Chapter 9

Behavioral Strategies to Achieve Financial Stability in Uncertain Times

Ashlesha Khedekar-Swaminathan
Symbiosis International University (Deemed), India

ABSTRACT

The automatic use of heuristics, the effects of framing, and the tendency to procrastinate when combined with the risk and uncertainty inherent in the financial environment can lead to financial instability for ordinary investors. This chapter explores established behavioral tendencies with respect to financial decision making within the framework of behavioral economics: how and why heuristics are used to make decisions, how different choice frames influence decisions, the crucial impact of biases like loss aversion on decision outcomes. The chapter also explores critical factors that induce the tendency to procrastinate saving and investing. The chapter suggests strategies that investors can use to achieve long-term financial stability by achieving predetermined financial goals as well as protect their investments from depreciating in value in the context of financial market instability.

INTRODUCTION

Instability in the economic and financial environment is unavoidable in current times. The main sources of market instability tend to be the unknown factors in the environment. These unknown factors or events can be referred to as market uncertainty (Slovik, 2011). Ellsberg (1961) defined an event as uncertain if it had unknown probability. Knight (1921) defined uncertainty as being characterized by randomness that cannot be measured precisely and therefore cannot be insured. Under these definitions, an uncertain event can be characterized as an event whose probability is unknown and immeasurable. With respect to uncertainty in financial markets, the efficient market hypothesis (Fama, 1970) provides another perspective. The theory states that market prices include all known information and instantly reflect any new information. This implies that in an efficient market, any unknown information cannot be reflected in market prices. This unknown information set represents market uncertainty.

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In current times, uncertainty can stem from events such as measures taken by governments and central banks like demonetization; changes in tax policies or trade relations; unexpected changes in international frameworks like the British vote to exit the European Union; political upheavals; as well as effects on business caused by natural disasters like floods or hurricanes or war-like situations. Such events are exogenously determined and are therefore difficult to predict even for experts. Uncertainty can also stem from unique events created by firms or individuals like conceiving Ponzi schemes, cooking the books, large scale financial frauds, announcement of mergers, acquisitions or hostile takeovers.

Globalization of business and cross border investments have increased the domestic impact of international events. Therefore, domestic financial markets, and consequently investors in an open economy, can expect to experience market instability that can be a result of local or international erratic/ uncertain incidents. When uncertain factors or events become more certain, or rather, their probability becomes more measurable, the new information will be reflected or adjusted in asset prices, and this adjustment can be positive or negative. The period of adjustment typically involves some degree of instability in asset prices until prices settle at some new level. This adjustment can be sudden or may take place over a period of time (Rigotti & Shannon, 2005; Slovik, 2011). Such an unanticipated change in prices can be perceived as instability in the financial markets. Another significant aspect of market uncertainty, from the perspective of market stability is the degree of market uncertainty (Slovik, 2011). Changes in prices would implicitly reflect the changes in the degree of confidence investors have in an estimate of the probability of an event’s occurrence (Ramsay, 1926; Ellsberg, 1961).

Media cascade was described by Kahneman (2011) as the extensive media coverage of uncertain or unpredictable events which tends to influence decision making. A media cascade focuses most investors’ attention on stock price movements, market developments and related news, thus informing the investors’ estimations of the probability of an event’s occurrence and prediction of values (Tversky & Kahneman, 1974) i.e. indirectly determining the unknown and known information sets for decision making. By extension, it can be assumed that a media cascade can also influence the degree of uncertainty of an event. Thus, investors tend to be unaware of or pay less attention to the gradual development of events outside the known information set and are subsequently taken by surprise when an uncertain event occurs or its probability of occurrence apparently increases suddenly (Tversky & Kahneman, 1974; Wilson & Brekke, 1994).

Although all financial markets are sensitive to the instability with a varying degree, this chapter focuses on stock markets rather than commodities markets, bond markets or currency markets. Stock markets are more accessible; therefore, they are relatively more attractive to ordinary investors (as opposed to experienced traders) (Jiwarajka, 2017; Investment Company Institute, 2017). For example, 83% of retail investors in India prefer to invest directly in stocks (Businessworld, 2017). An ordinary investor may invest directly in stocks or via mutual funds with the objective of increasing their wealth (Buch, 2017; Times of India, 2017). Instability in this financial market can adversely affect the wealth creation of participating investors due to its vulnerability to associated market uncertainties. As a reaction to changes in prices, an ordinary investor may restructure their investment portfolio or withdraw funds from the market. Given the risk-reward matrix in financial markets, should the investor choose to shift funds into products perceived as less risky, they would be implicitly accepting a lower return on their investment.

Literature in economics and finance distinguishes between uncertainty and risk wherein risk, characterized by randomness, can be measured precisely (Ellsberg, 1961), but ordinary investors tend to treat them synonymously. This is because uncertainty is not just a necessary condition for risk; the dynamic nature of risk also introduces uncertainty (Gough, 1988). Gough (1988) argues that the distinction