Chapter 1
Theory of Behavioral Finance

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ABSTRACT
This chapter explores the evolution of modern behavioral finance theories from the traditional framework. It focuses on three main issues. First, it analyzes the importance of standard finance theories and the situations where they become insufficient i.e. market anomalies. Second, it signifies the role of behavioral finance in narrowing down the gaps between traditional finance theories and actual market conditions. This involves the substitution of standard finance theories with more realistic behavioral theories like the prospect theory (Kahneman & Tversky, 1979). In the end, it provides a synthesis of academic events that substantiate the presence of behavioral biases, their underlying psychology and their impact on financial markets. This chapter also highlights the implications of behavior biases on financial practitioners like market experts, portfolio managers and individual investors. The chapter concludes with providing the limitations and future scope of research in behavioral finance.

INTRODUCTION

... The rage for possessing them soon caught the middle classes of society, and merchants and shopkeepers, even of moderate means, began to vie with each other in the rarity of these flowers and the preposterous prices they paid for them.

One would suppose that there must have been some great virtue in this flower to have made it so valuable in the eyes of so prudent a people as the Dutch; but it has neither the beauty nor the perfume of the rose.- Charles Mackay, on the tulip mania of 1630’s, Memoirs of Extraordinary Popular Delusions and the Madness of Crowds (1841)

Investors’ irrationality is an inevitable reality as long as the markets themselves have existed. Perhaps its earliest recorded evidence is given by Charles Mackay (1841). In his book Memoirs of
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Extraordinary Popular Delusions and the Madness of Crowds, he mentions three instances that highlight the erratic behavior of crowds. These were the Dutch Tulip bubble (1630’s), the South Sea company bubble (1711-1720) and the Mississippi Company bubble (1719-1720). Out of these, the Dutch Tulip bubble, popularly known as tulip mania is one of the most cited accounts. In the Dutch Golden Age, a new flower ‘Tulip’ was introduced in the Netherlands. The Dutch people became excited about this exotic variety and started investing their money in it. Gradually investments in tulips became a craze which pushed the prices higher and higher. At the peak of tulip mania, a single bulb sold for more than 10 times the annual income of a skilled worker. The market finally collapsed when people sensed they have spent a greater part of their income on a flower bulb. They started to dispose of their tulip stocks as quickly as possible and the price plummeted, leading to heavy losses (Mackay, 1841; Dash, 2001, Shiller, 2005).

Events like the tulip mania makes us ask a very basic question: are investors really rational? This question has been raised by various researchers in the past and it relates to the dilemma that investor behavior does not conform to traditional financial theories. The traditional theories focus on a widely accepted approach of “fully rational agent” where decision making is based solely on available data and mathematically proven concepts. This approach was considered the backbone of financial decision making until its predictions did not confirm with actual market conditions. In an ideal scenario where this approach is applicable, the market is informationally efficient, i.e. the security prices would incorporate all the information available in the market. In this case, all the securities would be fairly priced. However, we do not live in such a utopian world and the markets are largely inefficient. The presence of market anomalies like speculative bubbles, overreaction and underreaction to new information, is a proof that the financial decision making process involves more than a cold, calculative rational agent. Thus, the need for understanding such anomalies and shortcomings of human judgment involved with them became the precursor of behavioral finance.

Behavioral finance is a relatively new school of thought that deals with the influence of psychology on the behavior of financial practitioners and its subsequent impact on stock markets (Sewell, 2007). It signifies the role of psychological biases and their specific behavioral outcome in decision making. Meir Statman (1999) explains its concept in a more straight forward term by stating that “People in standard finance are rational. People in behavioral finance are normal”. This field tries to replace the rational homo economicus with a more realistic behavioral agent who is ruled by sentiments and is prone to make biased decisions. The knowledge about behavioral biases provides a deeper insight into the underlying psychology of market participants. It enlightens us about the fact that because of our psychology, or more aptly our human nature, we are prone to make certain mistakes. These mistakes can prove to be very costly in financial markets and thus they can’t be ignored. Stock market crashes are one of the consequences of such ignorance. This makes behavioral finance an extremely relevant topic in today’s times. This field helps the financial practitioners in recognizing their own mistakes along with those of others, understanding the reasons behind these mistakes and avoiding them. It makes the practitioners more aware of the forces that guide them in their decision making, as well as those driving the market. In this chapter we aim to discuss the progression of behavioral finance theories from the traditional framework. We then critically analyze the importance of traditional theories in the field of finance and the situations where they lack, along with the significance of behavioral finance in narrowing down these gaps. We finally provide a synthesis of academic events that substantiate the presence of behavioral biases, their underlying psychology and their impact on financial markets.
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