THE COMMERCE SOCIETY

SHRI RAM COLLEGE OF COMMERCE

BEHAVIOURAL FINANCE

A Research Report

EXPERIENCE TRADITION, CHASE SUCCESS.

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INTRODUCTION

The human brain works wonders and like a fingerprint, each person in the world has their own imprint of what life should be lived like. The psychology of money is just as diverse and thus, we have all spent years of research and observations studying about how people tend to spend their money. Behavioral Finance is a study of psychological influences and biases that affect the financial behaviours of investors.

The fundamental flaw in the traditional psychological theory about investment was that it assumed that investors make their decisions rationally which is not true as there are many other psychological factors which influence the decision of the investor and do not always follow the assumption of rationality. These irrational decisions often lead to losses on a personal level and "bubble" or crashes on the market level. Behavioural finance studies the human psychology associated with investment and provides reasoning for real life stock market events and predicts investor behaviour.

Behavioural economics (which by many definitions includes behavioural finance) began largely as the result of prospect theory as developed by Daniel Kahneman and Amos Tversky. Beginning in the 1980's, finance theorists first began to consider the idea that the laws of investing was not quite as clean as they had originally theorised. And, as computers have become more powerful it has become possible to analyse the mountains of data to prove these hypotheses true. Economists and financial analysts have accepted it as equivalent to mainstream financial theory and there is a significant amount of research currently in progress in this field.

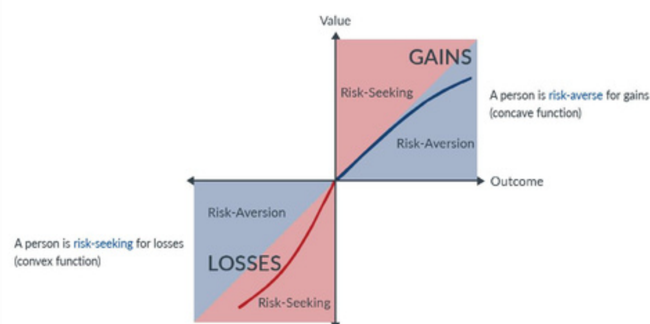
There are a variety of examples and perspectives we can take to explain behavioural financial decisions. The stock market, is in fact, where psychological behaviours are often assumed to influence market outcomes and returns. However, there are certain assumptions while analysing behavioural finance. It is assumed that the involved parties are not rational but rather dealing with influential elements. Since financial decision-making often relies on the investor's mental and

physical health, it can impact their decision-making and rationality towards their financial challenges or decisions. Despite this, we can also assume that people have a limit pertaining to their self- control.

Fear of Regret, or simply the regret theory goes hand in hand with the whole concept of Behavioral Finance. It deals with the emotional reaction people experience during a loss or when they realise they have made a mistake. Investors hate dealing with losses on their record and become emotionally affected by the choices of investments they make, the price and type of investment. While this theory is not only restricted to buying stocks, for example, but also about not buying stocks. Investors tend to get affected due to not buying a certain stock when they have the chance and their value skyrockets before their eyes. Some investors are also heavily shaped by the biases they face, sometimes subconsciously too, where they follow the herd mentality or ‘everyone else is doing it, I should too’.

Prospect Theory is another important concept studied under Behavioral Finance. Prospect Theory reveals that investors experience a different degree of emotions when experiencing a gain or a loss.

A loss of any amount hurts a lot more than any amount of gain. At the same time, the same amount of gain doesn't affect the investor to the same degree. It also explains an investor’s tendency to hold onto losing stocks and take more risks to avoid losses rather than realising their gains.



The report includes various subheads and dimensions of Behavioral Finance explained in detail with a segment including a talk conducted with experts in the field of finance. This will be an extremely informative ride since it covers many practical examples and explanations. This report shall teach or help the reader gain a new perspective of things they weren’t sure about or never knew the correct terminology or explanation.

OBJECTIVES- BEHAVIOURAL FINANCE

Understanding the psychological and emotional influences on financial decision-making and using that knowledge to enhance investment choices and overall financial outcomes are the goals of behavioural finance. The following are some specific goals of behavioural finance:-

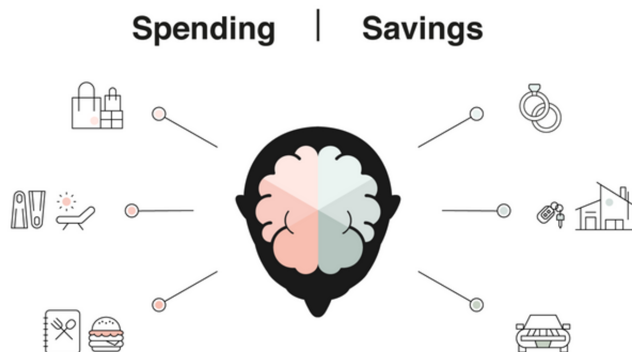
- Behavioural finance explains how human emotion, biases, and cognitive constraints on the mind's ability to comprehend and respond to information dramatically influence financial decisions on topics like investments, payments, risk, and personal debt.
- Behavioural finance examines how actual investors and financial professionals behave by using psychological and sociological factors. It aids in the creation of financial goods and tools that assist consumers achieve their financial objectives more quickly and effectively.
- The goal of behavioural finance is to increase our knowledge of how financial decisions, portfolio diversification patterns, and market pricing are affected. These are helpful for both retail and institutional investors, as well as for financial institutions, government agencies, and other parties involved in the financial markets.
- Investors adopt a "consensus" strategy in which they pool their expectations and take coordinated action. On the other hand, there are investors who are more likely to trade on stocks that are anticipated to outperform the consensus and steer clear of those whose market value is much below the consensus - estimated fundamental value. As a result, the concept of behaviour is relevant as soon as investors try to predict the future behaviour of other investors.

Basically, behavioural finance research aims to build a bridge between traditional finance and psychology, which is expected to provide a more comprehensive understanding of financial decision-making and ultimately help to improve the functioning of financial markets for each of its stakeholders.

CONCEPTS- BEHAVIOURAL FINANCE

1 MENTAL ACCOUNTING

The tendency for people to set aside money for particular uses is referred to as mental accounting. Some examples of mental accounting include tax refunds, bonuses, and lottery winnings.The notion of "mental accounting," developed by Nobel Prize-winning economist Richard Thaler, is based on behavioural economics and describes the various values that people assign to money depending on arbitrary standards.



Mental accounting frequently causes people to act in a financially unwise or destructive manner, such as contributing to a low-interest savings account while carrying significant credit card bills. People should perceive money as entirely interchangeable regardless of where they allocate it, whether to a budget account (daily living expenditures), a discretionary spending account, or a wealth account, to avoid the mental-accounting bias (savings and investments).

EXAMPLE:

The mental-accounting line of thinking seems to make sense but is in fact highly illogical. For instance, some people keep a special “money jar” or similar fund set aside for a vacation or a new home, while at the same time carrying substantial credit card debt. They are likely to treat the money in this special fund differently from the money that is being used to pay down debt, in spite of the fact that diverting funds from the debt-repayment process increases interest payments, thereby reducing their total net worth.

Broken down further, it’s illogical (and, in fact, detrimental) to maintain a savings jar that earns little or no interest while simultaneously holding credit card debt that accrues double-digit figures annually. In many cases, the interest on this debt will erode any interest you could earn in a savings account. Individuals in this scenario would be best off using the funds they have saved in the special account to

pay off the expensive debt before it accumulates any further.

The solution to this problem seems straightforward yet many people do not behave in this way. The reason has to do with the type of personal value that individuals place on particular assets. Many people feel, for example, that money saved for a new house or a child's college fund is simply "too important" to relinquish, even if doing so would be the most logical and beneficial move. So the practice of maintaining money in a low- or no-interest account while also carrying outstanding debt remains common.

2 HERD BEHAVIOUR

According to the theory of herd behaviour, people often imitate the financial habits of the vast majority of the herd. In the stock market, herding is infamous for causing jarring rallies and sell-offs. Throughout human history and in various circumstances, herd instinct has been observed. Herding can be used to explain a variety of asset bubbles and manias as well as riots, mass delusions, fads, political and social movements, sports enthusiasm, and many other phenomena. For instance, because the newest smartphone is so well-liked by other buyers, individuals might rush out to acquire one.

HOW CAN ONE AVOID FALLING VICTIM TO HERD MENTALITY?

A good way to avoid this is to make investment decisions that are based on sound, objective criteria and not let emotions take over. Another way is to adopt a contrarian strategy, whereby you buy when others are panicking, picking up assets while they are on sale, and selling when euphoria leads to bubbles.

At the end of the day, it is human nature to be part of a crowd, and so it can be difficult to resist the urge to deviate from your plan. Passive investments and robo-advisors provide good ways to keep your hands off of your investments.

3 EMOTIONAL GAP

Making decisions based on strong emotions or emotional strains, such as worry, wrath, fear, or enthusiasm, is referred to as the "emotional gap." Emotions are frequently a major factor in why people don't make logical decisions. Making foolish decisions while your emotions are in charge of your financial behaviour can be very costly. When buying a stock, for instance, an investor can be filled with joy and hope, but if the stock price declines rather than increases, they might feel let down and regret.

Similar to when an investor sells a stock, they could feel fear and anxiety, but if the stock price increases later, they might feel regret and sadness. The emotional gap can also be influenced by the framing of the investment decision. For example, if an investor perceives an investment as a "sure thing" they may experience disappointment if it doesn't perform as expected. This emotional gap can lead to suboptimal investment decisions, as investors may make decisions based on emotions rather than rational analysis.

It's important for investors to be aware of this emotional gap and to try to separate their emotions from their investment decisions as much as possible. This can be done by having a clear investment plan, regularly reviewing and adjusting the portfolio, and being mindful of the market valuations.It's usually best to ignore the trend at the moment—whether bullish or bearish—and stick to a long-term plan based on sound fundamentals. It's also critical to understand how risk-sensitive you are and to set your asset allocations accordingly when fear and greed grip the market.

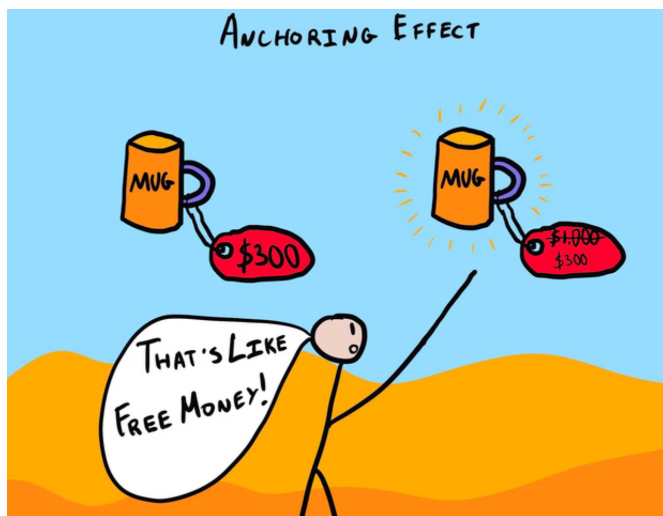
4 ANCHORING

Anchoring refers to attaching a spending level to a certain reference. Examples can include rationalising spending based on various satisfaction utilities or spending consistently at a set budget level. An unreasonable leaning toward an arbitrary benchmark value is referred to as anchoring in the field of behavioural finance.This benchmark then distorts market players' decisions regarding securities, such as when to sell an investment.In price and sales negotiations, anchoring can be leveraged to your advantage by establishing an initial anchor that will

impact later negotiations in your favour. Anchoring makes us overly reliant on the initial piece of knowledge we have on a subject. This may cloud our judgement and keep us from making the necessary updates to our plans or projections.

HOW DO YOU AVOID ANCHORING BIAS?

Studies have shown that some factors can mitigate anchoring, but it is difficult to avoid altogether, even when people are made aware of the bias and deliberately try to avoid it. In experimental studies, telling people about anchoring and advising them to "consider the opposite" can reduce, but not eliminate, the effect of anchoring. An investor should do complete research from trusted sources and not focus on one news or recommendation.



The bias can be used to your advantage as well. For example, If you are selling something or negotiating a salary, you can start with a higher price than you expect to get as it will set an anchor that will tend to pull the final price up.

If you are buying something or a hiring manager, you would instead start with a lowball level to induce the anchoring effect lower.

5 SELF ATTRIBUTION

Self-attribution refers to a tendency to make choices based on overconfidence in one's own knowledge or skill. Self-attribution usually stems from an intrinsic knack in a particular area. Within this category, individuals tend to rank their knowledge higher than others, even when it objectively falls short.

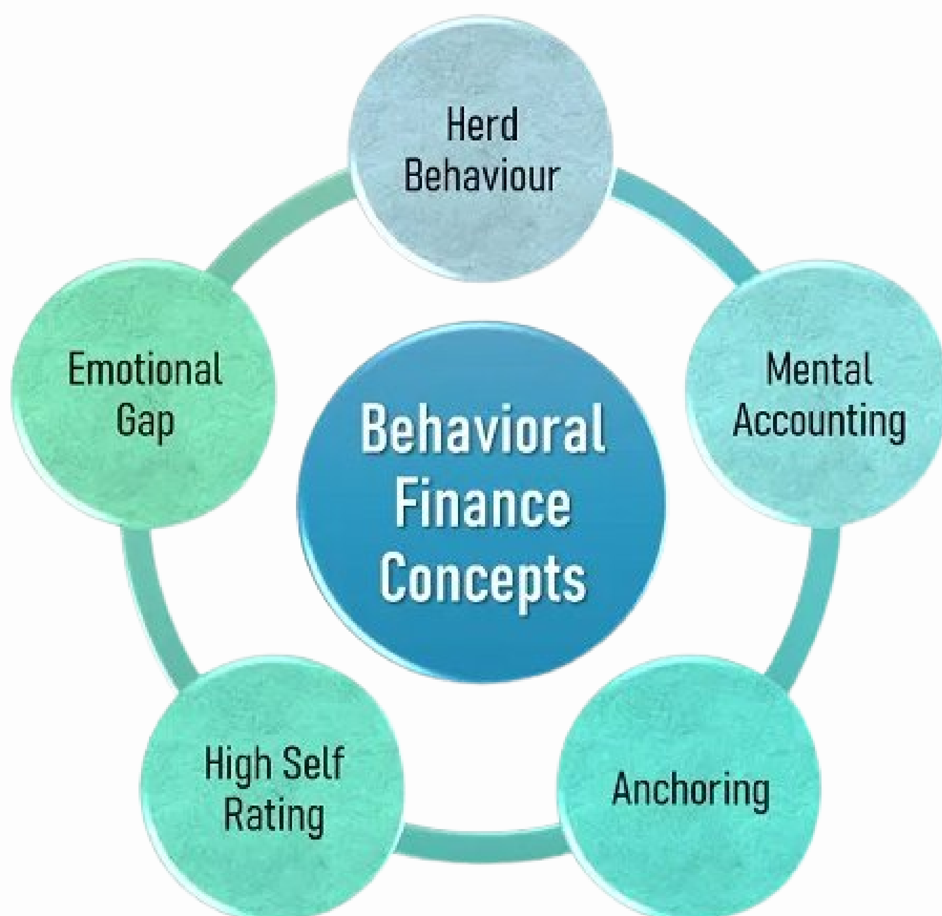
Self-enhancement is the tendency to attribute positive qualities to one's self and take credit for one's successes, whether or not these are accurate beliefs. The flip side of self-enhancement is when people tend to attribute losses or set back to factors beyond their control or to hostile intent by others. These biases can lead investors into mistaken decisions and prevent them from learning and improving their skills and strategies over time.

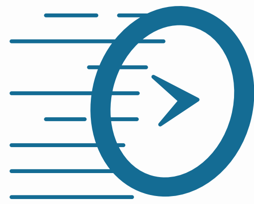
EXAMPLE OF SELF-ENHANCEMENT

A common example of self-enhancement is the finding that most people rate themselves "above average" when asked to rate their abilities and rate others as "below average." Most people rate themselves above average at driving a car, while rating other drivers below average. By definition, it is impossible for everybody to be above average in their driving ability. People also tend to rate their personal attributes—such as attractiveness, intelligence, leadership ability, and patience—as above average.

Self -enhancement can occur in many different situations and under many different guises. The general motive of self-enhancement can have many different underlying explanations.

In a financial context, self-enhancement can serve as something of a call-option. Whereby an individual can selectively exercise the call-option to attribute self-enhancing outcomes to their own design, they might let the option expire under scenarios they wouldn't want to take credit for.





FAST FACTS

- Behavioural finance is exploited through credit card rewards, as consumers are more likely to be willing to spend points, rewards, or miles as opposed to paying for transactions with direct cash.

- Behavioural finance theory suggests that the patterns of overconfidence are common to many investors and such groups can be large enough to prevent a company's share price from reflecting economic fundamentals.

- Familiarity bias can occur in so many ways. One may resist investing in a specific company because of what industry it is in, where it operates, what products it sells, who oversees the management of the company, who its clientele base is, how it performs its marketing, and how complex its accounting is.

- Traits of behavioural finance are: Investors are treated as “normal” not “rational”, They actually have limits to their self-control, Investors are influenced by their own biases, Investors make cognitive errors that can lead to wrong decisions

BEHAVIOURAL FINANCE IN ASIA & INDIA

BEHAVIOURAL FINANCE IN ASIA

As India is an emerging economy in Asia and its cultural characteristics are the same as in other Asian countries; there is a need to focus our vision on Asia. Asia is popular for its diversity of culture, variety of capitalism level and participants' financial experience. So, it is definitely one of the interesting places for studying behavioural finance. Although some Asian economies are still at their early stage of development, some others have been developed for a long time.

As there is difference in the level of knowledge and experience, it leads to the difference in decision making. This makes Asia a perfect platform for studying behavioural finance. Moreover, Asian people seem to be affected by cognitive biases more than Western people. Individual investors from Asia are thought to be mere gamblers (Kim & Nofsinger, 2008). Theoretically, social scientists and psychologists believe that tendencies toward behavioural biases can be nurtured by culture although the levels may vary (Yates, Lee, & Bush, 1997). Dramatic differences in environment in two cultures are often studied in cognitive studies as an 'individualism-collectivism continuum' (Kim & Nofsinger, 2008). Asian cultures are more socially collective than Western cultures.

In Asian cultures, family or group members often step up to help out other members in a drastic or adverse situation. In the individualist Western cultures, the decision maker is expected to bear the consequence of his decision, no matter how gross it would be. Collectivist society act like an insurance policy as it allows for the social diversification of risky decisions. Therefore, since the impact of a catastrophic loss is different for the Asian and Western cultures, so is its perception.

Thus, Asian cultures are of collectivist nature which makes investors' overconfident resulting in behavioural bias.

Many researchers believed that behavioural inclinations can vary among cultures. Some evidences have been found to prove that Western people have less behavioural biases than Asian people(Yates, Lee, & Bush, 1997). Not much of research has been focused on the topic of culture and decision making (Weber & Hsee, 2000). Moreover, Chen, Kim, Nofsinger and Rui provided a systematic literature about behaviours of Asian people and their effects on investment decision making (Kim & Nofsinger, 2008). In support of their theory, they found that Chinese investors suffer from an overconfidence bias and disposition effect more than U.S investors (Kim & Nofsinger, 2008).

Although behavioural finance is still a controversial topic, many financial researchers and analysts now have better understandings of human behaviours. It is also accepted that these behaviours can influence financial decision-making. Many researchers also agree that arbitrage is limited (Shleifer & Vishny, 1997), hence, these behaviours can affect prices.

BEHAVIOURAL FINANCE IN INDIA

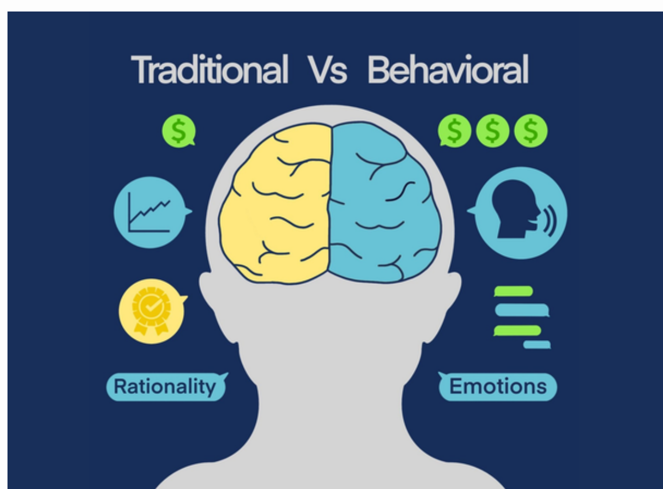
Empirical evidence shows that retail investors do not always make rational choices. The decision of an Indian individual investor is influenced by five psychological axes. Those pertinent axes were named as financial heuristics, self-regulation, prudence and precautious attitude, financial addiction, and informational asymmetry (Chandra & Kumar, 2012). Another study demonstrates how behavioural finance provides explanations for irrational financial decisions making of investors. The study demonstrates the effect of emotions and cognitive errors on the investor decision making process. The study shows that an assortment of causes that led to behavioural finance are anchoring, overconfidence, herd behaviour, over and under reaction and loss aversions (Chaudhary, 2013).

On the financial markets, the influence of behavioural finance is reflected in several stages, as shown in the graph above. An individual by nature has difficulty challenging his first impression. This is mental anchoring. So, if an investor thought that the market was bearish at a particular moment, it takes some time before he can change his position even in the event of a market downturn. Few investors buy in the trough or at the top of the wave, depending on whether the market is in a bullish or bearish trend.

TRADITIONAL VS BEHAVIOURAL FINANCE

Mainstream financial theory has always believed that investors exhibit rational behaviour. They gather or receive all the knowledge they have, and that data supports their decisions.

However, the closer analysis of the investor behaviour could reveal that there are numerous situations where the investor is engaged in irrational behaviour. Such behaviour could not be effectively explained by mainstream finance. behavioural finance explains that folks are irrational, and our own emotions and biases play a role in making investments decisions. In behavioural finance,
investors might base their decisions on fear, overconfidence, gut feeling, what others do, thereby following the gang and past experiences.



Behavioural finance differs from Mainstream finance in the following aspects-

ASSUMPTION OF RATIONALITY

Traditional finance assumes that an investor is a rational one and processes all information without any biases. While behavioural finance draws from real-world experience stating that an investor has biases and is irrational. His emotions play a role in all investment decisions undertaken. Behaviour finance aims to understand these emotions and other mental factors which affect the investor.

BROADER AND INCLUSIVE FIELD

Unlike the mainstream finance that only contain the economic and finance aspects, behavioural finance is a much broader and inclusive field as it combines economic, finance, behavioural and cognitive psychology to explain irrational financial decisions taken by the investors. The broader approach of behavioural finance makes it much more suitable for real world application.

EXPLANATION FOR ANOMALIES

Traditional finance states that the market is efficient and may represent the financial market's actual value but behavioural finance believes that the market is volatile, and that is why there are market anomalies. According to traditional theory, there should be no anomalies which is not the case in reality. However behavioural finance provides explanation and reasoning of such events which make it a more appropriate tool to analyse stock markets.

Various behavioural factors that affect investor's decision making in the stock market :

1 OVER CONFIDENCE

Overconfidence bias refers to the tendency for individuals to overestimate their own ability to predict future events, such as stock market movements. This can lead to a number of negative consequences in the stock market.

First, overconfidence can lead to excessive trading and portfolio turnover, which can incur unnecessary transaction costs and taxes. Second, overconfidence can lead to a failure to diversify one's portfolio, which can increase the risk of losses if a particular stock or sector underperforms. Third, overconfidence can lead to a failure to cut losses when a stock is not performing well. Instead of selling the stock, investors might hold on to the stock in the hope that it will recover and they will not recognize the loss. Fourth, overconfidence can lead to a failure to take profits when a stock is performing well. Investors might hold on to the stock in the hope that it will continue to increase in value and fail to recognize the gain.

It's important for investors to be aware of their own biases and to be mindful of the potential for overconfidence when making investment decisions. Diversifying your portfolio and having a plan for when to sell, can help mitigate the effects of overconfidence bias.

2 GAMBLER'S FALLACY

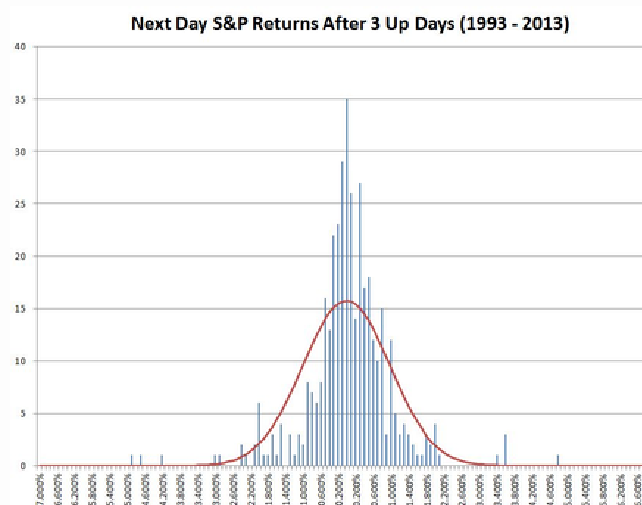
The gambler's fallacy is a faulty reasoning that occurs when people believe that a certain event is more or less likely to occur based on the outcome of previous events. In the context of the stock market, the gambler's fallacy can manifest itself

One example is the belief that a stock's past performance is an indicator of its future performance. Investors may believe that a stock that has gone up in value over the past few days or weeks is more likely to continue going up, and may therefore invest more heavily in that stock. However, past performance is not necessarily indicative of future performance, and this belief can lead to poor investment decisions.

Another example is the belief that a stock's price will eventually "correct" itself after a period of significant gains or losses. For example, an investor may believe that a stock that has gone up a lot in value will eventually come back down, and may therefore sell their shares before that happens. However, the stock market is not a zero-sum game, and there is no guarantee that a stock's price will eventually "correct" itself.

In general, it is important for investors to remember that stock prices are determined by a variety of factors, including company performance, market conditions, and investor sentiment. Rather than relying on past performance or the belief that prices will eventually "correct" themselves, investors should focus on analysing these factors and making informed decisions about when to buy and sell shares.

Overall, the gambler's fallacy can be a major pitfall in stock market investing and it's important to be aware of this bias and try to avoid it when making investment decisions.



3 AVAILABILITY BIAS

The availability bias occurs when people rely too heavily on information that is easily available to them, rather than considering all relevant information. In the context of the stock market, this bias can manifest itself in a few ways.
One example is the tendency for investors to base their investment decisions on recent news or stock performance, rather than considering a company's long-term prospects or fundamentals. For example, an investor might buy a stock because it has been performing.

Well recently, without considering whether the company's business

model or management team are strong. Another example is the tendency for investors to pay too much attention to information that is easily available, such as stock prices and news headlines, rather than seeking out less easily available information, such as financial statements or industry reports. This can lead to investors making decisions based on incomplete or inaccurate information.

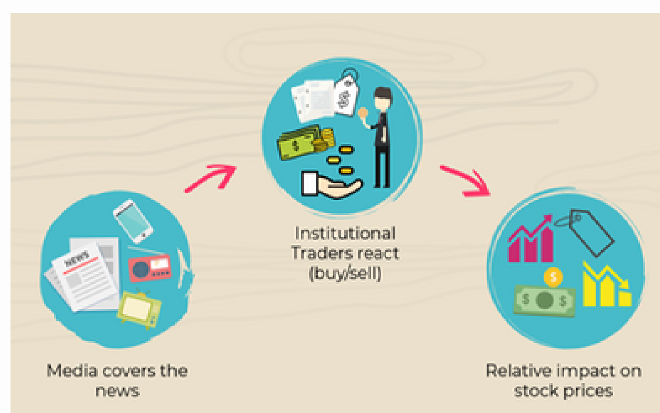
In general, it is important for investors to be aware of the availability bias and to make sure that they are considering all relevant information when making investment decisions. This can include researching a company's financials, management team, and industry trends, as well as monitoring news and market conditions. Additionally, investors should consider diversifying their portfolio, and not put too much weight on recent information or on the information that is easily available.

Overall, availability bias can have a significant impact on investors' decisions and can lead to poor investment decisions. It's important to be aware of this bias and to make sure that you are considering all relevant information when making investment decisions.

4 MEDIA EFFECT

A theory that relates how stories published in the media influence or amplify current trends. Borrowers or investors will read an article and be influenced to act quickly on the news. Media can have a significant impact on the stock market. Positive news coverage and positive financial reports can lead to an increase in investor confidence, which can drive stock prices up.

Negative news coverage and negative financial reports can lead to a decrease in investor confidence, which can drive stock prices down. It's important to note that media has no direct effect on the stock market, the market movements are based on the company's fundamentals, economic factors and other financial factors. The media can have an indirect impact by influencing the perception of investors.



Additionally, media outlets may also influence investor sentiment through their coverage of economic indicators and political events. It is important to note that the media can also create a bias on the information they present, and not all sources of information are created equal. It's important to do your own research and not make investment decisions solely based on media coverage.

5 REGRET AVERSION

It stems from investor's desire to avoid the pain of regret caused by a bad investment decision. This aversion encourages investors to hold underperforming stocks because avoiding their sale avoids the recognition of the associated loss and poor investment decision. Because investors can reduce their taxable income by realising capital losses, regret aversion creates a tax inefficient investment strategy. Regret aversion can lead to individuals holding on to losing stocks for too long, rather than cutting their losses and moving on to potentially more profitable investments. This is known as the disposition effect, where investors are more likely to sell winning stocks and hold on to losing stocks. This behaviour can lead to missed opportunities for gains, as well as increased losses.

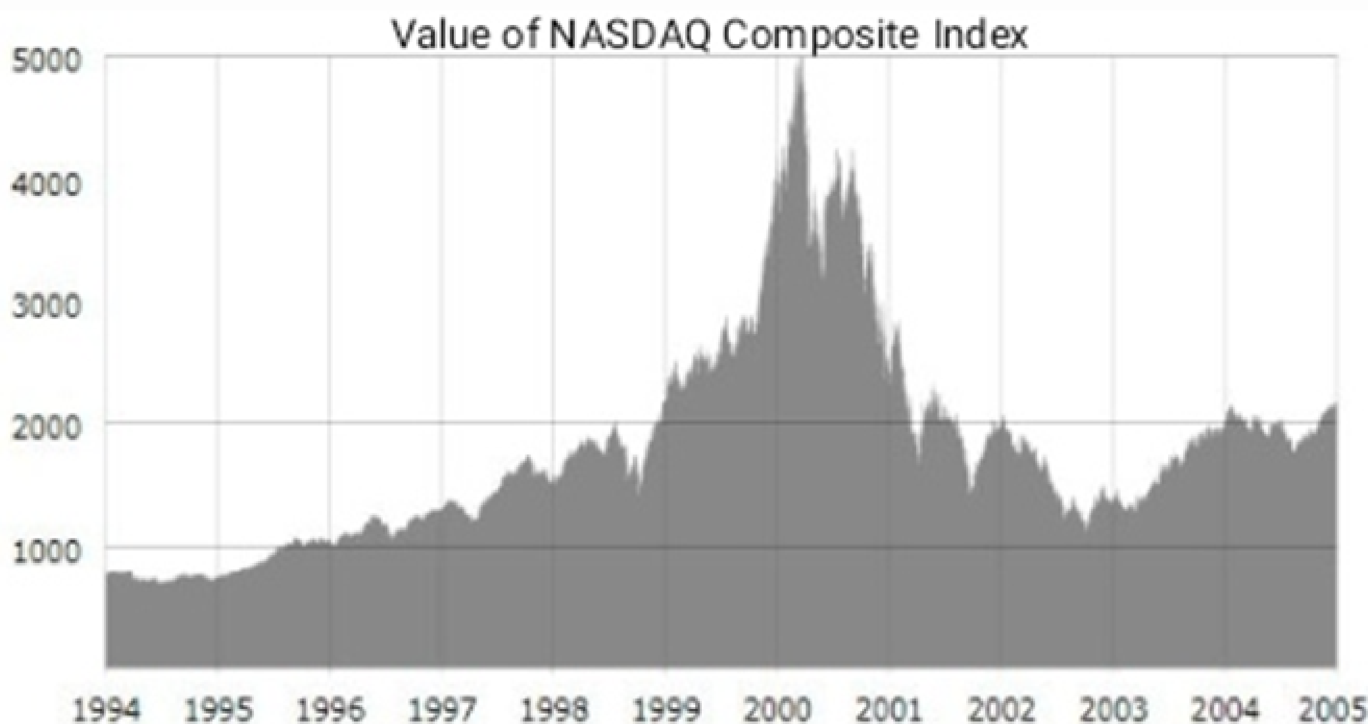
Additionally, regret aversion can lead investors to avoid taking a chance on a stock that they believe may be risky, but which has the potential for high returns. This can lead to missed opportunities for gains, as well as a reluctance to diversify one's portfolio.

It is important for investors to recognize and actively work to overcome this bias in order to make more rational and profitable investment decisions. One way to do this is to set clear investment goals and regularly review and adjust one's portfolio to ensure it aligns with these goals. It's also helpful to have a plan for exiting positions, including when to sell losing stocks and take gains

6 IRRATIONAL EXUBERANCE

Irrational exuberance refers to excessive optimism or enthusiasm in the stock market that is not supported by the underlying fundamentals or economic conditions. It is a term that was popularised by Alan Greenspan, the former Chairman of the Federal Reserve, in 1996.

Irrational exuberance can lead to market bubbles, where stock prices become inflated and disconnected from the underlying value of the companies. This can happen when investors become overly optimistic about future growth prospects and begin to bid up stock prices to levels that are not sustainable.



(DOTCOM BUBBLE)

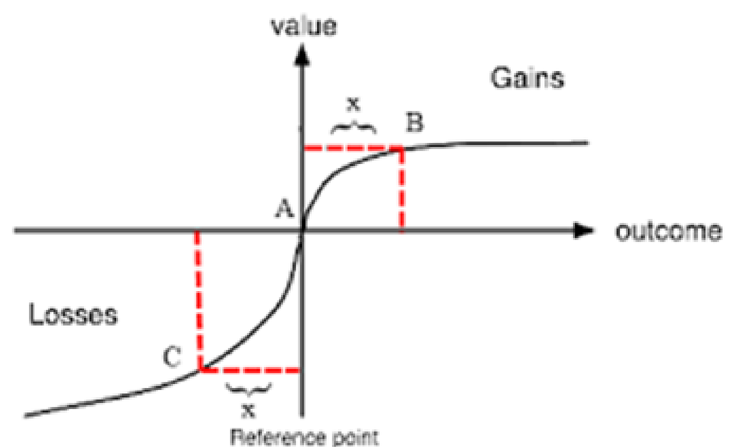
Once the bubble bursts, stock prices can fall rapidly, leading to significant losses for investors. This can also cause a ripple effect throughout the economy, as the fall in stock prices can lead to decreased consumer spending and decreased business investment.

It's important to note that it is difficult to predict such irrational exuberance in the market as it's driven by psychological factors and emotions. In order to protect themselves from the negative effects of irrational exuberance, investors should focus on fundamentals, diversify their portfolios and be mindful of market valuations.. Irrational exuberance is thought to have caused the infamous dot com bubble.

Investors base their financial decisions on irrelevant statistics and figures, some investors may invest in stocks that have witnessed considerable fall after continuous growth in the recent past. They believe that price has fallen which is only due to short term market movements, creating an opportunity to buy the stock cheap. However, in reality, stocks do quite often also decline in value due to changes in their underlying fundamentals.

BIASES REVEALED BY BEHAVIOURAL FINANCE

Behavioural finance reveals many aspects of human psychology related to finance in the form of biases. These biases can have significant consequences for individuals and institutions. They can lead to poor investment decisions and missed opportunities for growth. Understanding these biases can help individuals and institutions make better-informed decisions and potentially improve their financial outcomes.



1 LOSS AVERSION BIAS

Manya had invested in a stock 3 years ago but the stock has not been performing for the last 2 years. The future of the company was also not very promising. However, Manya is not in mood to redeem her investment in the hope that the company will recover soon.

Here, Manya exhibits **LOSS AVERSION** where she holds on to her unprofitable investment just to avoid the loss she has already incurred.

Loss aversion bias refers to a phenomenon where a loss is perceived by individuals as psychologically or emotionally more severe than an equivalent gain. The psychological effects of experiencing a loss or facing the possibility of a loss might even induce risk-taking behaviour that could make losses even more likely or more severe. Many investors don't acknowledge a loss until it is realised. Therefore, to avoid experiencing the pain of a "real" loss, they continue to hold onto an investment even as their losses from it increase. This is because they can avoid psychologically or emotionally facing the fact of their loss as long as they haven't yet closed out the trade. In their subconscious, if not their conscious, thinking, the loss doesn't "count" until the investment is closed.

The best way to avoid loss aversion bias is to take decisions in consultation with good financial advisors. It is important to objectively evaluate the performance of the portfolio and to book loss and invest in alternative funds if required. The investor should not be emotionally attached to any of the investments as it leads to irrational decision making and severe losses in the long run.

2 CONFIRMATION BIAS

Rajat has always been interested in Financial world. He used to read about how inflation is decreasing the worth of idle money he has saved so now he is looking to invest them somewhere. He himself always believes in safer investment so he thought that the debt market should be the way to go but he was still confused. The next day he met his two friends Neeraj and Aarti who were already investing for the last few years. Listening to his dilemma, Neeraj, who also invests in safer avenues suggest him to do the same while Aarti on the other hand emphasises on the potential of superior return associated with the Equity market.

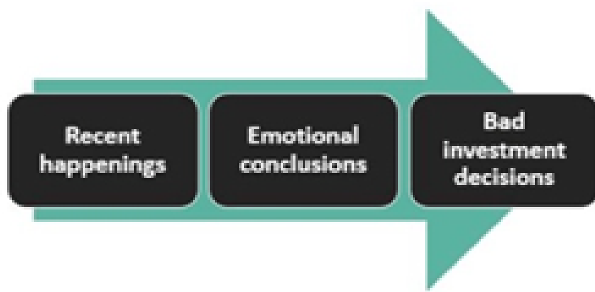
Rajat, however, ignored Aarti's opinion and focused only on what Neeraj said. Here, Rajat exhibits **CONFIRMATION BIAS.**

Confirmation bias is a term from the field of cognitive psychology that describes how people naturally favour information that confirms their previously existing beliefs. When researching an investment, the investors might inadvertently look for or favour information that supports their preconceived notions about the asset or strategy and fail to register or to under-weigh any or data that presents different or contradictory ideas. The result is a one-sided view and a self-reinforcing loop.

3 EXPERIMENTAL BIAS

Aman was given advice by his friend to invest in a particular company so he decided to research the stock. He found that the return in the last 1 year was 12 % but the return in the last 5 years was -33%. He decided that the stock was on an upward trend and decided to invest in it. Here, his decision is affected by **EXPERIENTIAL BIAS.**

Also known as recency or availability bias, experiential bias refers to the tendency for people to overweight new information or events without considering the probabilities of those events over the long run. It occurs when an investor's memories or experiences from past events make them choose sides even when such a decision is not rational.



It results in impulsive buying or selling of investment hoping that the current trend will continue. At the time of stock market crashes, some investors have a pessimistic view and expect less returns in the future, disregarding the status of economy or growth expectation. This was widely seen at the time of the 2008 economic crisis.
To avoid experiential bias, an investor should consider all relevant information related to the investment and not let recent events influence his decision making. It is necessary to understand the working of the stock market and business cycles.

4 FAMILIARITY BIAS

This bias is exhibited in many forms. The most common is the over investment by an employee in his own company or in sectors related to his profession and investment only in own country. Some investors over allocate their funds towards Savings Account, Fixed Deposits, PPFs, etc with no exposure to the equity market for the same reason. This behaviour shows **FAMILIARITY BIAS**. Another example of this is home country bias as the investors often do not invest in markets outside of their home country even at the time of a great opportunity.
It is defined as the tendency for individuals to prefer what is familiar and to seek to avoid the unknown. Familiarity bias has a negative impact on diversification of an investor's portfolio and reduces the exposure to different sectors making the portfolio more risky. The risk of a familiar stock is usually underestimated leaving the investor susceptible to irrational decisions.
Investors should do their research and interpret the analysis objectively. It is important to understand that investing in one's comfort zone does not guarantee good returns and fulfilment of financial goals and hence it is necessary to take appropriate risks.

5 HINDSIGHT BIAS

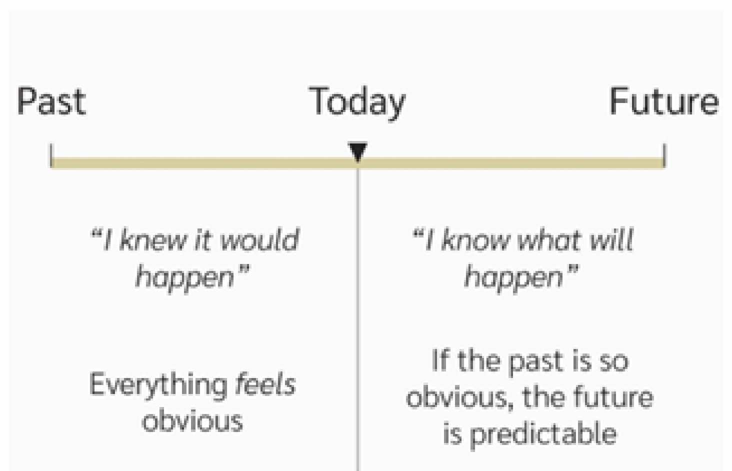
An investor thinks casually that the price of a stock will increase but does not buy it. Later, when it increases he believes that he can analyse the stock market better than everyone else and so indulges into over-investment even in bad securities. Here, the investor's decisions were affected by **HINDSIGHT BIAS.**

Hindsight is a psychological phenomenon that allows people to convince themselves after an event that they accurately predicted it before it happened. The idea is that once the outcome is known, it is much easier to construct a plausible explanation.

There are three distinct components of this bias :

1. **Memory distortion** - It occurs when the outcome affects the individual's re-collection of the event.
2. **Foreseeability** - It is a person's subjective belief that they could have predicted the outcome. A person with information about outcomes always considers it more likely as compared to other alternatives in afterthought.
3. **Inevitability** - It is a person's perception about the objective likelihood that it had to occur.

The bias often leads to investors overestimating their predictive abilities and taking unnecessary risks resulting in losses. Investors should be careful when evaluating their own ability to predict how present events will impact the future performance of securities. They should maintain a record for their reasoning in the form of a journal so that they have tangible evidence of their prediction which can be compared to the actual outcome.



IMPORTANCE IN TODAY'S MARKET

In the tumultuous market environment of today:

1. It helps advisers create portfolios that are more suited to their clients' needs and foster long-term connections with their clients. Investors are susceptible to making biassed, emotional financial decisions because they are only human. Understanding the psychological or emotional causes of investor behavioural biases can assist advisers set themselves apart from the competition and, ultimately, provide better services to their clients.

2. The discrepancy between anticipated and actual efficient, rational investor behaviour can be explained in part by behavioural finance. In order to provide a more complex understanding of financial decisions, behavioural finance expands on traditional logic by incorporating behavioural aspects.

3. In the modern world, companies that invest in finding researchers with the right training in how financial markets function will fare better than those who don't. As a result, a solid understanding of the behavioural aspects of finance can help individuals pursue rewarding careers in both academics and business. The actual competitive advantage is knowledge, and those who have a behavioural understanding of finance in addition to conventional theories will always be at an advantage.

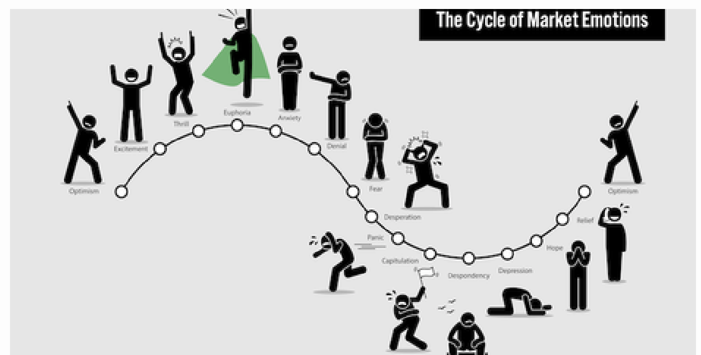
4. The enormous financial sector, both in India and internationally, is constantly looking for qualified individuals who take pleasure in learning, conducting research, and acting on their discoveries. The needs and wants of their clients must be balanced by the financial advisors. And the only way to do this is to comprehend money, cognitive biases, and psychological elements that affect decision-making.

BEHAVIORAL FINANCE IN OUR LIFE

Both individual and institutional investors may be significantly impacted by behavioural finance. Understanding the psychological biases that might affect financial decisions can help individual investors make better financial decisions. For example, people tend to be loss averse, which means they feel the pain of a loss more than the pleasure of a gain. Investors can create plans to combat this bias and make better logical choices by recognising it.

However, institutional investors, including pension funds, insurance firms, mutual funds, and hedge funds, can employ behavioural finance to enhance their risk management and investment strategies. They can build investment products and communication plans using behavioural finance principles to more successfully combat psychological biases.

Regulatory agencies have also begun to consider behavioural biases when creating regulations and oversight structures. This serves to safeguard investors and advance more effective marketplaces.



In general, behavioural finance can assist us in improving our financial decisions by revealing the psychological aspects that affect our behaviour and outlining methods for overcoming these biases. Additionally, it has a big impact on the financial sector by assisting businesses in creating new products and business models that better serve clients and support more effective markets.

TALK WITH EXPERTS

Any report is not complete without thorough research and the worst thing any academic pursuing a professional course could do is not have their secondary research backed by primary sources and not fact check their data. We had the amazing opportunity to talk to CFOs and senior managers of leading companies.

It was incredible learning from experienced and knowledgeable experts like Mr. Shambhu Bhotika, CFO of USPL, Bangalore; Mr. Shubam Goyal, Deputy Manager Finance at DLF Limited and lastly Mr. Prateek Jain, Senior Manager- Credit & Fraud Risk at American Express. We hope to provide insights and an experienced point of view through this segment and hope to teach certain tips and tricks.

1. SHUBHAM GOYAL

Shubham Goyal explained the concept of Averaging Out. Averaging, in the stock market, is a bundle of comprehensive trading strategies that involve the fundamental principle of reducing or increasing your share prices to overcome market volatility.

There are multiple kinds of averaging strategies a trader uses in a variety of market settings. He explained the examples of Herd Behaviour and Loss Aversion. Loss minimising becomes the priority instead of expectation of a gain. According to him, before investing an individual should check four things mainly- Background of the company, Experience of the management, Financial Analysis of all the reports published in public domains and detailed study of market trends with the helps of graphs based on past performance of the company. He believes that the students should keep some key points in mind before investing. In his opinion, students pursuing higher education should start investing right away. In addition, it is necessary for commerce students to start investing at a young age to get their hands on practical aspects of investments and trade. Retail investors should consider the small cap companies. One should not have entire focus on the Greed factor, that is key parameter should not be only on increasing our profit but on also other factors as well.

A person should not worry about incurring losses as patience is the key to success in trading. He added by saying all the businesses aim at making profit and expanding their businesses operations. The most important point of the discussion was that the person investing with inadequate knowledge is bound to make a loss.

2. PRATEEK JAIN

In the interview, Mr Prateek Jain explained the relevance of behavioural finance in the present times. Currently, the global economy is facing a slowdown whereas India is growing steadily and in such a situation the investment from both retail and institutional investors is expected to increase. With more and more investors, the biases and fallacies are much more evident in the markets. He described the concept of loss aversion and how people keep investing more and more in loss making investment to, often unsuccessfully, make profit. He also provided insights upon how one can even use biases to his advantage.
He gave the example of herd mentality where an individual can follow a group but only those which align with his short term and long term goals and that too by restricting himself to certain principles. He talked about how companies also take advantage of biases and many companies

which are built on the basis of influence on behaviour of individuals. He emphasised on having knowledge about the financial markets from an early age so that the investing decisions made in life later are not anchored on specific information or are affected by recency bias. He considered that self evaluation is the best way to learn about behavioural finance and to reduce the impact of the biases. One must have a rationale behind every decision and the person should make a conscious effort to prevent making decisions based upon emotions or intuition.

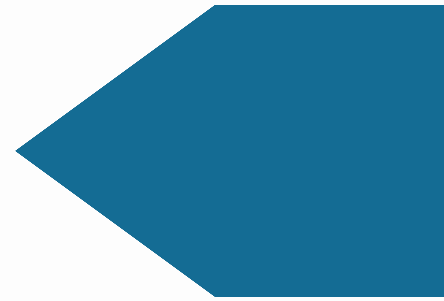
3. SHAMBHU BHOTIKA

Shambhu Bhotika explained to us about the importance of making a plan.Whether from our own money or others' money that could be loans or interest. Interest is another yearly or monthly burden.There should be a strategy to utilise our money. Our income is defined but our expenses. We should try to avoid the loan part of money.

He explained to us about having a long term view. “Do your homework. Don’t listen to others. Research well about the company.” were Mr. Shambhu’s words. MISTAKES are an important part of our life. He mentioned that we should have the courage to accept our mistakes plus the capacity to bear it. “Don’t put good money in the bad money.” If we are dealing with money on a short term basis, stop loss is a must. When asked about how we can educate people and ourselves about the same, he replied by saying that reading books, watching business news channels which keep telling us about what all is happening in the business world, insights into frauds etc. might prove to be useful. He also gave us examples for the same eg. How SEBI raided a few houses and got to know about people who start to initiate their fraudster activities but get caught in the first step itself.He advised us to go into the practical knowledge rather than the bookish one. He asked us to observe our very own behaviour in different aspects of life. On an informal note, the expert mentioned “Jha pyaar hota hai wha budhi nhi hoti.”

Remove the love part of everything. That is when logical cognitive thinking comes into place and then we are able to make quite informed decisions. If we consider the Herd mentality, information is coming from a huge time lag. We were advised to either act faster than the general public or reduce our range. He asked us to be happy with small gains. Small losses may be a lesson for us. People’s intentions can’t be changed. It is important to diversify funds. For example, a fixed deposit can be made, cover under the insurance sector can be taken, mutual funds, investment in gold or silver. It is advised to put money in diversified portfolios. The proportion can be decided accordingly. The speaker mentioned that according to him, loss biases would be the best. Doing research by yourself is the most important thing. As mentioned earlier, stop losses are a must. It is empirical to act on both sides.

CONCLUSION



Making rational decisions is not possible every time as humans are a social animals and their decisions get effected by interaction and emotions. Behavioural Finance has been used across all fields of education to study the human brain, its reactions and outcomes towards material changes in one's finance. An individual might have a doubt regarding the relevance and significance of behavioural finance in current scenario. It is important because a person can study his decisions in order to avoid mistakes in the future and develop strategies to better manage their emotions. It can also help in establishing a strategy to identify, monitor, and manage the potential risks associated with trading activities. While real time experiences and tips are already mentioned in the report by the experts themselves, here are some more rules one should follow while investing;

Stubbornness, egos, and emotions are the worst indicators for entries and exits. This goes hand in hand with the Loss Aversion Theory. In addition, You must always formulate a plan and that has to be the anchor in your decision-making.

A sound advice to all is that don't let your emotions take over the plan made. Sell the losing holding and move on. Further, Do not worry about losing money that can be made back, instead worry about losing your trading discipline. Lastly, If you cannot afford to invest yet, simply don't. Keep emergency funds with instant access and clear any debts you have.

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