CONTRIBUTION OF BEHAVIORAL FINANCE IN INVESTMENT DECISIONS-AN ARTICLE

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Decision making is a contextual and complex process that involves thorough analysis of problem variables to select an alternative course of action. An investment decision is not an exception. Experiential learning is challenging the assumption of investor rationality, taken by traditional theorist since long. There are a large number of studies in financial research that have recognized the role of psychological element in financial decision making and led to the emergence of a new area of research called 'Behavioural Finance'. The stream takes the discipline of economics and psychology to explain the reasons behind investor irrationality. The proponents of behavioral finance believe that the effectiveness of investment strategies can be enhanced by incorporating psychological factors in investment decisions.

The contributions of Adam Smith on psychological principles of individual behaviour and Jeremy Bentham's writing on 'Motivational Underpinnings of utility in Decision Making', clearly shows a link between economics and psychology during the classical era. During the inception of neo-classical period, the explanation of economic behavior was deduced from the assumptions with respect to the nature of economic agents, which clearly signaled the distance between economics and psychology. The concept of economic human assumed that the investors have infinite ability to make rational decisions. The recourse to rationality in economic decision making had indication of tilted approach and psychology started taking a distance from economics during the mid of the twentieth century.

Models of expected utility and discounted utility resurged behavioral finance by forming the ground for decision making under uncertainty and inter temporal consumption respectively. But the most significant contribution to the field of behavioral finance came from Kahneman and Tversky in 1979 in the form of their paper on 'Prospect theory: Decision Making under Risk'

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which explained the anomalies in rational economic decision making based on cognitive psychological techniques.

The two pillars on which the field of behavioural finance is structured are Limits to Arbitrage and Psychology. Limit to Arbitrage refers to the practice of taking benefit of a price differential between two or more markets and is a precondition for a general economic equilibrium. Arbitrageurs coexist with sub-optimal investor rationality. The deviations from rationality are being explained by the behavioral economists based on empirical evidences of the biases. The factors that are of interest in this regard are beliefs and preferences. Beliefs encompass impact of overconfidence, optimism and wishful, representativeness, conservatism, confirmation bias and anchoring on investment decisions. Preferences are explained by the Prospect Theory and Ambiguity Aversion.

Absence of a Behavioural CAPM, empirical evidences in support of Efficient Market Hypothesis and investor rationality that led to systematic mental mistakes by investors emphasized on need to develop deeper understanding towards behavioral aspect of individual as well as institutional investors. Despite offering insights into systematic mental mistakes and causes behind deviations from rational behavior, the field of behavioral finance is not free from criticism. It has been criticized due to its concentration on anomalies; inapplicability of experimentally observed behaviour to market situations; limitations of experimental and survey based techniques; weak empirical evidence; too much emphasis on individual irrationality and more weightage on attitude than an investment system.