proves with evidences that people commit systematic errors in their thought. They always decide easily, have high confidence and value current experience (agency), separate decision making which must be merged (intellectual accounting), mistake in individual problems (frame), tendency for slow changes (conservatism) and their regulations prevent losses and meet achievements.

Financial behavioral uses models that in them some next factors are rational because of regulations or wrong beliefs. In the case of regulations, it is assumed that people oppose losses, because they are bas Bayesians (statistical methods, probability, guess), there are wrong beliefs. Most of the basic financial-behavioral theories are concerned with a series of new concepts called "limited rationality", a term which is associated with Herbkst Simon (1947, 1983). This term relates to cognitive limitations in decision making. As a result, behavior of human is built based on simplified methods and innovations (Torskey and Conman, 1974). This is consistent with the study of

Slavy (1972) on risk taking behavior of investor. He found that human had limitations as a processor of information and showed some judgment prejudices which guide people in the direction of extra information. Individuals are inclined to show extreme reaction to information (DeBandet and Thaler, 1985, 1987).

Shiller (1999) presented some key ideas in financial-behavioral including landscape theory, regret theory, stabilization, extreme and less sensitivity. Landscape theory by Comnan and Torsky (1979, 1981, and 1986) showed that people give different answers to same situation depending loss theory. Generally, investors in loss landscape are anxious and are consent with likely achievements. Sometimes they face certain profit. Most of the investors escape from risk but in encountering certain loss they become risk takers. According to Conmon theory, investors hate losses. This hatred of losses means that they take more risks to avoid losses and increase gains. Hatred of losses explains this essential notion that although investors are optimists about predictions (this stock is certain), but they are inclined to lose less money than earn.

Regret theory (Laric, Bulls, 1995) is another theory which deals with feelings and reacts to judgment error. For example, investors avoid selling valueless stocks to prevent regret from bad investment and regret from loss. Shame may help the tendency of not selling investment that some researchers put forward this theory investors follow common wisdom to avoid regret when it was proved that they follow wrong decisions. Most investors find that buying public shares and rationalizing it for coming down is easy because others have that share and think of it. Buying share with a bad imagination is more difficult than rationalizing it.

The Foundations of Behavioral Finance

Discussions of behavioral finance appear within the literature in various forms and viewpoints. Many scholars and authors have given their own interpretation and definition of the field. It is our belief that the key to defining behavioral finance is to first establish strong definitions for psychology, sociology and finance (please see the diagram located below).

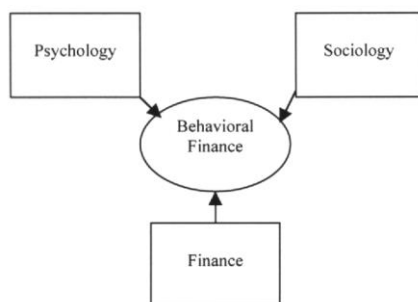


Figure 2. Foundations of Behavioral Finance

Figure 1 demonstrates the important interdisciplinary relationships that integrate behavioral finance. When studying concepts of behavioral finance, traditional finance is still the centerpiece; however, the behavioral aspects of psychology and sociology are integral catalysts within this field of study. Therefore, the person studying behavioral finance must have a basic understanding of the concepts of psychology, sociology, and finance (discussed in Figure 2) to become acquainted with overall concepts of behavioral finance.

CONCLUSION

Behavioral finance, a study of the markets that draws on psychology, is throwing more light on why people buy or sell the stocks they do - and even why they do not buy stocks at all. This research on investor behavior helps to explain the various 'market anomalies' that challenge standard theory. We conclude Most investors find that buying public shares and rationalizing it for coming down is easy because others have that share and think of it. Buying share with a bad imagination is more difficult than rationalizing it. It is emerging from the academic world and beginning to be used in money management. The field merges concepts from financial economics, psychology and sociology in an attempt to construct a more detailed model of human behavior in financial markets. Currently, no unified theory of behavioral finance exists. Shefrin and Statman, (1994) began work in this direction, but so far, most emphasis in the literature has been on identifying behavioral decision-making attributes that are likely to have systematic effects on financial market behavior. Even as behavioral factors undoubtedly play a role in the decision-making processes of investors, they do not quash all the predictions of efficient market theory; they offer plausible explanations of financial markets which would otherwise be categorized as anomalous. The current state of

research from the efficient market and behavioral perspectives therefore suggests that an inclusive and diverse approach in the choice of theoretical explanations of the behavior of financial markets will be the pragmatic response to the inconclusive results on either side of the debate. While, on the one hand, investors are not making large sums of money from market anomalies, not many people will disagree that the stock market bubble burst of 2000 or in 2008 is better explained by hubris and irrational exuberance grounded in behavioral finance than by the efficient markets theory.

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