INFLUENCE OF BEHAVIORAL PATTERNS IN DECISION MAKING

Abstract

Behavioural finance is a field of study that explains how people make financial decisions. It combines the basic underlying principles of economy with the views from psychology and sociology to explain why investors often make suboptimal decisions.

Key concepts in behavioural finance include:

1. **Overconfidence:** Cognitive bias in which people are highly optimistic about the outcome of the investment and they feel that the information they have is adequate for them to make any investment decisions.
2. **Herding:** refers to the tendency of the investor to follow the actions done by the larger group and try to imitate others
3. **Mental Accounting:** a tendency to assign different values for the same sum of money
4. **Anchoring Bias:** believe in the first piece of information which they receive regarding the topic they are searching for.
5. FOMO & FOR

Behavioural finance has important implications for investors, financial advisors, and policymakers while making decisions. By understanding psychological factors, investors can make appropriate decisions.

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I. INTRODUCTION

Investors follow a certain set of investment procedures while making any investment. Theoretically, investment decisions made by the investors are considered to be rational. Over past decades, there were many theories like

1. **Capital Asset Pricing Model:** according to this, the investors need to be compensated for the time value of money and market specific risk.

2. **Arbitrage Pricing Theory by Ross (1976):** according to this, an attractive opportunity is created by irrational traders through creation of mispriced securities

3. **Expected Utility Theory:** states that decision makers choose between risky prospects after comparing their expected value. etc which contributes to the same thought.

But there were a lot of anomalies that remain unanswered. These anomalies were

- Reasons for market crash
- How to prevent the both
- Factors that are responsible for the uncertainty

In the 1970s certain cases were found out where people behave irrationally while making decisions. Even if the investors have a thorough knowledge about market investor behaviour, always make changes in the market trend. Some researchers started to think on applying these concepts into the field of finance and learn how the investors behaviour has impact on the investment patterns and the application of these concepts is called behavioural Finance.

II. BEHAVIOURAL FINANCE

Behavioural finance is a field of study that explains how people make financial decisions. It combines the basic underlying principles of economy with the views from psychology and sociology. It explains how people make suboptimal financial choices due to the impact of their emotions, bias and cognitive limitations and tends to make irrational decisions.

The concept of behavioural finance was explained in two levels:

1. Behavioural Finance Micro (BFMI) examines how decisions are made by each individual
2. Behavioural Finance Macro (BFMA) detects and describes anomalies in the efficient market hypothesis that behavioural models may explain (Pompian 2006)

III. PSYCHOLOGICAL FACTORS THAT INFLUENCE DECISION MAKING

Behavioural finance, do take into consideration the maximum number of psychological factors that have an impact on investment decisions of the investors. Some of those are anchoring bias, overconfidence bias, mental accounting bias, herding bias etc which are explained below

1. **Herding Bias:** In behavioural finance, herding bias refers to the tendency of the investor to follow the actions done by the larger group and try to imitate others. They are largely influenced by emotions and instincts of the larger group rather than that of their own.

   There could be many reasons why the herding bias happens. One such reason might be due to lack of information or a feeling that others get the correct information prior to us. So when the investor makes an investment and later on when he sees that there is a drastic change in the investment pattern of their peer group, he tends to change his investment portfolio. According to an article given in Forbes, the researcher Amy Morin says that when people don't have a strong opinion about the choices presented to them, rather than asking questions they prefer to mimic those around them.

2. **Mental Accounting:** Mental accounting theory was introduced in 1999 by Richard Thaler in a paper titled “Mental Accounting Matters”. He noticed that individuals classify money differently on the subjective criteria and are always making irrational investment decisions.

   So basically, mental accounting with regards to behavioural finance is the set of cognitive operations to organize, evaluate and keep track of activities done in finance. It could also be explained as a tendency to assign different values for the same sum of money.

   For example, if a person is getting a bonus amount for his/her outstanding performance, he would rather think of spending that money on a lavish dinner, vacations or some entertainment purpose rather than making an investment as he/ she would do with the regular source of income.

   According to Thaler (1999), in mental accounting there are three main components

   - In the first one, they capture how outcomes are perceived and experienced, and evaluate how they make decisions later on. The studies helped to understand how consumers make choices by incorporating the value of the ‘deal’ i.e., transaction utility.
   - Second, all the activities are assigned to a specific account. All the sources and uses of those funds are labeled properly. All the expenditures are grouped into categories whereas spendings are constraints with budgets.
   - Whereas the third component evaluates how often do people evaluate these accounts whether daily, weekly or monthly.

3. **Overconfidence Bias:** Overconfidence is a cognitive bias, in which people are highly optimistic about the outcome of the investment and they feel that the information they have is adequate for them to make any investment decisions. It could also be interpreted as the tendency in which one will overestimate their skills and predictions for success. This bias tends to change the behaviour of the investors. They underestimate the risk they are going to take while making the investment and always overestimate the ability to control events that are going to happen.

There are many types of overconfidence according to the article given on the topic Overconfidence Bias in the CFI (2022). They are as follows

- Over ranking is where someone feels that their personal performance is higher than what it actually is.
- Illusion of control bias occurs when people think they have control over a situation when in reality they have no control on it. On an average, most of the people believe they can control each situation which they are going to face.
- Timing optimism relates to time the investment required to pay back. Most of the people underestimates about the duration it project will take to pay the investor back.
- Desirability effect otherwise known as wishful thinking is one in which the investor always believe that outcome is more probably the same as they think, just because that's the outcome they want

4. **Anchoring Bias:** In most of the cases with human beings, they tend to believe in the first piece of information which they receive regarding the topic they are searching for. That information will act as an anchor and all the remaining information received will be compared to the anchor. The decisions which they make will be irrational.

   For example, when we search for a house on rent, brokers will always show us the flats which have minimal facilities and then as time goes on they will try showing us better flats. Reason behind it is that the first house which we see will act as an anchor and we compare that with other houses which we see. So, we feel the 5th or 6th house which is shown to us is better compared to the older ones.

IV. IMPLICATIONS FOR FINANCIAL MARKET

1. **Market Bubbles:** it's a phenomenon where the investors are over optimistic and they tend to buy assets with higher prices. For example, when a new airport is about to begin, the surrounding area price will rise and people will tend to pay more,that builds up a bubble and if the news is fake then the market will crash which will lead to financial crisis & recession.

2. **Market Volatility:** There are two terms associated with that. One is feel of missing out (FOMO) and the second is the feel of regret (FOR).

   When you feel that you are missing out something good, the anxiety or the insecurity that is developed is called as feel of missing out. For example, in a stock market, if the share price is increasing continuously, most of the investors tend to purchase those shares in a fear that they shouldn't miss out on the gain.

   Feel of regret are otherwise known as Regret aversion. Investors make suboptimal decisions in a tendency to avoid making decisions that will lead to future regret. In the stock market, the investors tend to hold on losing stocks for a longer time in the fear that they will sell at a loss and later they will regret.

3. **Market Crashes:** whether its market bubble or market volatility, the end result is a market crash where the financial market will be totally down and chances of recession is high.

V. HOW TO OVERCOME BIAS

1. Try to find out our biases
2. Do systematic research before investing
3. Do ask for professional advice
4. Be patient before making any decisions

VI. CONCLUSION

Behavioural finance is a complex and fascinating field of study that combines human nature & investments. As we continue to learn more about this topic, we will be able to know how investors behave in given circumstances and we will be able to train them to make more precise decisions instead of suboptimal decisions and reach their financial goals faster.

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