

Chapter 6

The Role of Psychological Factors in Behavioral Finance

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ABSTRACT

This chapter introduces the role of psychological factors in behavioral finance, thus explaining the theory of behavioral finance, the application of behavioral finance theory, the empirical achievement in behavioral finance, the utilization of psychological factors in behavioral finance regarding beliefs (i.e., overconfidence, too much trading, optimism and wishful thinking, representativeness bias, conservatism bias, belief perseverance, anchoring, and availability bias) and preferences (i.e., prospect theory and ambiguity aversion). Behavioral finance is a comparatively new management field that seeks to combine behavioral and cognitive psychological theory with conventional economics and finance to provide descriptions for why people make unreasonable financial decisions. Psychological factors in behavioral finance hold out the expectation of a better understanding of financial market behavior and scope for investors to make better investment decisions. Applying psychological factors in behavioral finance will tremendously enhance financial performance and achieve strategic objectives in global finance.

INTRODUCTION

Behavioral finance studies the psychology of financial decision-making. People in the industry commonly talk about the role greed and fear play in driving stock markets. Behavioral finance extends this psychological analysis to the role of biases in decision making, such as the use of simple rules of thumb for making complex investment decisions. Behavioral finance has been growing over the last twenty years specifically because of the observation that investors rarely behave

according to the assumptions made in traditional finance theory. Psychology factors are including in behavioral finance (Brahmana, Hooy, & Ahmad, 2012). The approach of behavioral finance is clustered in functionalism known as behaviorism (Brahmana et al., 2012).

Behavioral finance is reverting back to the original intents of utility theory (Nawrocki & Viole, 2014). Behavioral finance substitutes behavioral portfolio theory for mean-variance portfolio theory, and behavioral asset pricing model for the capital asset pricing model (CAPM)

DOI: 10.4018/978-1-4666-7484-4.ch006

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and other models where expected returns are determined only by risk (Statman, 2014). One of the most important factors of behavioral finance is the people's reaction and perception (Bikas, Jureviciene, Dubinskas, & Novickyte, 2014). The finance theory is of limited relevance to practitioners because its quantitative approach requires data about the future that are unavailable (Coleman, 2014). Behavioral finance describes the behavior of people making investment decisions (Sahi, 2012). Behavioral finance suggests that human decision making involves a combination of cognitive and affective dimensions (Olsen, 2010). Behavioral finance holds that human decision making can be explained from cognitive, emotional and social dimensions (DeBondt, Forbes, Hamalainen, & Muragoglu, 2010).

Regarding behavioral finance, the psychological studies are frequently cited in the business and finance literature to bolster claims that various kinds of economic disasters, from the large proportion of start-ups that quickly go out of business to the exaggerated confidence of financial investors, can be attributed to overconfidence (Olsson, 2014). Personal values, emotions, personality traits and societal influence affect investors' subjective perception of reality in financial decision making (Nga & Yien, 2013). In coping with ambiguity and uncertainty, investors often rely on cognitive biases in making financial decisions (Keil, Depledge, & Rai, 2007). Glaser, Noth, and Weber (2004) considered behavioral finance as a sub-discipline of behavioral economics is finance incorporating findings from psychology and sociology into its behavioral finance theories.

The strength of this chapter is on the thorough literature consolidation of psychological factors in behavioral finance. The extant literature of psychological factors in behavioral finance provides a contribution to practitioners and researchers by describing a comprehensive view of the functional applications of psychological factors in behavioral finance to appeal to different segments of psycho-

logical factors in behavioral finance in order to maximize the financial impact of psychological factors in behavioral finance.

BACKGROUND

The study of behavioral finance has its roots in cognitive psychology (Sahi, 2012). Cognitive psychology is a branch of psychology that pertains to the understanding of the internal mental processes of thought like visual processing, memory, thinking, learning, feeling, problem solving and decision making, judgment, and language (Sahi, 2012). Cognitive psychology considers emotion to be a product of the cognitive evaluation of an event. Though emotional factors have found to impact the financial decision making in addition to the cognitive limitations that human beings are subject to, these have found to be leading to distortions in cognitions causing biases, that need to be corrected or modified (Pompian, 2006). Behavioral finance models are usually developed to explain investor behavior or market anomalies when rational models provide no sufficient explanations.

People choose between alternatives in a rational manner (Von Neumann & Morgenstern, 1944), and that they know the probability distribution of future states of the world (Arrow & DeBreu, 1954). Modern finance assumes that markets are efficient, and that agents know the probability distribution of future market risk (Markowitz, 1952; Merton, 1969). Interdisciplinary research becomes more widespread and it is likely that greater collaboration between finance and sociology will develop in the future behavioral finance may have started as a multidisciplinary endeavor but it is now an interdisciplinary field with its own learned societies, journals and conferences. In addition, behavioral finance is still developing and continues to borrow methods and ideas from other disciplines.

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