

# Comparison of Behavioral Finance and Traditional Finance: For Investment Decisions

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**Abstract-** This study has been conducted to find out the difference in traditional financial system and the behavioral finance and its application in decision making. The traditional theory believes that investors are knowledgeable, rational and they act smartly in financial markets, they are not diverted by their emotions or feelings and they have perfect information. But clearly reality does not match these assumptions. Behavioral finance is there working and influencing the financial decisions, it has been growing since 1980s specifically because of the observation that investors rarely behave according to the assumptions made in traditional finance theory. In traditional theory it has been assumed that, investors are smart, rational and they make right decisions at right time, with correct information at hand, but this assumption is not true in reality. On the other hand Behavioral finance does not depend upon emotions and mass market behavior or herds or intuitions.

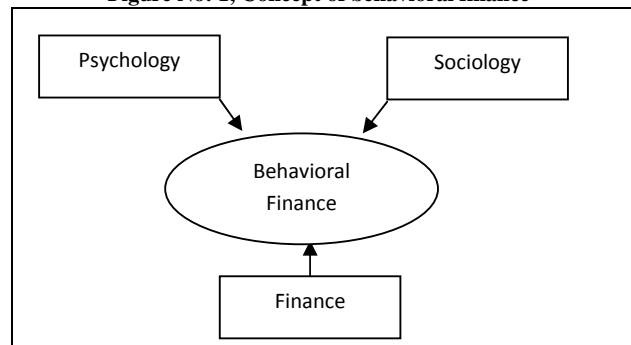
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## I. INTRODUCTION

Stock market investments are prone to emotions and herd behavior, so the sudden fall or rises of stock market indices are common. In behavioral finance investors are normal and not rational, or intuitive so that they can take decisions about investments based upon company's performances, facts and profits. [1] takes this first step as the author offers a great overview of the behavioral finance's evolution through the decades. In the 1980's, the consistency of the efficient markets model of traditional system was starting to be challenged. One issue that troubled the efficient markets complete acceptance was the problem of excess volatility. Behavioral researchers have taken the view that finance theory should take account of observed human behaviour. They use research from psychology to develop an understanding of financial decision making and create the discipline of Behavioral finance. Research in psychology has documented a range of decision-making behaviors called biases. These biases can affect all types of decision-making, but have particular implications in relation to money and investing. Behavioral finance is an add-on paradigm of finance, which seeks to supplement the standard theories of finance by introducing Behavioral aspects to the decision-making process. Contrary to the [2], [3] approach, Behavioral finance deals with individuals and ways of gathering and using information. At its core,

Behavioral finance analyses the ways that people make financial decisions. Behavioral finance seeks to understand and predicts systematic financial market implications of psychological decision processes. In addition, it focused on the application of psychological and economic principles for the improvement of financial decision-making. Markets are assumed to be inefficient in behavioral finance.

Figure No: 1, Concept of behavioral finance



As we can see in this figure behavioral finance is the combination of psychology, sociology and maximization of profits. [1] in his best-selling *Irrational Exuberance*, cautioned that society's obsession with the stock market was fueling the volatility that has since made a roller coaster of the financial system. Shiller's thought that our infatuation with the stock market distracts us from more durable economic prospects.

Shiller describes six fundamental ideas for using modern information technology and advanced financial theory to temper basic risks that have been ignored by risk management institutions. Shiller gives us a powerful means to convert our ordinary riches into a level of economic security, equity, and growth never before seen. As seen from Shillers work, investors will be less affected by market fluctuations if they follow models of behavioral finance. In this paper attempt has been made to study concept of bounded rationality for investment decision.

The study of bounded rationality also considers behavior of consumer while investing in energy efficient appliances in households.

## II. REVIEW OF LITERATURE

Modern Portfolio Theory [3] and Capital Asset Pricing Model [2] [3] has been in the practice as traditional finance theories. The theories are based on the notion that investors act rationally and consider all available information in the decision-making process, and hence investment markets are efficient, reflecting all available information in security prices.

In case of behavioral finance, Prospect theory proved useful to economics however, because it attempts to model the way people actually make decisions as opposed to simply relying on the utility decision-making strategies that made up finance theory. Prospect theory argues that people make decisions based on the potential value of gains and losses rather than the utility of the decision. [4], added that, in economic and finance theory it is necessary to apply prospect theory to financial markets. All three of these men, Amos Tversky, Daniel Kahneman, and Richard Thaler, are today considered to be among the founding fathers of behavioral finance.

Behavioral finance has the potential to be a valuable supplement to classical and neoclassical financial theory, which currently dominates financial analysis. It considers psychological factors as important input to financial analysis and decisions and is gaining increasing momentum in academic research and practical uses. Behavioral finance explains many reactions on financial markets that appear to be contrary to conventional theory and can thus make an important contribution to avoidance of serious mistakes and to finding investment strategies [5].

“To understand what behavioral finance is one must, and why it was thought to be fleeting heresy, one must first understand the standard approach to financial economics and why those who used this approach believed on theoretical grounds that cognitive biases could not affect asset pricing” R Thaler, R. (1999).

Edward J. McCaffery [6] in their chapter about the intersection between the fields of behavioral economics and public finance, said public finance is the major field in the economics fold. Its positive and normative branches rest on two basic assumptions. One, and central to public finance’s positive agenda, is that individuals are rational, maximizing agents, in the simple sense that they act consistently on the basis of a well-defined utility function.

According to Olsen, [7] increasing number of academic and professional articles are being published about research on and potential applications of behavioral finance. In the process, the traditional dominance in finance of the economic concepts of subjective expected utility and rationality are discussed. In addition, the article argues that the newer theories of chaos and adaptive decision making, which have a place in behavioral finance, can help explain the puzzle of stock-price volatility.

Neuroscientist Damasio, [8] describes how early in his career he realized that traditional views on rationality had to be wrong. He saw a patient with all the faculties for rational

behavior intact—attention, memory, logic. But brain damage had deprived the man’s ability to experience feelings, and this had robbed him of the ability to make successful decisions.

Mauboussin, [9] says classical economic theory assumes that all people have the same preferences, perfect knowledge of all alternatives, and an understanding of the consequences of their decisions. No one really believes that this idyllic state exists. In fact, ample empirical research and anecdotal evidence show that people are not perfectly rational. This gap between theory and practice has spawned the relatively new field of behavioral finance. Behavioral-finance researchers seek to bridge the gap between classical economics and psychology to explain how and why people, and markets, do what they do.

Matthew [10] Keynes drew upon psychology in developing his economic theories, and researchers in behavioral finance have integrated psychology into the study of how investors make financial decisions. Another group of researchers, experimental economists, tested some remarks of Keynes on the psychology of economic actors in specifically designed experiments. Some research in these fields, however, has been misguided because of an inadequate understanding of Keynes’s original insights.

## III. RESEARCH METHODOLOGY

This is the descriptive type of research paper. In this paper attempt has been constituted to study and understand the concept of behavioral finance, and its benefits to investment decisions.

Objectives:-

- i. To study the concept of behavioral finance
- ii. To understand difference between traditional finance and behavioral finance
- iii. To analyze the utility of models of behavioral finance for better investments decisions
- iv. Study of behavioral economics for understanding concept of bounded rationality

This conceptual paper is focuses on analysis of behavioral finance, and traditional finance, also attempting to compare both the concepts, while understanding the utilization of behavioral finance in real life, with reference to energy conservation behavior.

Data sources: secondary data from reputed journals and databases, all the sources are authentic and relevant.

## IV. BEHAVIORAL BIAS EXISTED WHILE MAKING DECISIONS -

*Confirmation Bias*- We like to think that we carefully gather and evaluate facts and data before coming to a conclusion. But we don’t. Instead, we tend to suffer from

confirmation bias and thus reach a conclusion first. Only thereafter do we gather facts and see those facts in such a way as to support our pre-conceived conclusions. When a conclusion fits with our desired narrative, so much the better, because narratives are crucial to how we make sense of reality.

*Optimism Bias*- This is a well-established bias in which someone’s subjective confidence in their judgments is reliably greater than their objective accuracy. Indeed, we live in an overconfident, venture capitalists are wildly overconfident in their estimations of how likely their potential ventures are either to succeed or fail.

*Loss Aversion*- We are highly loss averse. Empirical estimates find that losses are felt between two and two-and-a-half as strongly as gains. Loss aversion favors inaction over action and the status quo over any alternatives. Therefore, when it comes time for us to act upon the facts and data we have gathered and the analysis we have undertaken about them, biases 2 and 3 – unjustified optimism and unreasonable risk aversion – conflict. As a consequence, we tend to make bold forecasts but timid choices. Sometimes, we tried to sale the stocks which are sold by many investors.

*Self-Serving Bias*-Our self-serving bias is related to confirmation bias and optimism bias. Self-serving bias pushes us to see the world such that the good stuff that happens is my doing while the bad stuff is always someone else’s fault

*The Planning Fallacy*-Nobel laureate Dan Kahneman outlines what he calls the “planning fallacy.” It’s a corollary to optim\*ism bias and self-serving bias. Most of us overrate our own capacities and exaggerate our abilities to shape the future. The planning fallacy is our tendency to underestimate the time, costs, and risks of future actions and at the same time overestimate the benefits thereof. It’s at least partly why we underestimate bad results. It’s why we think it won’t take us as long to accomplish something as it does.

*Choice Paralysis*-Intuitively, the more choices we have the better. However, the sad truth is that too many choices can lead to decision paralysis due to information overload.

*Herding*-We all run in herds — large or small, bullish or bearish. Institutions herd even more than individuals in that investments chosen by one institution predict the investment choices of other institutions by a remarkable degree. Even hedge funds seem to buy and sell the same stocks, at the same time, and track each other’s investment strategies.

*We Prefer Stories to Analysis*-As noted above, narratives are crucial to how we make sense of reality. They help us to explain, understand and interpret the world around us. They also give us a frame of reference we can use to remember the concepts we take them to represent.

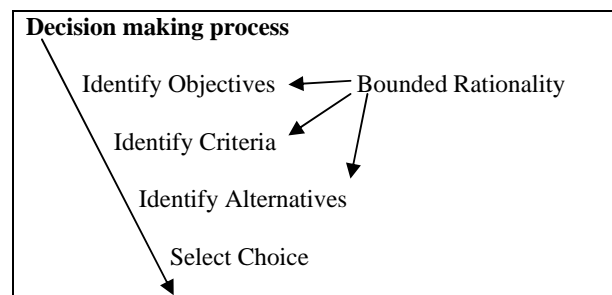
*Recency Bias*- We are all prone to recency bias, meaning that we tend to extrapolate recent events into the future indefinitely. We try to involve the current experience in our decision makings.

*The Bias Blind-Spot*-- cognitive biases which influence us and make it difficult for us to make good choices. One example is “When physicians receive gifts from pharmaceutical companies, they may claim that the gifts do not affect their decisions about what medicine to prescribe because they have no memory of the gifts biasing their prescriptions. However, if you ask them whether a gift might unconsciously bias the decisions of other physicians, most will agree that other physicians are unconsciously biased by the gifts, while continuing to believe that their own decisions are not. This disparity is the bias blind spot.

#### IV. RATIONALITY VS BOUNDNED RATIONALITY

Rationality assumes that the consumer is having perfect information, in practice consumers tends to behave on rule of thumbs instead of optimization, researchers in the Behavioural Economics field have identified a host of behaviors that are counter to rational choice theory and can generally be classified under the umbrellas of cognitive bias and bounded rationality. Bounded rationality describes decision-making based on imperfect information and includes behaviours such as procrastination, simplified decision-making heuristics, and disproportionate weight to readily observable factors, which result from a lack of readily available and complete information. Behavioral Economics research suggests that these deviations from neoclassical assumptions are sufficiently consistent to have doubt on the usefulness of the neoclassical paradigm or traditional models of decision-making. (IEA, 2014)

Figure No: 2 -Concept of bounded rationality



From above figure No.02, it is indicated that, bounded rationality is active at all the stages of rationality model of decision making.

The Bounded rationality means that the consumers are rational but they have cognitive limitations in processing information [11] this phenomenon focuses on constraints of human being while taking any decision. Therefore behavioral finance takes in to account the psychological aspect of human being, which deviates from rationality in certain circumstances.

## V. TRADITIONAL FINANCE

Traditional finance has dominance in the market. It assumes that efficient market hypothesis concept, means markets are efficient in the sense that investors are rational and by implication securities are valued rationally. Second is based on the idea that everyone takes careful account of all available information before making investment decisions. It is related to internal consistency.

The third principle is that the decision maker always pursues self-interest. Most widely applied in finance is the expected utility model of choice under risk, proposed by Von Neumann and Morgenstern [12] [13] its rationality is based on axioms underlying expected utility maximization as the optimal rule. The accumulation and processing of information and the formation of expectations occur efficiently, yielding possible outcomes (of total wealth) and wealth maximization.

## VII. BEHAVIORAL ECONOMICS APPLICATION

Behavioral finance can be used for avoiding stock market crises, financial crises and for maximization of wealth of investors. Various biased can be overcome by application of behavioral finance theories. Behavioral finance focuses on research that removes the traditional assumptions of expected utility maximization with rational investors in efficient market. The two building blocks of behavioral finance are cognitive psychology and the limits to arbitrage [14]. Cognitive refers to how people think and the limit to arbitrage when market is inefficient. There is a huge psychology literature documenting that people make systematic errors in the way they think: they always make decision easier (heuristics) by rule of thumb, overconfidence, put too much weight on recent experience (representativeness), separate decisions that should be combined (mental accounting), wrong presenting the individual matters (framing), tend to be slow to pick up the changes (conservatism), and their preferences may also create distortion when they avoid realizing paper losses and seek to realize paper gains (disposition effect). Behavioral finance uses models in which some agents are not fully rational, either because of preferences or because of mistaken beliefs. An example of an assumption about preferences is that people is loss averse. Everyone wants to avoid losses; this habit tends to influence our decisions of investments and other financial issues.

By drawing on critical insights from behavioural economics and psychology, [15] illuminated the key cognitive biases and motivational factors that may explain why energy-related behaviour so often fails to align with either the personal values or material interests of consumers. This approach may be helpful in planning the intervention for energy conservation.

## VIII. CONCLUSION

Emotions and feeling are definitely working while we are taking any decision, in case of financial decisions related to investments; we have to avoid any kind of bias, influence so that as investors' we can minimize losses. Behavioral finance is extension of behavioral economics. Daniel Kahneman was awarded Nobel Prize for his contribution to behavioral economics. For avoiding biases and heuristics investors' has to carefully study the market, or has to follow technical details given by the experts. Markets will see sustained growth if they follow strategy, plan and perfect action by avoiding mental shortcuts, biases or intuitions. Consumer behavior is complex phenomenon, when it comes to decision making about energy savings consumers prefers short cuts and heuristics. Study of behavioral economics is necessary for planning related to energy conservation.

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