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Behavioral Finance: A Comprehensive Review of Literature

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Abstract
Behavioral finance is an emerging area, that has successfully refuted and questioned traditional financial theory. It soon provoked thought and developed into more than just another investing model—rather, it became conventional wisdom. Behavioral finance is considered a novel, more complete, and progressive theoretical framework due to its considerable emphasis on individual investors. This fundamental approach challenges conventional thinking while also enhancing investment proposals and procedures. To comprehend the idea influencing behavioral finance and determine whether this theory is implemented accurately when making investment decisions, the current study set out to undertake a thorough evaluation of the literature on this novel approach to investing decisions. The study's findings demonstrated the significant psychological elements influencing behavioral finance, and there is no supportive model to predict accurate results all the time.

Keywords: EMH, Behavioral Finance, market anomalies, psychological bias, Cognitive errors.

INTRODUCTION:

The investment decisions of the investors are influenced by many factors. Traditional finance theory mainly assumes that investors are rational and rational analysis of investment decisions is considered a vital influencing factor. Over some time, a good number of quality research conducted by psychologists revealed that investors are not always rational and are normal investors too. Many times normal investors make investment decisions with their psychological and cognitive errors. These facts evolved a new concept popularly known as "Behavioral Finance." A new field of study has emerged that challenges the conventional models by acknowledging the psychological component of financial decision-making (Singh, R. 2009). Behavioral finance studies on how psychology affects the financial markets (Forbes 2009). Behavioral finance is a branch of study on how psychology affects how financial professionals behave and how that behavior affects markets (Sewell 2005). Behavioral finance repudiates the idea of market efficiency by illuminating the reasons and mechanisms by which human irrationality can lead to inefficiencies in the market. Psychology experts have determined that psychological biases such as herd, cognitive errors, overconfidence etc influences the human decisions. (Cooper, M.J., et.al. 2002). The influence of psychology on the behavior of financial professionals and how that behavior affects stock markets is the subject of behavioral finance, a relatively recent field of study (Martin Sewell 2007). An economic theory called behavioral finance takes into account investors' frequently unreasonable and normal financial behavior. The study of behavioral finance integrates ideas from economics and psychology to better understand how people and markets behave, particularly when making financial decisions. The study looked into the best ways for researchers and academics to simulate the psychological underpinnings of financial decision-making (Forbes, W. 2009). These theories have profoundly influenced both academic research and practical financial management (Andrikopoulos, P. 2005). Behavioral finance is important because it can explain why and how financial decisions diverge from conventional economic theories, which frequently presume rational behavior.

NEED FOR THE STUDY:

Behavioral Finance is seriously considered in scholarly research and market anomalies in investment decisions. Market experts, Investment advisers, and academic researchers have been continuously discussing, debating, and examining the concept of efficient market hypothesis and behavioral finance theory for the last two decades. Both theories have their positive strength and negative aspects. Since the theory of behavioral finance can answer the questions on market anomalies and cannot give the expected results all the time, it creates many research avenues on this concept for future research.

OBJECTIVES OF THE STUDY:

The key objectives of the study include

a) To understand the key concepts affecting the behavioral finance.
b) To understand the application of behavioral finance.
c) To find the research gap and to shed light on future research.

RESEARCH METHODOLOGY:

The review of the literature was attained through a systematic literature survey. Existing literature for the study was secured through an online database mainly from Google Scholar, Research Gate, sci-hub, and academia. Keywords like economic theory of finance, behavioral finance, and cognitive bias. Literature available in books, journal articles, and book chapters is used for the study.

REVIEW OF LITERATURE:

The goal of the traditional approach to investor behavior was to maximize the expected utility for a logical investment. The foundations of standard finance theories were perfect self-interest, perfect market information, and perfect rationality. Assuming investors are rational, theories of conventional finance have been developed to give a mathematical explanation for real-world investment problems. These concepts include the Markowitz portfolio selection theory, the Miller and Modigliani arbitrage theory, the Sharpe, Lintner, and Mossion CAPM theories, and the Black, Scholes, and Metron option pricing theory. The rationality of investors is a foundational premise of efficient market hypotheses (EMH). When stock market abnormalities occurred, standard theories of finance were unable to provide investors with an appropriate mathematical explanation. An investor's approach to comprehending investment market anomalies is the concept of behavioral finance. According to behavioral finance, the most common causes of anomalies in the stock market and other investment markets are irrational investors, inefficient markets, and regulations. The review of existing literature on behavioral finance includes the following parameters to achieve a quality result.

a) The truth behind the paradigm shifts from the Efficient Market Hypothesis to the theory of behavioral finance.
b) Key aspects of behavioral finance.
c) Impact of behavioral finance on investment decisions.

Mier Statman (1999) attempted to identify an approach that would resolve the conflict between standard finance and market efficiency. In this instance, security prices are either a result of investors' inability to beat market efficiency or rationality. The findings of their examination revealed that behavioral finance can be used as a device for settling the battle against standard finance. Value-expressive characteristics in asset prices and investor decisions are part of behavioral finance. The research paper highlights that behavioral finance may explore asset pricing models.

Ritter (2003) in their research study, the researcher challenged the conventional wisdom that states that in an efficient market, rational investors would maximize expected utility. Cognitive psychology (the study of how people think) and the limit of arbitrage (the point at which a market becomes inefficient) are the two fundamental concepts of behavioral finance.

Akintoye, I. R.(2008) conducted a literature survey on efficient market theory and behavioral finance. The study revealed that the impact of personal biases or psychology on market circumstances appears to be supported by the sense that market fluctuations might occasionally seem unexplainable in terms of the traditional theories of stock price determination. Behavioral finance is a rapidly expanding topic of study that examines how individual or group cognitive or emotional biases produce deviations from the Efficient Market Hypothesis (EMH) as well as anomalies in market prices and returns. Behavioral models generally combine neo-classical economic theory with psychological insights.

Ricciardi V (2008) A prevalent feature in the research on the perception of risk is how investors absorb information, as well as the different behavioral finance theories and concerns that may impact an individual's assessment of risk during the decision-making process. Heuristics, overconfidence, prospect theory, loss aversion, representativeness, framing, anchoring, familiarity bias, perceived control, expert knowledge, affect (feelings), and worry are some of the behavioral finance theories and concepts that affect a person's perception of risk for various financial services and investment products.

Bloomfield (2010) Although behavioral finance is still debatable, it will gain traction if it can forecast changes from conventional financial models without using excessively "ad hoc" assumptions. The study also made the case that behavioral researchers in finance should focus on the "normal science" that their new paradigm advocates: recording and improving our knowledge of the psychological influences that shape people's behavior in financial contexts and how those actions impact market phenomena.

Borges M. R. (2010) examined the inconsistent data surrounding the efficient market hypothesis (EMH). The hypothesis is not supported on daily data for Greece and Portugal because the returns exhibit first-order positive autocorrelation.

Konstantindis et.al. (2012) The efficient market hypothesis (meh), which was most well-known and popular until the 1990s, is thought to be highly disputable and is often challenged. The study also examines the theory of behavioral finance, which is being used by financial institutions more and more frequently. The study emphasized that the theoretical foundation for successful and lucrative investing should be the theory of behavioral finance, which encourages human behavioral and psychological perspectives.

Bikas, E. et.al. (2013) The purpose of the paper is to examine, using a historical-theoretical perspective, the investing habits of non-professional investors. This article describes the psychological impacts of investing activities and highlights the goals of feelings and cognitive variables on market movements, concentrating on a small number of investor rationality. In the article, the techniques of description, comparison, analysis, and synthesis were used.

Chaudhary A K (2013) in their descriptive study, the researcher investigated the impact of behavioral patterns on investors and revealed that it strongly provides supportive insights to investors while making investment decisions. The study also revealed the new theory explains the causes of irrational investment decisions of investors, which mainly include anchoring, overconfidence, herd behavior, under and over-reaction, and loss aversion.

Shama (2014) in their study on they highlighted the fact that there is no denying that investors have feelings and personal psychological reinforcements because they are human. It will undoubtedly result in a good new development to define the stock market anomalies if the investor rationality concept of the EMH is improved and, as a result, added elements of behavioral finance too. Nevertheless, as the field is still young enough to recognize theories, behavioral finance by itself cannot be deemed to be flawless. Furthermore, behavioral finance is merely a conglomeration of ideas and concepts that are advisory and descriptive in nature. To make behavioral finance a better theory, more debates and research are needed to highlight its shortcomings.

Bashir Ahmad Joo (2015) researcher has clearly stated from the literature review that the goal of behavioral finance is to close the gap that exists between expected (prudent) behavior and actual (typical) activity. There is no comprehensive theory of behavioral finance exists that takes into account all the factors that impact investors' financial choices.

Anthony and others (2017) An investigation was conducted to determine the impact of behavioral characteristics on investors' investment decisions. To investigate the behavioral biases of the investors, five behavioral characteristics were taken into consideration: overconfidence bias, representative bias, regret aversion, mental accounting, and herd behavior. It was discovered that regret aversion and overconfidence bias had a significant influence on investors in Kerala. Their decision-making was less affected by herd behavior.

Nidhi Kumari (2017) The literature on behavioral finance a rapidly expanding area in finance, is examined in this study. The goal is to increase the understanding of behavioral finance concepts and literature to expand the area's accessibility. A comprehensive analysis of the literature has been carried out with a range of criteria and references. Following an analysis of current Behavioral Finance research trends, an agenda for future study has been established.

Virigineni et al. (2017) explored behavioral finance and stated that because of behavioral biases, the process of making investing decisions is more human than analytical. More attention has recently been paid to how investor behavior contributes to market abnormalities in prospect theory and heuristic decision-making processes. Also examined behavioral finance at a time when irrational behavior is proven not only in security markets but also in other markets like property, bullion, and commodities.

Kapoor, S., & Prosad, J. M. (2017). The conceptual foundation of traditional financial analysis was covered in the study, along with the use of traditional theories when they are thought to be inadequate. The researcher also clarified the impact of behavioral finance and its unique ability to close the gaps between conventional theories and actual-life scenarios.

ESSENCE OF THE STUDY:

The psychological behavior plays a significant role in making wise investment decisions. As a result, when choosing an investment option, an investor has to carefully consider various factors, including their financial situation, life goals, spending and saving patterns, income, perceptions of investments and lifestyle changes, time horizon, and disposition toward risk and return. Such decisions are not achieving the expectation due to various bias involved in investment decisions. These are the main reason for rising behavioral finance as an alternative to tractional EMH and is an upcoming research area.

FINDING AND CONCLUSION:

The present review of the literature study reveals the following facts.

1. A large number of research studies were carried out in the United States of America and the UK, it is comparatively very less in the Indian context. Since the condition of the investment market depends on the psychological factors considered by investors on decision making and cognitive feelings are different from nature to nation. It is very essential to conduct a primary survey on the role of behavioral finance and its impact in the Indian context.
2. The survey of available literature on behavioral finance reveals the fact that the theory is explained only from the investors' point of view and ignores the prominent role played by others like policymakers, advisors of investors, traders, employees, etc.
3. Many research studies carried out were conceptual. Future researchers can extend the application of conceptual theory to measure its cause and effect on Investment decisions in various markets.

To conclude, the "normal science" advised by new model requires behavioral researchers in finance to focus on recording and improving our knowledge of the psychological influences that shape individual conduct in financial contexts and the ways in which those actions impact market phenomena. The discipline of behavioral psychology will need to receive a lot more focus for this than what the body of current research indicates.

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