

Impact of Behavioral Finance & Traditional Finance on Financial Decision Making Process

Muhammad Zulqarnain Asab (Corresponding author)
Department of Management Sciences, The Islamia University of Bahawalpur
Abbasia Campus, Bahawalpur, Pakistan
E-mail: asabmuh@gmail.com

Sobia Manzoor
Department of Management Sciences, The Islamia University of Bahawalpur
Abbasia Campus, Bahawalpur, Pakistan
E-mail: sobia.manzoor56@yahoo.com

Hina Naz
Department of Management Sciences, The Islamia University of Bahawalpur
Abbasia Campus, Bahawalpur, Pakistan
E-mail: hinanaz64@yahoo.com

Abstract

This paper examines the individual investment preferences and discusses the different factors of behavioral finance which are related to investment influence in developing countries like, Pakistan. Introduction simply discuss difference between traditional and behavioral finance literature consists on different factors of behavioral finance and traditional finance. Third portion consists on impact of both traditional and behavioral finance on investment the fourth sections discusses the comparison of different research results and at the last part contained the conclusion.

Keywords: Behavioral Finance, Traditional Finance, Investment Decision. Efficient Market Hypothesis.

Introduction:

Decision making is very important activity for the process of choosing an alternative option from a situation that show good results to individual or investors. Investment purpose is to generate money for investors. Market individual and information structure influence the decision of investment. So that investment sometimes show negative results to investors for that purpose they invested or they not get satisfied results from their investment due behavior of investors about investment. Buchan, (2001) stated that "Money is desire Embodied". Kahneman and Tversky, (1979) and Statman, (1999) stated that people feelings of pain when they find out that the other choice have good results. So Behavioral finance is the study that gives description to investors who are interested about finding how individual emotions or behavior are related to drive share prices.

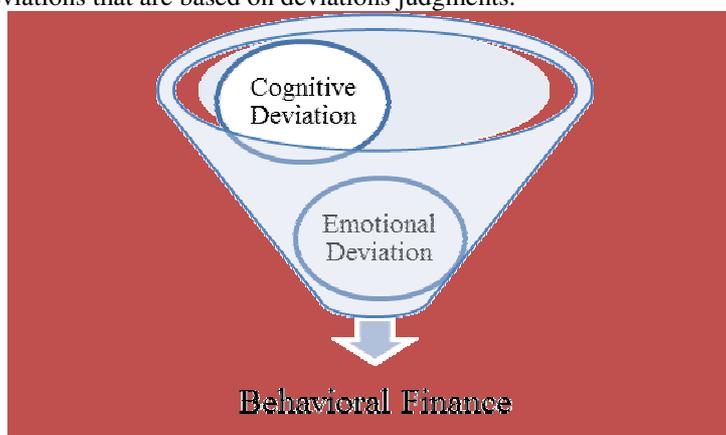
Behavioral finance explains about how and why emotions and cognitive biases create anomalies about stock market for investors. But in modern finance we take the concept of rationality and logical theory based decision like Capital Asset Pricing Model, efficient market theory that considered people are rational and work for their wealth maximization but the fact is that people behave irrationally that are not predictable in real life that irrationality is linked from behavioral finance. Behavioral finance explains our action and behavior but modern finance is related to explanation of actions of an economic man. Traditional finance is related to decisions in which full information's are available for making investment decision.

Becker (1962); Thaler (1990) stated in role of Behavioral Economics and Behavioral Decision making in Americans Retirement savings decisions that Individuals keep the full information according to the Traditional theory; they can also share the information and rational decision makers. Proprieties of these people remained constant overtime and well-defined. Phung, (2010) explained that Behavioral finance is comparatively a new field that develop the combination of psychological theory, cognitive and behavioral with finance and conventional economic that provide the conclusion about the irrational decision making of the people. Behavioral finance theory was firstly developed in 1980 among small group of academics of different fields.

Shefrin (1999) stated the behavioral finance is a rich expansion in the field of finance that compare the influence of psychology on financial practitioner behavior. Statman (1999) stated that behavioral finance also explain that how emotions and cognitive errors show their impact on the decision making process of the investor about the investment. Behavioral finance consists of two reasons that people do not find about their financial attitudes that investigate feeling of investors that are deviated in attitude these deviations are consists of two sub categories that are.

- (i) **Cognitive Deviations:** These deviations are generated by time, memory, attentions and limitations of these deviations have priority for behavioral finance.

- (ii) **Emotional Deviation:** It is the Second type of deviation of human's behavior that is so for neglected in behavioral finance. Diagram shows Behavioral Finance related attitude that are diverted about investment. Hirshleifer & Teoh, (2002) stated that Heuristic simplifications come from cognitive limitations that bring the emotional deviations that are based on deviations judgments.



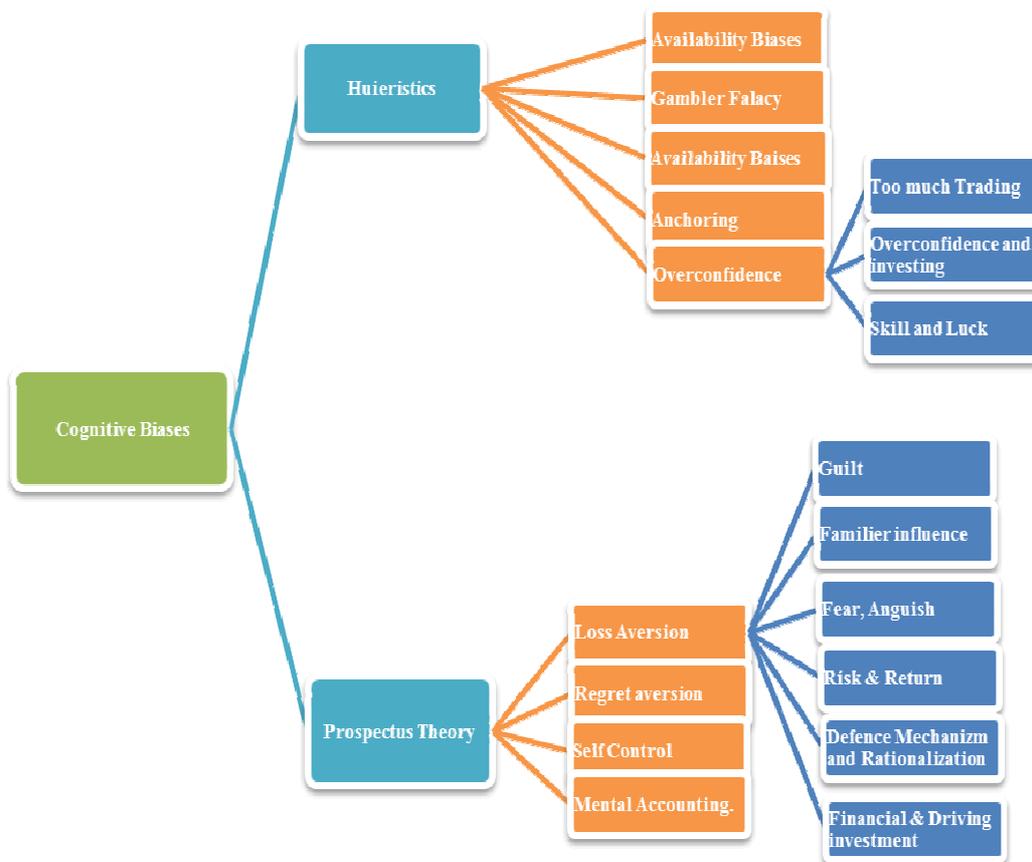
Ritter, (2003) elaborated the behavioral finance by using models that are less narrow than those that are based on Von Neumann. Its stated in this article that behavioral finance have two building blocks on which behavioral finance depends means that are dependent variables of behavioral finance. First one is cognitive psychology and second is arbitrage. Cognitive psychology is about the thinking and all systematic errors that are involving when they are thinking about investment the limits to arbitrage is refers to predicting the effective way of investment or forecasting in what situations arbitrage will be profitable and when it will not be. Behavioral finance have its own theory that facilitate its investors about investment decisions that shows market efficiency regarding share prices of stocks available to investors. Behavioral finance focuses on irrational decision of people. Ritter, (2002) cited in article of Behavioral finance that the Behavioral finance is consisted of 2 types of blocks limits to arbitrage and cognitive psychology. Cognitive psychology study the behavior of people about investment in stocks or related other investment of efficient market. Cognitive biases are related to how people take decision of investment that show their impact on investment decision and how these all factors that related to behavior how they impact our efficient markets. Some of factors that related to cognitive psychology that impact on decision are as follows.

- Heuristics
- Overconfidence
- Mental accounting
- Framing
- Representativeness
- Conservatism
- Disposition effects
- Loss Aversion

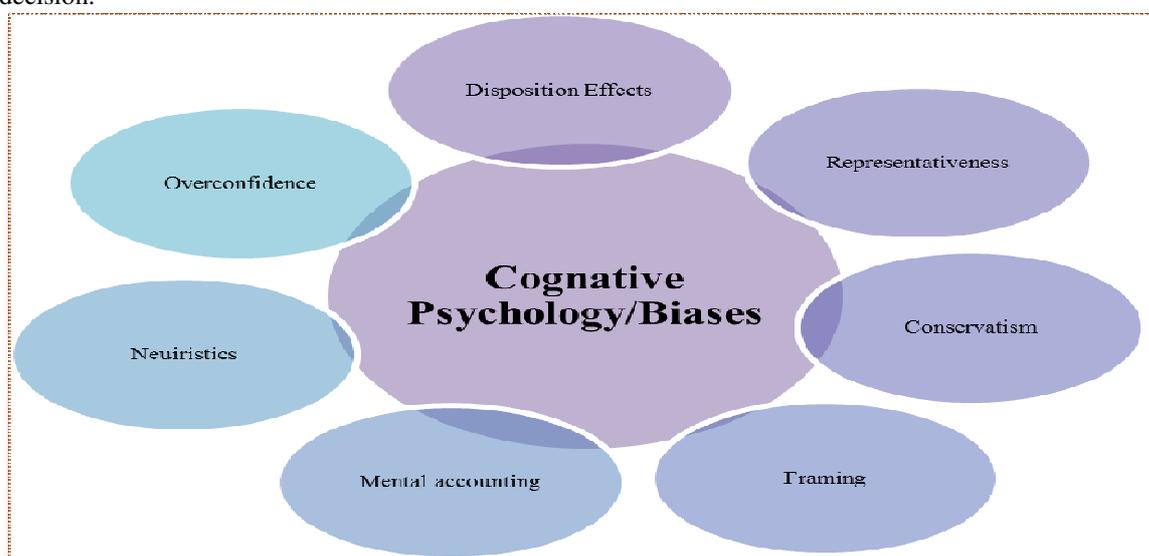
These all are the factors that relate to cognitive psychology of individual that effect efficient market when investors use prescriptions for finding out trends toward investment decisions. As the first factor that is dependent variable of cognitive Biases is Heuristics that appears when any change comes to or when they face some change that not in their rules of thumb they lead to biases. The other related factor is overconfidence that is also the dependent variable of cognitive biases in which people are overconfident about their abilities of doing work or about their investment decision for making investment. The other factor is about mental decision that depends on thinking power of people about decisions that are followed by some individuals as separate but that actually are dependent for each other or must be joint in particular decision. Cognitive Biases impact on decision making process that make influence on investors decision depend on two types of variable that are.

- (i) Heuristics
- (ii) Prospect Theory.

Diagrammatical Explanation



These both variables are moderate for cognitive biases that are dependent on the some sub set of independent variable that are main cause for generating cognitive illusions for investment decisions. Variable overconfidence and Loss aversion factors are divided into some other dependent factors. Kahneman and Tversky, (1979) stated in article loss aversion: a qualitative study of behavioral finance, “Loss Aversion is the main concept that work in behavioral finance” Rabin, (1998) and Shalev, (1996) it’s explained that people feel much pain of loss than the pleasure with an equivalent gain. The following presented diagram shows the interconnection and how these variables are dependent or independent to each other in investment decisions. Godoi ,Marcon, Silva et all;(2005) stated in article “Loss Aversion: a Qualitative study of Behavioral finance that as Subjective aspect of financial decision.



Traditional Finance arose with the concept of Markowitz (1952) for portfolio selection that concepts are still used in investment Decisions. Its work continued till capital structure work of Modigliani and Miller, (1958). (Sharp; 1964, Mossin; 1966 and Fama; 1970) gives the idea of efficient market theory of modern finance that represents the rise of modern finance. These Efficient market Hypotheses gives the efficient machine processing information's related to the stock market and its efficiency that provide better decision making ability about investment for present and future profits or gains. Black, Scholes and Merton; (1973) presented the new theory which names as option pricing theory that is now used for evaluation of options. Utility Expected theory characteristics are just like the Modern Finance theory. The struggle between modern finance and behavioral finance is the study of efficient market or the market efficiency that Statman, (1999) stated efficiency of market as of meaning point of view from one side view market efficiency refers about the systematic patron of trading on the other hand the view point prices of stocks are rational that replicate only important and useful characteristics like risk that not sport to psychology like feelings etc. Byrne and Utkus stated in "why bother with behavioral finance". In traditional theory investors are not confused about the information's that are provided them so that an assumption of traditional finance not matches with the reality.

Objective of the Study

The psychology in human being plays a major role for taking the decision about the certain action. Its natural that human being make the mistakes. There is need to understand the cognitive biases & Emotional Deviation and factors effecting the decision making process of the people. Most import questions which answers are required. How Cognitive biases influence the psychological approach of the investors to taking the decision about certain action? Is there any relationship between behavioral and traditional fiancé showing their impact during decision making process? How it is determined?

Contribution of the Study

This study examines the impact of behavioral and traditional finance on Investor's decision making process. This study is helpful or used as a tool for the better decision making by the investors. This will also helpful for decrease the chances of mistake. It is also helpful for the

Limitations of the Study

This study is not referring any group or any specific region therefore the implications cannot be based on entire domain. It is much based on the opinion and result of the different authors, however some findings/points can be implemented on specific investors.

Impact of Traditional finance and behavioral finance on investment:

Olsen, (1998) stated in "Investor Irrationality and Self-Defeating Behavior" that people behavior is rational in traditional finance that create profit maximization that are incomplete model that do not fully consider the behavior of people for investment that are studied in behavioral finance. Efficient market Hypothesis (EMH) is corner stone of rationality under Semi Strong form of efficient market hypothesis are connected with all present and previous info's that are related to ups and downs in asset price. Under the traditional finance it's considered that decisions of investment on rationality concept that consider rational behavior of people regarding investment. But there is no exact rationality exists in the real world so its impact on investment decisions that comes from the market share prices movement. Behavioral finance influence investment decision that comes from biases and emotions of people so as well the traditional finance impact on investment decision Behavioral finance also effect investors decisions. Baker and Haslem (1974) stated "the expected returns dividends and financial stability of firm are serious investment considerations for individual investors in 1977 they also elaborated it's again that investors behave rationally and take into account investment risk and return tread off". The modern finance uses mathematical models that are used for interpretation of finance for making investment decisions it's have expansion over the past decades. Investment is based on financial runs mostly that are currently prevailed a country that may be the finance crises that arise in stock market due to any reasons that impact on investment decision for investors of stock market face the inconsistency in their investment behavior that may be the change in return rate or systematic or nonsystematic risk which effect investors investment in stock market. Factors that influence the investors decision making of investment related developing country like Pakistan behavior of investment have different pattern in same society and same income group as Mishra & Dash, (2010) stated that the level of risk is dependent of age and people show the different level of risk due to difference in age group as tolerance of risk level during decision making is difference in genders. Means the age and gender differences are also factors for investment behavior of individual. The other factor that most influencing is stated by Sultana, (2012) "found was stock marketability, previous performance of the stock, recent price fluctuation, risk minimization, wealth maximization, social responsibility and expert recommendation". Barber and Odean (2008) concluded that most of the traders like to purchase the stock that is

much highlighted in market/news and like to invest in stock which gave extra return in the past so they like to choose the stock which is giving the extra-large gain.

Ahmed & Khalil, (2011) presented the concept of individual decision making and how rational and irrational decision impact. Wickham, (2003) stated that people face the decision bias due to representative heuristics that encourage them to overvalue low probability actions that leads to incorrect decisions about the new ventures trading. It's further analyzed by Griffin and Tversky, (1992) that when people decide about future investment they ignore statistical explanations and give more weight to source means they biased towards strength then its fault. Kliger and Kudryavtsev, (2010) elaborated in individual decision making that the people generally take the decision on the basis of their past experience in the presence of heuristic. Sevil, et al (2007) also asserted that the decision making process in the stock exchange is much influence due to heuristics.

Comparison of Studies Result Finding Factors Influence and to Check Impact of Behavioral Finance and Traditional finance in developing countries like Pakistan:

study of research consists on secondary data from research that use comparison method of descriptive research on the hypothesis of rational decision preference or irrational decision are preferred by investors citations used for evaluating results to describe behavioral finance and traditional finance for taking consideration factors influence on individual investor decision in developing countries like Pakistan. Following citations conclude on above literature basis about decision making in Pakistan. N.Ahmed, et al (2011) concluded that in Lahore Stock Exchange small investors are much influenced by the Decisions. In their research concluded results of individual investors about behavioral judgment when they invest how rationality influence or either they follow rationality or not by using simple SPSS 16.0 descriptive analysis regarding investors behavior. This research concluded that investors at small scale like Lahore exchange not take decision by seeing or taking full available information they use irrational decision for investment.

T. Bashir et al, (2013) an assessment study on the "factors influencing the individual investor decision making behavior" this research based primary data direct Questioners used 125 sample size and 33 items 6 month influence and 34 variable are used that shows that on the basis of cognitive and different emotional investors show the different behavior rational or irrational. This research conclude five categories of factors that are like accounting information, self-image, neutral information, firm image, personal financial needs and advocate recommendation, that measure Cranach alpha for reliability of data that is respectively 0.620, 0.672, 0.414, 0.588, and 0.617. "This research has shown that dividend paid reputation of the firm, feeling for firm's products, get rich quick and firm's involvement in solving community problems are high on list of criteria that is considered by a high percentage of individual investors i.e. 77.6%, 71.2%, 71.2%, 70.4% and 68.8% while choosing stock investments. On the other hand conditions of financial markets, stock marketability, opinion of firm "majority stock holders and attractiveness of non-stock investment are the least important factors to most investors while making investment decision i.e. 28%, 25.6%, 23.2% and 16% and very percentage of individual investors considers them important investment decision criteria".

Criteria used for analyzing investor's decision.



Ali & Kashif ur Rahman, (20013), use primary data analysis in "stock selection behavior of individual equity investors in Pakistan" that conclude investors behavior of investment by using hypothesis and their results are as follows.

Next study shows factors and shows results how investors decision impact:-

Regression Weights: paths, estimates, Standers Error, P value and their description are as respectively shown by

research from primary data use.

All results of study conclude about stock selection behavior of individual investor in Pakistan. Supported description shows impact of hypothesis and acceptance criteria.

Singh, (2012) stated in *Investor Irrationality and Self-Defeating Behavior: Insights from Behavioral Finance* views that when new information arises anchoring and overconfidence are adjusted by analysts these biases may result in case when:

- I. Impact of reaction due to change of prices.
- II. Implementation of the past practices into future.
- III. Lack of focus to necessary underlying stock.
- IV. Excessive focus on popular stocks.

Proponents of EMH, in fact, anomalies used the small money and forcefully maintain the prices at their original level. The research shows that the rational investors cannot ignore their irrational investor's actions. Edward & Miller, (1977) asserted that "largely be due to the inability of smart money to engage in short sales when the bulk of shares are held by irrational investors". Previous comparison and literature shows how individual decisions are biased by their behavior and from market information. With the study of research comparison I in this research paper concluded some suggestion for investors of developing countries for making decisions.

First investors should understand the biases and try best to avoid individual preference of biasness. Secondly investors should aware with its investment criteria and with its investment reason why investing in that area if the investor will aware of its investment area and purpose they will conscious about their losses and will move some steps toward rational investment. Third one that will be more beneficial in investment that is diversification it insure individual more security for its investment.

Conclusion:

It's concluded that behavioral finance and traditional finance influence investors decision of investment. Behavioral factors undeniably play a vital role in decision making process of traders. Cognitive behavior of investors is critical that suggests that human behavior cannot be ignored while making investment decision. Irrationality exists in behavioral finance due to factors of prospect theory and Heuristics. Investor's rational view of traditional finance efficient market hypothesis plays important role for generating more profit but in developing countries like Pakistan it is not possible rational decision due to uncertainty and lack of available information to investors. There are many other factors like cost and time waste or opportunity elimination threat in case for searching rational information for investment. For analysis of different studies its concluded that behavioral finance play important role and have more role in investors decision making than the rational investment decision and more factors of behavioral finance involve in investors consideration while they make decision of investment.

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