An Investigation of the Affect Heuristic in the Brazilian Stock Market

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ABSTRACT

It is considered that decisions are influenced, even in part, by aspects of affect. It is agreed with that studies that suggest the action of the affect heuristic, which can influence the perception of risks and benefits, even in environments where rationality should be more prominent, such as in the financial market. This paper investigates how risks and benefits are perceived by Brazilian stock market investors. Additionally, it investigates whether these aspects could be explained by gender, age or perceived knowledge about the market. The analysis makes use of the t-test, logistic regression and factor analysis and is applied to a sample consisting of 143 investors. The results confirm the existence of the affect heuristic and a negative association between perceived knowledge of the market and the affect heuristic.

Keywords: Affect Heuristic, Behavioral Finance, Benefit, Biases, Economic, Heuristic, Psychology, Risk, Stock Market

1. INTRODUCTION

Heuristics are mental shortcuts used by individuals to simplify a decision process. For Bazerman & Moore (2010), heuristics simplify the decision process, but can sometimes lead to serious errors. These errors result from biased decisions, when the use of heuristics is not implemented properly, leading the decision-maker to fall into one of the many pitfalls of judgments: biases.

The word heuristic derives from the Greek Heureka, which means “discovered” (Ferreira, 2008). The present study examines if persuasive stimuli lead individuals to change their perception of the risk and benefit of a financial investment.

Decisions involve people, professional relationships, financial issues and feelings. The question here is whether these decisions are made correctly, i.e., if these decisions take into consideration all of the pros and cons based on economic rationality. Evaluation is difficult because the influences that affect decisions may be driven by emotions, value judgments or impulses. They are affected by external or internal stimuli that make the decision imperfect, escaping from the prerogatives of homo

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economicus that are immune to behavioral or emotional interference.

Works like those by Shefrin (2001) and Ackert, Church & Deaves (2003) have shown that systematic decisions, and even financial ones, are strongly influenced by behavioral factors. Ackert, Church & Deaves (2003) discuss the influence of emotions on judgments and decisions of a financial nature. They conclude that emotional factors do not necessarily contaminate the decisions (in the negative sense) and emphasize the need to incorporate non-cognitive factors, like emotion, to understand the decision process, especially in a financial context. For Shefrin (2001, p. 2) “behavioral costs tend to undermine value creation. They are the costs – or, alternatively, the loss in value – associated with errors that managers make because of cognitive imperfections and emotional influences.”

The locus of decisions and judgments made, particularly in the context of finance and investments should not have room for the absence of rationality. Decisions should be taken with consideration and analysis of all possibilities, in addition to evaluating all possible interactions between risk and return. The alternative that maximizes usefulness should be chosen. This study contributes to the discussion by analyzing the presence of the affect heuristic in a sample composed of 143 Brazilian investors. Furthermore, it studies judgments associated with positive and negative stimuli related to risks and benefits. Additionally, it investigates which variables could explain the manifestation, incorporating discussions on age, gender and knowledge.

Although some studies have aimed to investigate the influence of the affect heuristic in various fields, this paper contributes to the literature by providing two points that have been little explored. Firstly, the affect heuristic may even manifest in individuals who should be especially rational, in this context, investors in the stock market. Secondly, the relationship between the presence of the affect heuristic and age, gender, and knowledge is studied.

Furthermore, this study is pioneering because it deals with investors in emerging markets in the context of the affect heuristic, which is an unknown area in research. In this sense, this paper fills an existing gap and makes way for new research on the subject.

### 2. THEORETICAL BACKGROUND–MATERIAL

In this section, the theoretical foundation of the affect heuristic and key studies that support its theoretical framework will be presented. One of the studies that stands out is an empirical study by Finucane, Alhakami, Slovic & Johnson (2000), whose methods and results are given in Table 1. In addition to this important study, other studies conducted internationally are shown in Table 2.

Kahneman & Tversky (1974) identify the existence of three heuristics: (a) representativeness, (b) availability, (c) anchoring and adjustment. In more recent works such as Finucane, Alhakami, Slovic & Johnson (2000) and Slovic, Finucane, Peters & MacGregor (2002) signs of the affect heuristic, in which individuals are influenced by emotional factors, have begun to appear. The central proposition of these studies focuses on the fact that “affect is an essential component in many forms of judgment and decision making.” The authors do not attribute the influence of decisions only to emotional aspects, but argue that these aspects act in unison with the cognitive to be responsible, albeit in part, for decisions.

According to the definition of the affect heuristic given by Finucane, Alhakami, Slovic & Johnson (2000), this may serve as a shortcut for many important judgments. Using a set of feelings already available can be much easier - and more efficient - than weighing the pros and cons, or retrieving the relevant information from memory, especially when the decision or judgment is complex, or resources (time, information, knowledge) are limited. This characterization of a mental shortcut led the authors to use the label affect heuristic.
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