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A preliminary investigation of the behavioral barriers to investing

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Abstract
For nearly two decades, the financial sector was mostly influenced by conventional financial ideas, such as modern portfolio theory and efficient market hypothesis. Behavioral finance is a developing area of study that examines the social and psychological factors that influence how individual and institutional investors make financial decisions. This study focuses on pervasive behavioral biases among investors and their impact on individual investors, institutional investors, the market, and regulators. Prior to making an investing decision in the stock market, investors should create a checklist of behavioral biases.

Keywords: Behavioral finance, efficient market hypothesis, behavioral biases

Introduction
The Efficient Market concept exerted significant influence over the financial industry for nearly twenty years. Efficient market theory has two significant implications. Firstly, it asserts that asset prices comprehensively incorporate all accessible information, regardless of whether it is private or public. Additionally, it posits that the market price of securities consistently aligns with their inherent value. The second and most significant implication is that no investor can outperform the market by engaging in fundamental or technical analysis. Therefore, it is unattainable to surpass the market. Nevertheless, it is challenging to create a technology that can accurately ascertain the genuine inherent worth of a security, and it is equally challenging to verify if the market price consistently aligns with this intrinsic value. Thus, all examinations of market efficiency have concentrated on evaluating the effectiveness of active trading tactics employed by investors. Neither category of tests has provided definitive evidence on the matter. The behavioral school of thinking contends that determining the accuracy or fallacy of security prices is a challenging task. Therefore, the inability of traders who rely on fundamental analysis or technical analysis to succeed should not be considered as evidence of market efficiency. Behavioral finance assumes that conventional financial theories do not incorporate the behavioral aspects of investors in their financial models. However, in reality, there are numerous behavioral biases that impact investors during the investment process. The area of behavioral finance is founded on the premise that investors exhibit irrational behavior, in contrast to the assumption of rationality typically associated with them as ordinary individuals. There is a significant population of economists worldwide who argue that financial abnormalities are indicative of various "irrationalities" in investor behavior, rendering their actions complex. Furthermore, it is believed that investors frequently fail to accurately interpret information, leading them to attribute an inaccurate probability distribution to the future rate of return. Nevertheless, if these irrationalities impact prices and lead to stock market anomalies, astute arbitrageurs, who are responsible for exploiting such profitable opportunities, are anticipated to restore the stock prices to their appropriate values. However, behaviorists contend that the activities of these arbitrageurs are constrained and inadequate to compel prices to align with their intrinsic (true) worth. The argument put out by behaviorists is noteworthy. If the behaviorist's argument on the existence of a limit to arbitrage is accurate, then the absence of profit opportunities does not always indicate market efficiency. Furthermore, it was observed that the majority of studies on the efficient market hypothesis primarily examined the presence of profitable possibilities.

However, the inability of the investors to surpass the performance of the market does not indicate that markets are efficient.

Need of the study

Traditional financial theories, such as contemporary portfolio theory and the efficient market hypothesis, claim that investors are rational. Nonetheless, the burgeoning discipline of behavioral finance posits that the decision-making process of investors is influenced by psychological and social aspects. The objective of our study is to investigate the behavioral irrationalities that have not been identified by conventional financial theories.

Objective of the study

The study has two primary goals

a) To ascertain the prevailing behavioral biases that are most commonly observed among investors in the stock market.
b) To examine the influence of behavioral biases on various demographic groups.

Major Behavioral Biases

- **a. Representative Bias:** The representativeness bias refers to the tendency to make judgments or decisions based on how closely something matches our preconceived notions or prototypes. Representativeness is a prevalent cognitive bias observed in humans. Our assessment of a scenario is consistently influenced by our prior experiences. Investors in the stock market evaluate the performance of a stock or company they plan to invest in based on its recent historical outcomes. While it does save time and effort, the likelihood of making an incorrect decision significantly escalates. For instance, we have a preference for investing in familiar companies and tend to avoid investing in new initiatives. All participants in the stock market, including individual investors, brokers, and sub-brokers, are affected by this prejudice. It is noteworthy that investors tend to favor investing in the stocks of large companies with a strong pace of growth, among other factors.
- **b. Overconfidence:** The excessively self-assured investors consistently overrate their capabilities, expertise, and aptitude, resulting in their financial losses in the stock market. Overconfident investors consistently maintain the belief that they possess superior stock-picking abilities compared to others in the stock market. Additionally, they exhibit a preference for investing in high-risk equities in order to maximize short-term gains. In addition, they maintain a selection of stocks from a few well-regarded companies in their portfolio, with the expectation that their portfolio would outperform the market. Overconfident investors consistently depend on their abilities to forecast the future value and trajectory of the stock market.
- **c. Availability bias:** Humans have an inherent inclination to constantly seek for readily accessible solutions. As human beings, we depend on cognitive heuristics to make rapid decisions. The fundamental idea is that if a memory can be readily recalled, it indicates a sense of comfort or familiarity. Investors tend to prioritize experiences that they can readily recall. When investors make investment decisions in the stock market, they depend on advice from financial analysts, which indicates the presence of availability bias among investors.
- **d. Anchoring and Adjustment:** An anchor refers to a central reference point that serves as a base for making modifications while also considering the focal point, also known as the anchor point. Within the stock market, investors utilize a given price or a particular piece of information as a reference point to assess the value of a stock or company. Once an anchor is established, subsequent actions are heavily influenced by it, leading to a biased interpretation of other information pertaining to the firm or stock. For instance, investors make a record of the stock price when it rises, and view a decrease in price as a chance to purchase it at a reduced price.
- **e. Disposition effect:** Human beings commonly exhibit a tendency to hesitate when making decisions that entail financial loss. This mentality is prevalent among investors as well. They have a tendency to retain stocks that are causing them financial losses, while selling securities that are generating profits. They approach gains and losses with contrasting mindsets.
- **f. Herd Behavior:** It is the prevailing attribute of an average human being. In our daily endeavors, we tend to rely on the guidance of others rather than relying on our own abilities and expertise. The actions of investors in the stock market can lead to stock market collapses and bubbles. Numerous people engage in stock market investments based on the recommendations of their acquaintances and family members, so contributing to the formation of speculative bubbles and subsequent market crashes. Given the limited information in investment operations, it is reasonable for investors to conform to popular opinion. Investors' adoption of herd behavior diminishes personal uncertainty and fosters a collective sense of confidence.
- **g. Mood:** Mood is a dynamic variable that undergoes continuous fluctuations over time. It is transient and subject to alter over time. In our lives, we encounter both positive and negative moods. Various factors, such as weather conditions (humidity, cloud cover), and the outcomes of sports events, might influence our mood. Research has shown that experiencing unfavorable outcomes in major sporting events leads to a pessimistic outlook and a tendency to refrain from making investments during that period. Several mood elements, such as weather conditions, sporting tournament results, and the cycle of the moon, have an impact on stock market performance.
- **h. Cognitive dissonance:** Cognitive dissonance refers to the inability of the mind to simultaneously maintain two or more opposing concepts. Throughout our daily lives, we encounter several situations in which we find ourselves harboring two or more contradictory perspectives. The frequent characteristics of investors suffer from cognitive dissonance are that they keep to their belief after making an investment, show unwillingness to sell the stock/share at a loss, generally concentrate on positive aspect of the stock/company after making an investment. This approach to investment leads to illogical decision-making and undermines the assumptions of conventional financial theory.
- **i. Culture:** Culture encompasses the transmission of

customs and convictions from one cohort to the next. Culture not only influences individuals, but it also has a lasting impact on future generations. Culture has a significant impact on the growth and development of a country. Culture is shaped by religion, which varies throughout different countries. Culture significantly influences financial decision making. For instance, under the Muslim faith, interest income is regarded as a sinful act, leading to a reluctance to lend money, which consequently has a negative impact on the stock market. Similarly, under the Hindu religion, some days of the year are seen as unlucky, leading investors to refrain from placing fresh investments in the stock market during this time.

j. **Confirmation Bias:** Confirmation bias is a cognitive bias where an individual selectively seeks for options that align with their existing ideas and disregards those that contradict their opinions. It is simply the cognitive bias of a human being. Investors in the stock market utilize message boards to solicit and validate information in accordance with their preexisting convictions. This habit has a negative impact on their investing performance.

k. **Mental Accounting:** - There exists a robust correlation between the framing and mental accounting. Frames and mental accounting are essential components of prospect theory. The mental accounting is contingent upon the framing of the situation. Mental accounting refers to the process of interpreting a situation or information. Our frame of mind influences how we understand situations and information. Mental accounting refers to the phenomenon where individuals allocate and perceive money differently based on its origin of acquisition. For instance, individuals are inclined to expend a greater amount of money when their income originates from sources such as gifts, lotteries, bonuses, tax refunds, etc., in contrast to their regular anticipated wages. Investors in the stock market exhibit distinct behaviors towards stocks based on whether they perceive them as potential profits or as potential losses.

l. **Regret Aversion:** Regret aversion, sometimes referred to as loss aversion, Normal individuals often experience a reluctance to make decisions when faced with uncertainty. Put simply, our inclination is to be more responsive to losses rather than benefits. We feel worried when we encounter losses and enjoy joy when we achieve gains. Within the stock market, investors willingly assume greater risk in order to mitigate potential losses, placing a higher emphasis on avoiding losses rather than pursuing gains. Additionally, it plays a significant role in the prospect theory as well. Regret aversion refers to the tendency to avoid actions that may lead to feelings of regret. It is closely related to the optimism bias, which is the tendency to be overly optimistic about the likelihood of positive outcomes. In the context of financial decisions, regret aversion can manifest as a reluctance to take risks that may result in financial losses.

Application of behavioral finance

a) **Individual Investors:** Traditional financial theories operate under the premise that individuals who engage in trading without adhering to fundamental analysis do not exert any influence on the stock or the market. The argument presented by the behavioral analyst contradicts it. According to them, noise traders have the ability to inflate the stock price and cause it to deviate significantly from its underlying value. The initial price movement may not align with the investors' basic analysis, but it has the capacity to alter their beliefs and subsequently influence their future actions.

b) **Institutional Investors:** Conventional financial theories operate under the premise that arbitrage is crucial in rectifying errors made by noise traders. Arbitrageurs exploit the investor's error, ensuring that such mistakes do not impact the market price. However, the existence of constraints to arbitrage has brought into doubt the capacity of arbitrageurs to rectify the misvaluation of the company or the market. Nevertheless, the rationale for arbitrage based on conventional financial theories may lack persuasiveness inside a corporate context. Within a business environment, only a select few individuals have the authority to make decisions that involve millions of rupees. Therefore, their biases not only influence the stock market but also directly impact the behavior of the corporate culture. Hence, the examination of behavioral finance is expected to hold greater significance inside a business environment.

c) **Markets:** Understanding how market participants are influenced by behavioral biases is crucial. The stock market is a crucial factor in the advancement of an economy. The stock market facilitates the pooling of household savings and directs them towards productive investments. Hence, it is crucial to maintain the robustness of the stock market by ensuring its immunity to any form of cognitive biases. Behavioral biases among market makers or prospective floor traders might lead to the generation of noisy pricing in the derivative market. Therefore, it may be inferred that behavioral finance likewise has an influence on the markets.

d) **Regulators:** Behavioral finance has a significant influence on both individual and institutional investors, as well as regulators. The behavioral biases that affect investors and managers also exert an influence on the legislators responsible for formulating rules and regulations for the country's capital market.

Conclusion

We are all interested in identifying lucrative investment opportunities. Behavioral finance critiques traditional financial theories, specifically the efficient market hypothesis, based on the concept of irrationality. Investors are still uncertain about the potential profitability of exploiting stock mispricing. The behaviorists remain silent regarding this matter. Financial economists and behavioral analysts engage in an ongoing dispute regarding many aspects. Researchers assert that the behavioral approach lacks organization. Behavioral finance is a nascent area of research that challenges the notion of complete rationality in investor decision-making. While the criticism of rationality is widely accepted, there is ongoing debate on the extent to which irrationality influences stock pricing. Nevertheless, investors who acknowledge their incapacity to digest the information might prevent such mistakes. It is recommended to create a checklist of several behavioral

biases before to making investment decisions in the stock market.

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