AN ANALYTICAL STUDY ON BEHAVIORAL FACTORS AFFECTING BUYING DECISION OF INVESTORS IN STOCK MARKET

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Abstract:

The field of behavioral finance unlike traditional finance could provide an excellent insight about how markets having both rational as well as irrational agents are functioning. From an individual investor's point of view also, this study helps in determining the presence of psychological biases in the process of making optimal investment decisions. The objective of this research is to identify the behavioral factors that emerge out of the psychological biases. It is found that people typically give too much weight to past experience and extrapolate recent trends. Investors tend to become more optimistic when the market goes up and more pessimistic when the market goes down.

Keywords: *Behavioral Finance, Investors, Stock, etc.*

1.1 Introduction:

A financial market is a place where people trade in financial assets at prices that are determined by the demand and supply forces. Stock market is one kind of financial market where traders buy and sell equities. Participants in a stock market range from small individual investors to large institutional investors.

The stock markets are often considered as the prime indicator of a country's economic strength and development. Participants in the stock market often move asset prices away from their true value. However, financial economists argue that financial markets are efficient and this led to the emergence of the Efficient Market Hypothesis.

1.2 Efficient Market Hypothesis:

The Efficient Market Hypothesis (EMH) states that it is impossible to "beat the market" because stock market efficiency causes existing stock prices to reflect all available information.

Traditional finance is mainly characterized by this Efficient Market Hypothesis, which has become widely accepted since the early1960's as the 'theory of random walks' and as the 'rational expectations theory' in mainstream economics literature. The Efficient Market Hypothesis progressed from a state of curiosity, taken seriously by only a few researchers in the economics and finance communities, to that of a dominant paradigm in finance. It is the basis of an emerging revolution in macroeconomics where the principle is still generally referred to as 'rational expectations'. In the literature of finance, accounting and the economics of uncertainty, the Efficient Market Hypothesis is accepted as a fact of life (Meredith Beechey, David Gruen and James Vickery, 2000).

1.3 Rationale behind the study:

The field of behavioral finance unlike traditional finance could provide an excellent insight about how markets having both rational as well as irrational agents are functioning. This helps policy makers, the corporate world and all other stakeholders to get a better understanding of their markets and thereby be in an advantageous position as regulators, arbitrageurs or participants.

From an individual investor's point of view also, this study helps in determining the presence of psychological biases in the process of making optimal investment decisions.

Stock markets are the barometers of an economy. A country's economic well being is judged by how well the stock markets are performing. Thus, this study will probe into the health status of the Indian stock market as a whole and the investing crowd in particular.

2. Literature Review:

Gilovich, Griffin and Kahneman (2002) in their book compiled the most crucial research in the field of heuristics and biases. In the introduction, they identify six general purpose heuristics namely affect, availability causality, fluency, similarity and surprise. They also identify six special purposes heurtistics namely attribution, substitution, outrage, prototype, recognition, choosing by liking and choosing by default.

The next book on individual irrationality is the one written by Dan Ariely (2008) and the book is titled, 'Predictably Irrational'. This book is about human irrationality in general and about their distance from perfection. According to him irrational behavior are neither random nor senseless. They are systematic and since it is repeated again and again it is also predictable.

Martin Sewell (2007) in his paper on 'behavioral finance' reviewed the major works and gives a summary of important heuristics. He discussed Kahneman and Tversky's prospect theory and states that according to the theory value is assigned to gain and losses rather than to final assets and also probabilities are replaced by decision weights. The important heuristics identified by him are affect heuristic that is responses given to stimulus , availability and similarity heuristic.

3. Research Methodology:

3.1 Research Design:

In the present research descriptive research design has been used to describe the behavioural factors that emerge out of the psychological biases of investors and also to discriminate different categories of traders based on their trading frequency.

3.2 Objective of the Study:

The following are the specific objectives of the study:

a. To identify the behavioral factors that emerge out of the psychological biases.
b. To study those behavioral factors that best discriminate different categories of traders based on their trading frequency.

3.3 Data Collection:

For the purpose of this research the primary data has been collected through semi-structured questionnaire from traders in stock market and secondary data is collected from official website of NSE and BSE.

3.4 Sample Size:

Initially it was proposed to collect approximately 400 responses for which 500 questionnaires were distributed. 368 completed questionnaires were collected out of which 24 questionnaires

were rejected for incomplete and improper information. Hence the final sample settled at 344 which represents a response rate of 68.8% which was considered as reasonable for this type of study.

3.5 Sampling Technique:

Data was collected through stratified random sampling technique based on the frequency of trading as recommended by experts in the field, thereby giving representation to different categories of traders. This was done in order to understand investor behavior based on frequency of trading.

4. Behavioral Finance:

The traditional framework is extremely simple but after many years of research it is clear that the basic concepts about the capital markets across the world, that is, the cross section of average returns and individual trading behavior cannot be well understood in this framework. Also modern thinkers in the field of finance disclaim the validity of the weak form efficiency and also state that the strong form efficiency is extremely unreal and cannot exist in the real world. Moreover concepts like arbitrage which is the process by which prices come back to their fundamental values are questioned. This is because in real markets where there are many complications and uncertainties prevailing, it is difficult for the smart money makers to offset the mispricing created by the noise traders. The term noise trader refers to an investor who makes trading decisions without using fundamental data. (Fischer Black 1986). This being the case it is also important to understand that the assumptions underlying efficient markets especially the one that investors are rational is highly questionable. The world is not perfect and there are real people in this world who may not be such rational agents at all times.

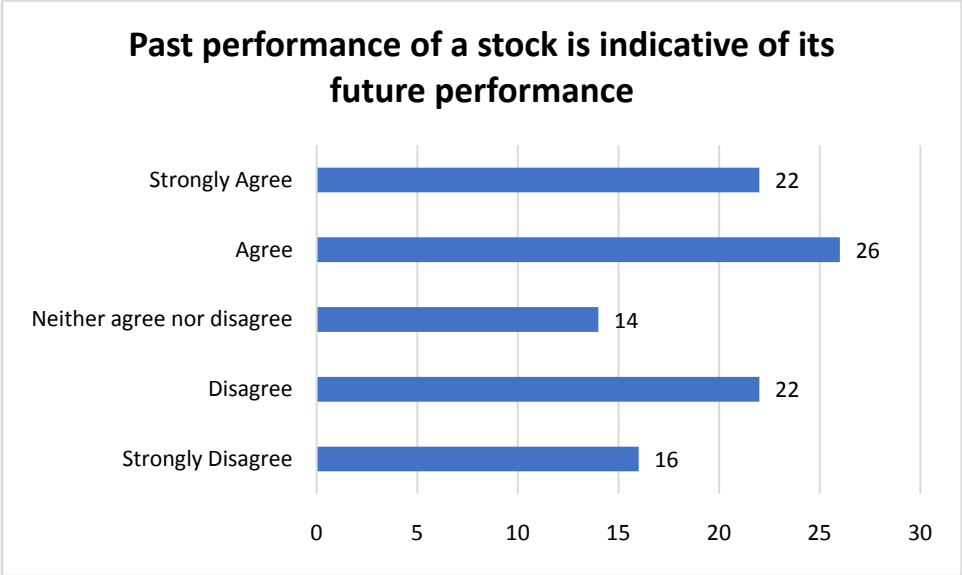

Fig. 1

(Source: Primary Data)

When asked whether the past performance of a stock is indicative of its future performance, majority i.e. 36% of the respondents agree to this and 22% strongly agree to this. However, 11% of respondents neither agree nor disagree to this. Whereas, 18% of respondents disagree to this and remaining 13% strongly disagree to this.

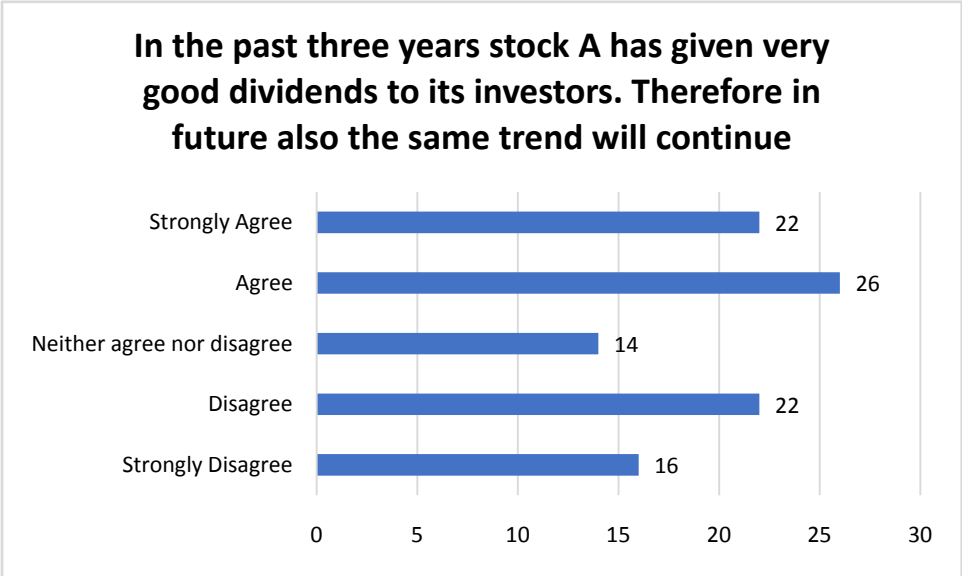

Fig. 2

(Source: Primary Data)

When asked whether In the past three years stock A has given very good dividends to its investors. Therefore, in future also the same trend will continue, majority i.e. 34% of the respondents agree to this and 19% strongly agree to this. However, 13% of respondents neither agree nor disagree to this. Whereas, 19% of respondents disagree to this and remaining 15% strongly disagree to this.

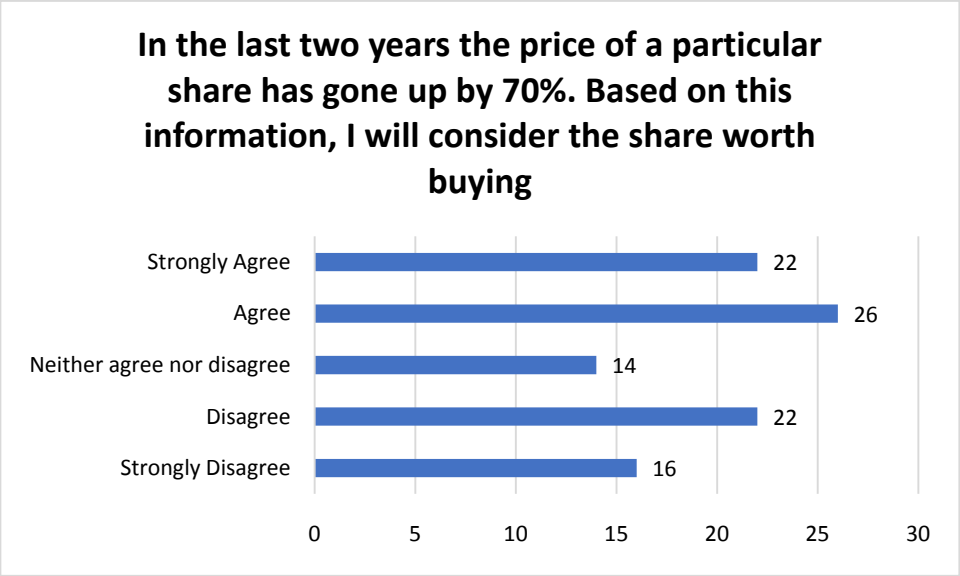

Fig. 3

(Source: Primary Data)

When asked whether in the last two years the price of a particular share has gone up by 70%. Based on this information, I will consider the share worth buying, majority i.e. 24% of the respondents agree to this and 20% strongly agree to this. However, 15% of respondents neither agree nor disagree to this. Whereas, 23% of respondents disagree to this and remaining 18% strongly disagree to this.

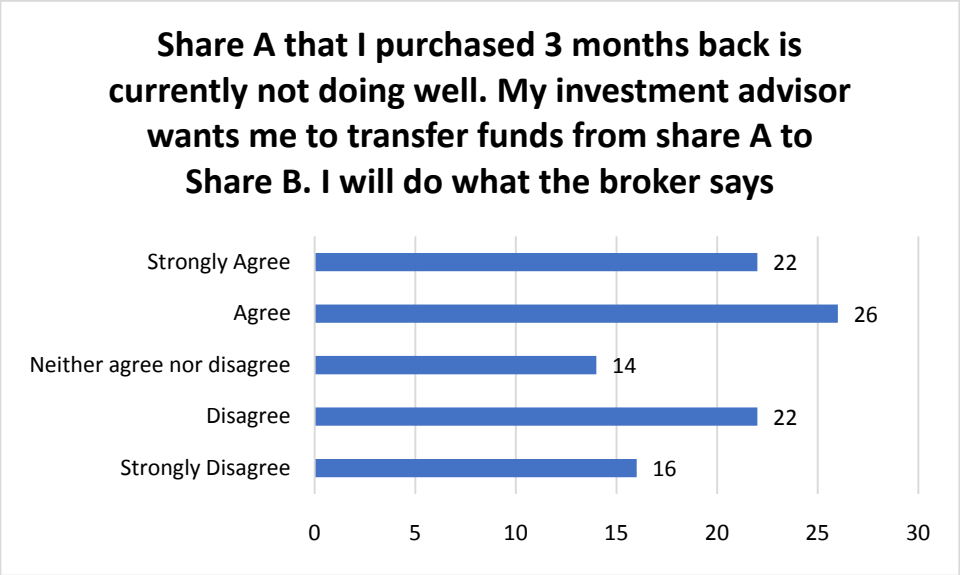

Fig. 4

(Source: Primary Data)

When asked that, Share A that an investor purchased 3 months back is currently not doing well. The investment advisor wants him to transfer funds from share A to Share B. He will do what the broker says, majority i.e. 26% of the respondents agree to this and 22% strongly agree to this. However, 14% of respondents neither agree nor disagree to this. Whereas, 22% of respondents disagree to this and remaining 16% strongly disagree to this.

5. Conclusion:

Based on the above finding, it is concluded that people typically give too much weight to past experience and extrapolate recent trends. Investors tend to become more optimistic when the market goes up and more pessimistic when the market goes down. Also, it is concluded that many time investors do not behave rationally and depend on the advice received from their brokers. Objectivity or rationality is not easy to attain as humans are subject to emotions like fear, greed, pride of opinions and all other exciting states of mind that prevent rational judgment.

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