

Financial Markets Transition from Traditional Finance to Behavioral Finance

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Abstract

The traditional finance sector, also known as conventional finance, and the more recent field of behavioral finance comprise the two main segments of the financial market. In the beginning, traditional finance theories—like Harry Markowitz's Model and the Efficient Market Hypothesis—that presuppose investor rationality were the main focus in the financial markets. But because of their implausible premises, these traditional theories were questioned in the 1990s. The global nature of today's financial markets is shaped by a multitude of factors, such as domestic economic processes, information dissemination, institutional and political constraints. The most important ones are people's opinions and responses among these. Examining the transition from traditional finance theories to behavioral finance and emphasizing the value of behavioral finance are the goals of this research paper.

Keywords: Traditional finance, rationality, Behavioural Finance.

Introduction

To stay competitive, businesses need capital for expansion and diversification. Financial markets, which are places where participants buy and sell a variety of financial assets, can be used to raise this money. Securities issued by businesses, such as bonds, stocks, shares, and debentures, are among these financial assets. As a result, a lot of research scholars now focus on studying financial markets.

Various theories have been developed to classify the financial market broadly into Traditional Finance and Behavioral Finance. Traditional Finance theory is based on the premise that investors act rationally, aiming to maximize profit while typically being risk-averse. However, these assumptions of market efficiency are often violated due to market speculations and unpredictability, commonly referred to as "market anomalies." As a result, an alternative theory known as "Behavioral Finance" emerged. Behavioral Finance focuses on the sociological and psychological aspects of investors' decision-making processes, highlighting market inefficiencies and anomalies.

A relatively recent idea, behavioural finance looks at investor psychology and how it affects financial decision-making. It implies that decisions are greatly influenced by human behavior and emotions. With information easily available to everyone, people respond almost instantaneously to emotional cues. Due to illogical and inefficient investor behavior, this can cause irrational price changes that are influenced by news and investor sentiment. Occasionally, this can lead to stock market catastrophes. There are two primary components to behavioral finance: behavioral finance macro, which looks for deviations from the efficient market hypothesis, and behavioral finance micro, which analyses the behavior of individual investors.

Literature Review

Lal (1992) examined the portfolios of 1,200 individual investors from various parts of India using a sample of this size. According to his research, Indian investors favour portfolios with more than five companies in them.

Table 1: Financial Market Anomalies and Possible Investor Bias.

Financial Market Anomalies	Possible Investor Bias
Market Over-reaction	Overconfidence
Market Under-reaction	Conservatism/anchoring/availability bias/confirmation bias/representativeness/belief perseverance
Excessive volatility	Overconfidence
Momentum	Overconfidence/availability bias/confirmation bias/herding.
Post-earnings announcement Drift	Overconfidence/availability bias/confirmation bias/herding.
Panics and Crashes	Overconfidence/availability bias/confirmation bias/herding
Holding losers too long/selling winners too quickly	Disposition Effect/prospect theory.

According to Shefrin (2001), behavioral finance is the study of how human psychology impacts financial decisions. Daniel Kahneman (2002) offered valuable perspectives on the amalgamation of economic science and psychological investigations.

Studying behavioral finance, Pompian (2006) pointed out that it is predicated on two things: individual investors and the market as a whole. He divided behavioral finance into two general categories: macro and micro behavioral finance. According to Jureviciene et al. (2012), micro behavioral finance focuses on the behavior of individual investors, setting them apart from rational thinkers who follow mathematical and statistical models, while macro behavioral finance investigates market anomalies connected to the theory of market efficiency.

In his research, Kannadhasan (2006) demonstrated that there are two models that are used in conventional finance: the Efficient Market Hypothesis and the Markowitz Model.

Table 2: Types of Biases

Emotional Biases	Cognitive Biases
1. Status Quo Bias	1. Availability Bias
2. Regret Aversion Bias	2. Framing Bias
3. Loss Aversion Bias	3. Self Attribution Bias
4. Confirmation Bias	4. Overconfidence Bias
5. Optimism Bias	5. Cognitive Dissonance Bias
6. Self Control Bias	6. Hindsight Bias
7. Endowment Bias	7. Mental Accounting
	8. Anchoring And Adjustment Bias
	9. Ambiguity Aversion Bias
	10. Representativeness Bias
	11. Conservatism Bias
	12. Illusion Of Control Bias
	13. Recency Bias

Source: Pompian (2006)

Nevertheless, investors are also influenced by other factors.

Tseng (2006) put forth a hybrid theory that combined aspects of behavioral and neural finance with the classic Efficient Market Hypothesis, which emphasizes people's rational behavior. According to Tseng, the conventional Efficient Market Hypothesis is less accurate than the recently put forth Adaptive Market Hypothesis. Traditional finance is founded on a number of important ideas:

Anticipated risk and yield

- The Capital Asset Pricing Model's measurement of risk.
- The price as a contingent claim
- The Miller-Modigliani Model

The rationality of investors is the foundation of these principles. Nevertheless, conventional finance fails to answer the following queries:

- How and for what reason do investors trade?
- How is a portfolio framed by an investor?
- How do risk-affected returns vary?

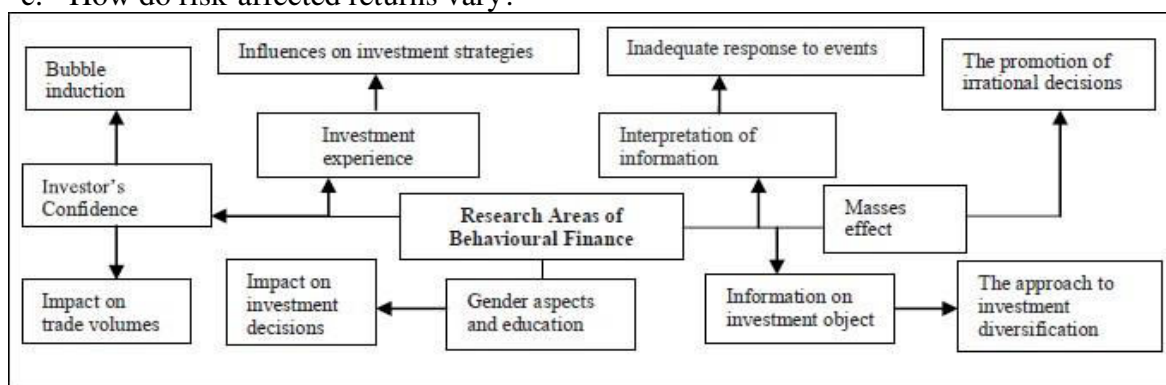


Figure 1. Research areas of behavioural finance

Finance, according to Bodie et al. (2007), focuses on the psychological aspects that affect investor behavior.

Sewell (2007) gave a summary of the evolution of behavioral science using the conclusions of numerous research studies. In order to investigate financial security, savings, and investment choices made by individual investors, NCAER (2008) looked at 60,000 households in both rural and urban areas. The study came to the conclusion that people prefer risk-free, liquid assets like bank accounts and post office schemes over stock market investments and typically save for long periods of time.

In order to better understand behavioral finance, Jordan & Miller (2008) examined people's feelings and perspectives regarding market prices and the process of making investments. According to Graham et al. (2009), small investors place greater trust in their own abilities than in the expertise of experts. They found that competent investors trade more and keep diversified portfolios, and they developed an empirical model to determine trade frequency based on investor competence. The study also discovered that, in comparison to female investors or those with lower education levels, male investors or those with higher education levels have more diversified portfolios. Using a sample of 100 individual investors, Walia

and Ravikiran (2009) investigated investor preferences for mutual funds in the Indian state of Punjab. They used ANOVA, chi-square, and ranking and rating techniques to come to the conclusion that different investors have different tastes in mutual funds. Investor behaviour is influenced by personality and demographic factors, as explained by Parashar (2010). Using a sample size of 100 individual investors, he investigated personality traits influencing investment decisions using a variety of tests, such as factor analysis, cluster analysis, correspondence analysis, and Kruskal-Wallis analysis.

According to Kabra et al. (2010), an investor's propensity for taking risks is influenced by their age and gender. A sample size of one hundred investors from the public and private sectors was employed. In his 2010 analysis, Arvid favored the behavioral approach over traditional portfolio theory, examining the effects of systematic differences on individual portfolios.

Using a sample of 38,000 households, NCAER (2011) investigated how households behaved toward different financial instruments traded in the stock market under SEBI regulation in 44 cities and 40 villages. According to the study's findings, investors are very risk averse. A study was carried out in the state of Punjab by Dawar and Wadhwa (2011), utilizing 275 Jalandhar residents as the sample size. They discovered that investors' decisions are influenced by accounting information, impartial information, one's own perception of oneself, advocate recommendations, one's own financial needs, and social relevance.

Thomas, Joost M. (2011) used client records and monthly survey data to explain how the financial crises of 2007–2009 affected society. According to his research, investors who perceived more risk had higher turnover than those who did not. Five behavioural biases were identified by Hon-Shire et al. (2012) as influencing investor decision-making in the stock market: availability heuristic, hot hand fallacy, gambler's fallacy, and herd behavior.

According to Konstantindis et al. (2012), economists and finance analysts largely acknowledged the efficient market hypothesis as the foundational theory of finance a generation ago. They did, however, note that it has been criticized for a variety of reasons. According to Konstantindis et al. (2012), economists and finance analysts generally acknowledged the efficient market hypothesis as the foundational theory of finance a generation ago. The hypothesis is not without detractors, though, for a variety of reasons, and financial decision-making is still a challenging endeavour. Several academics have questioned investors' rationality, pointing out that personal resources should not be the only factor considered when making decisions.

Based on a sample size of 92 respondents, Subash (2012) discovered that biases like gambler's fallacy, hindsight, and anchoring affect younger investors more than experienced ones.

Lubna (2012) emphasized that a variety of factors, including age, race, demographics, education level, sex, and social and economic background, contribute to individual differences in financial behavior.

Hilbert (2012) demonstrated that, in contrast to institutional investors, overconfidence, reinforcement, and herding behaviors have a greater impact on retail investors and other individuals.

Coffie (2013) provided evidence of a positive relationship between stock investment

strategies and behavioral finance theories. Additionally, his research found a few loose connections between different tactics and theories, including herding, prospect theory, anchoring, and regret theory. According to Suresh (2013), a number of financial characteristics and biases, including loss aversion, the endowment effect, hindsight bias, and anchoring, influence how people make financial decisions.

After researching the variables influencing the behavior of individual investors, Abhijeet Chandra & Ravinder Kumar (2014) discovered five psychological axes that affect decision-making. Underconfidence, caution and prudence, conservatism, financial addiction, and information asymmetry were these underlying variables. Chitra K. & Jayashree T. (2014) gathered information from 110 investors and used factor analysis, descriptive analysis, and ANOVA to examine the influence of demographic factors. They came to the conclusion that conservatism, regret aversion, overconfidence, price anchoring, and representativeness are the five primary factors influencing investor behavior.

In order to investigate behavioral traits like mental accounting, gambling, and herding, Dhole (2014) studied medical students. Neelakatan (2015) created a model to analyze investor behavior using structural equation modelling, or SEM. The findings showed that psychological biases and demographic variables affect investors' investment decisions. Through empirical research, Sukheja G. (2016) investigated the ways in which emotions, biases, and moods affect investor behavior. According to the study, overconfidence and anchoring have a big influence on decision-making. According to Mounika (2017), when it comes to making financial investment decisions, investors don't always behave logically and are swayed by behavioral.

Research Objectives

The following are the main research goals:

- To assess Traditional Finance Theory's drawbacks.
To examine how Behavioural Finance Theory and Traditional Finance Theory differ from one another.
To draw attention to the development and significance of behavioural finance theory.

Research Methodology

Study Type: The research paper uses a combination of conceptual and descriptive study methods.

Data Sources: Journals, papers, and articles from websites pertaining to conventional and behavioral finance make up the secondary data sources. To develop the research paper, a number of physical books and journals were also reviewed paper.

Analysis

Limitations of Conventional Finance

- Rationality Concept: The rationality of investor behavior is the foundation of traditional finance. However, as many researchers have pointed out, this assumption is a serious flaw in the theory. The best use of the knowledge at hand, as determined by an impartial analysis, is the definition of rational behavior. However, because they are social creatures who are affected by emotions, investors could behave irrationally, display biases, and ignore sensible factors.

- Investors' Emotional Attitude: Conventional finance frequently downplays the significance of emotions in making investment decisions. Given their social nature, investors' emotions have a significant impact on their decision-making when it comes to money.
- Accuracy of Information: Stock prices are a reflection of the assumption made by traditional finance that investors have access to all available information. As investors cannot access all information at once, this is actually not possible.
- Experience: Conventional financing makes the assumption that each investor is equally knowledgeable and skilled. In actuality, seasoned investors are probably going to make better and more informed choices than novices.
- Demographic Factors: A number of demographic factors, including family, sex, age, background, religion, and income, can have a big impact on investor behavior. These factors are not taken into account by traditional finance.

B. Growth of Behavioral Finance

Typical Investment Practices:

- Limited Asset Consideration: Investors typically concentrate on stocks and securities that are easily recognizable or visible, viewing them as less hazardous and more alluring because of their exposure, according to Kent et al. (2001).
- Loss Aversion: According to research by Kent et al. (2001), investors would sooner hang onto depreciated assets than sell them at a loss. The strong correlation between trading volume and price movements can be attributed to this loss aversion.
- Representation Biases: Investors frequently believe that historical performance indicates future results. This bias, referred to as representative bias, results in technical analysis based on historical stock prices by evaluating the likelihood of future events based on historical data.
- Aggressive Behavior: When faced with untrustworthy information, investors—especially the overconfident ones—tend to overreact. Male investors behave more aggressively than female investors, according to Odean (1999). Furthermore, successful investors might trade more, attributing their prior gains to skill rather than chance (Barber & Odean, 1999).
- Herding Behavior: Rather than conducting their own research, investors usually emulate the behavior of others. Because of this herd mentality, decisions may be made as a group based on the actions of the majority.
- Inefficient Portfolios: A variety of biases and illogical actions frequently cause investors to fail in building efficient portfolios.
- Anchoring: Past stock price highs and lows have an impact on investors' perceptions and choices. Anchoring is a bias that leads investors to base their current investing decisions on irrelevant past values.

C. Implications of Behavioral Finance:

"Only two things are infinite, the universe and human stupidity, and I'm not sure about the former," stated Albert Einstein in a famous quote. By examining how investor behavior deviates from reason, behavioral finance questions the presumptions of conventional finance. It takes into account the illogical psychological biases that traditional finance frequently ignores.

D. Key Concepts in Behavioral Finance:

- Cognitive dissonance: This is the uneasiness investors feel in their minds when their choices don't align with their values and worldviews. Investors may turn to irrational decision-making procedures in an attempt to ease their discomfort.
- Heuristic: When making decisions or solving issues, heuristics are mental short cuts or rules of thumb. Heuristics are helpful tools, but they can also introduce systematic cognitive biases. In finance, common heuristics consist of:
- Herd Behavior: Rather than depending on their own sound judgment, investors frequently follow the lead of the majority. Peer pressure and the need to fit in are the driving forces behind this behavior, which has resulted in a generalized follow-the-leader mentality in the

Table 1: Theories of Behavioral Finance

The Prospect Theory	Heuristics
Loss aversion	Herd behavior
Mental accounting	Overconfidence & over under reaction
Self control and regret	Anchoring

Source: Johnsson, et al. (2002)

financial markets.

E. Behavioral Biases:

- Overconfidence Bias: Investors who are overconfident think their evaluations and assessments of securities are more accurate than those of others. Psychologists speculate that these investors overestimate their knowledge, underestimate risks, and exaggerate their ability to control events.
- Anchoring: This bias describes the propensity to base a large number of investment decisions on a single piece of information. Investors may underreact to fresh information and shifts in trends when they base their decisions on past performance or recent observations.

F. Prospect Theory:

According to prospect theory, when faced with possible losses, investors take more risks; when faced with potential gains, they take fewer risks. Investors value profits and losses differently, giving perceived gains a higher priority than perceived losses.

- Loss and Regret Aversion: According to this theory, psychological discomfort stemming from losses is greater than psychological satisfaction resulting from comparable gains. The phrase "losses loom larger than gains" captures it. The theory explains why behavior is frequently motivated more by penalty frames than by rewards.
- Mental Accounting: People assess and classify their financial transactions using the mental accounting process. It entails dividing up funds into several budgets or accounts, which may have an impact on how much people spend and save.

Conclusion

The study of investors' psychology and sociology from their point of view is the main goal of behavioral finance. It exposes the psychological biases that influence actual investment decisions and questions the rationality assumption of conventional finance theory. When these biases are widespread, they have the potential to cause market disruptions, also known as market anomalies, and to result in investors making less-than-ideal decisions.

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