

DegreeLive

BEHAVIOURAL FINANCE

BBA Semester 5 – Calicut University

DegreeLive

MODULE 1: BASICS OF BEHAVIOURAL FINANCE

Behavioural Finance

1. Behavioural Finance studies how psychology influences financial decisions and market outcomes.
2. Challenges the assumption that investors are always rational.
3. Combines finance, economics and psychology.

Scope

1. Investor behaviour.
2. Market anomalies.
3. Decision-making biases.
4. Asset pricing.

Objectives

1. Understand investor behaviour.
2. Explain irrational market movements.
3. Improve investment decisions.

Significance

1. Explains stock market fluctuations.
2. Helps understand financial mistakes.
3. Improves portfolio management.

Applications

1. Investment decisions.
2. Portfolio management.
3. Financial planning.
4. Risk management.

Psychology of Financial Markets and Investor Behaviour

Investor Behaviour

1. Actions and decisions made by investors regarding investments.

Psychological Factors

1. Emotions.
2. Beliefs.
3. Expectations.

4. Biases.

Impact on Markets

1. Overreaction.
2. Underreaction.
3. Herd behaviour.
4. Market volatility.

Behavioural Finance Market Strategies

Meaning

1. Investment strategies considering psychological factors and market behaviour.

Objectives

1. Identify market inefficiencies.
2. Exploit investor biases.
3. Improve returns.

Examples

1. Contrarian investing.
2. Value investing.
3. Sentiment-based investing.

Prospect Theory, Mental Accounting and Disposition Effect

Prospect Theory

1. Developed by Daniel Kahneman and Amos Tversky.
2. People value gains and losses differently.
3. Losses hurt more than equivalent gains provide satisfaction.
4. **Key Idea:** Investors are generally loss-averse.

Mental Accounting

1. Individuals separate money into different mental categories.
2. Example: Treating bonus income differently from salary income.

Disposition Effect

1. Tendency to sell winning investments too early and hold losing investments too long.

MODULE 2: BUILDING BLOCK OF BEHAVIOURAL FINANCE

Cognitive Psychology and Limits to Arbitrage

Cognitive Psychology

1. Study of how people think, learn and make decisions.

Importance in Finance

1. Explains biases in investment decisions.

Arbitrage

1. Earning profit from price differences in markets.

Limits to Arbitrage

1. Risks and costs prevent arbitrageurs from correcting market mispricing completely.

Reasons

1. Market risk.
2. Transaction costs.
3. Information uncertainty.

Demand by Arbitrageurs

Arbitrageurs

1. Investors seeking profit from pricing inefficiencies.

Demand by Arbitrageurs

1. Buying undervalued assets.
2. Selling overvalued assets.

Importance

1. Helps improve market efficiency.
2. Reduces mispricing.

Risk, Noise Trader Risk and Professional Arbitrage

Risk

1. Possibility of financial loss.

Noise Traders

1. Investors making decisions based on rumours, emotions or incorrect information.

Noise Trader Risk

1. Risk created by irrational trading activities.

MODULE 3: RATIONALITY

Ellsberg's Paradox

1. Demonstrates that people prefer known risks over unknown risks.
2. Challenges traditional expected utility theory.

Significance

1. Shows investors dislike uncertainty.
2. Supports behavioural finance concepts.

Rationality: Economic and Evolutionary Perspectives

Economic Perspective

1. Rational individuals maximize utility using available information.

Evolutionary Perspective

1. Human decisions evolved for survival rather than perfect financial optimization.

Implication

1. Financial decisions may not always be fully rational.

Different Ways to Define Rationality

Rationality

1. Making decisions logically and consistently to achieve objectives.

Different Views

1. Economic Rationality.
2. Psychological Rationality.

Professional Arbitrage

1. Trading by skilled investors attempting to exploit market inefficiencies.

Limitation

1. Irrational behaviour may continue longer than expected.

Destabilizing Informed Trading and Expected Utility

Informed Trading

1. Trading based on superior information.

Destabilizing Informed Trading

1. Sometimes informed traders can increase market volatility instead of reducing it.

Expected Utility Theory

1. Traditional theory explaining decision making under risk.

Principle

1. Individuals choose options providing highest expected satisfaction (utility).

Importance

1. Foundation of traditional finance theory.

3. Practical Rationality.

Dependence on Time Horizon

Short-Term Rationality

1. Focuses on immediate outcomes.

Long-Term Rationality

1. Focuses on future benefits and sustainability.

Individual and Group Rationality

Individual Rationality

1. Decision benefits individual decision-maker.

Group Rationality

1. Decision benefits the group as a whole.

Difference

1. What benefits an individual may not always benefit the group.

Herbert Simon and Bounded Rationality

Herbert Simon

1. Nobel Prize-winning economist.

Bounded Rationality

1. People make decisions with limited information, limited time and limited cognitive ability.

Result

1. Individuals seek satisfactory solutions rather than perfect solutions.

Concept

1. "Satisficing" instead of maximizing.

Demand by Average Investors

Average Investors

1. Ordinary investors with limited information and expertise.

Characteristics

1. Influenced by emotions.
2. Influenced by media and market sentiment.
3. Often follow trends.

Impact

1. Can contribute to market inefficiencies.

Belief Biases, Limited Attention and Categorization

Belief Biases

1. Errors caused by personal beliefs and assumptions.
2. Examples: Overconfidence, Confirmation Bias, Anchoring.

Limited Attention

1. Investors focus only on selected information while ignoring other relevant data.

Categorization

1. Grouping investments into simplified categories for decision making.
2. **Effect:** Can lead to inaccurate judgments.

MODULE 4: INVESTOR BEHAVIOUR

External Factors and Investor Behaviour

External Factors

1. Economic conditions.
2. Political events.
3. Government policies.
4. Media reports.
5. Global developments.

Impact

1. Influence investment decisions.
2. Affect market expectations and confidence.

Fear and Greed in Financial Markets

Fear

1. Causes investors to sell investments quickly.
2. Leads to panic selling and market declines.

Greed

1. Encourages excessive risk-taking.

Non-Traditional Preferences

Meaning

1. Preferences that differ from traditional rational finance assumptions.

Examples

1. Fairness concerns.
2. Social preferences.
3. Loss aversion.
4. Emotional preferences.

Importance

1. Better explains actual investor behaviour.

Bubbles and Systematic Investor Sentiment

Bubble

1. Asset prices rise significantly above intrinsic value.

Causes

1. Excess optimism.
2. Speculation.
3. Herd behaviour.

Investor Sentiment

1. Overall market mood or attitude.

Systematic Investor Sentiment

1. Widespread optimism or pessimism affecting market prices.

Effects

1. Overvaluation.
2. Undervaluation.
3. Increased volatility.

2. Leads to speculative buying and market bubbles.

Importance

1. Major drivers of market movements.

Emotions and Financial Markets

Emotions Affect

1. Risk perception.
2. Decision making.
3. Investment timing.

Common Emotions

1. Fear.
2. Greed.
3. Hope.
4. Regret.
5. Overconfidence.

Impact

1. Irrational investment decisions.
2. Increased market volatility.

Geomagnetic Storm

Meaning

1. Disturbance in Earth's magnetic field caused by solar activity.

Behavioural Finance View

1. Some studies suggest geomagnetic activity may influence human mood and behaviour.

Possible Effects

1. Changes in investor sentiment.
2. Changes in risk-taking behaviour.

Note

1. Evidence remains debated and not universally accepted.

Statistical Methodology for Capturing External Influences on Stock Returns

Purpose

1. Measure relationship between external factors and market returns.

Common Techniques

1. **Correlation Analysis:** Measures relationship between variables.
2. **Regression Analysis:** Examines impact of one variable on another.
3. **Time Series Analysis:** Studies market behaviour over time.

Applications

1. Investor sentiment studies.
2. Market prediction.
3. Behavioural finance research.

Importance

1. Helps understand how external influences affect stock market performance.