CHAPTER –I
CONCEPTUAL BACKGROUND
CHAPTER I

CONCEPTUAL BACKGROUND

INTRODUCTION

With the current revolution in the financial services market, personal financial management is becoming increasingly complex and single service financial companies are being replaced by financial supermarkets. In addition, a new group of multidiscipline financial planners is evolving. As with increased exposure to new sources of information than ever before and increased level of investor awareness various factors such as self-thought, family discussion, friends and media such as TV, newspaper are expected to influence investor decision. The present study is an attempt to understand the underlying factors that govern the investment behavior of individuals which shall ultimately depend upon broad macroeconomic factors such as saving rate, financial inclusion, literacy, employment rates and more importantly on the individual investor perception and attitudes towards financial planning, planners, and investment portfolio decisions. It has helped to identify the factors which are perceived as important by investor and whether such factors are influenced by socio demographic attributes of the respondents and to what degree such relationship does exist. The study can be useful in identifying various factors governing investment decisions and role played by these factors for further identification and development of prudent investment practices.
1.1 SIGNIFICANCE OF UNDERSTANDING FACTORS GOVERNING INDIVIDUAL INVESTOR

With the decreased government intervention in pension system and welfare in general and the increased responsibility of individuals to fend themselves the pattern of investments and selection of assets may have crucial determinant on future of present generation. Further a plethora of factors which are listed below also make it crucial to understand the various facets of individual behavior. The factors that contribute to make the present study relevant are listed below

- Instances of Financial Swindling
- Increased Investor awareness
- Savings could be channelized to proper resources for development
- Decreased role and liability of Government to manage pension funds
- Decreased liability of Government for welfare schemes
- Increased disposable income.

1.2 BACKGROUND OF THE STUDY

Today the field of investment is even more dynamic than it was only a decade ago. World event rapidly events that alter the values of specific assets the individual has so many assets to choose from, and the amount of information available to the investors is staggering and continually growing. The key to a successful financial plan is to keep apart a larger amount of savings and invest it intelligently, by using a longer period of time. The turnover rate in investments should exceed the inflation rate and cover taxes as well as allow you to earn an amount that compensates the risks taken. Savings accounts, money at low interest rates and market accounts do not contribute significantly to future rate accumulation. While the highest rate come from stocks, bonds and other types of investments in assets such as real estate. Nevertheless, these investments are not totally safe from risks, so one should try to understand what kind of risks are related to them before taking action. The lack of understanding as how stocks work makes the myopic point of view of investing in the stock market (buying when the tendency to increase or selling when it tends to decrease) perpetuate (Kabra, Mishra, & Dash, 2010).
1.3 DEFINITION OF FINANCIAL-BEHAVIORAL

Behavior of investors is a part of academic discipline known as "financial-behavioral" which states how feeling and cognitive errors influence investors and their decision-making. It is long time that the behavior of individual investors is interested academia and managers of securities, but not investors because sometimes mentality of public dominates rationality. Behavior of people is caused by the involuntary intellectual interaction in individuals who react to others' behavior signals (Proctor, 1999).

Behavioral finance attempts to explain and increase understanding of the reasoning patterns of investors, including the emotional processes involved and the degree to which they influence the decision-making process. Essentially, behavioral finance attempts to explain the what, why, and how of finance and investing, from a human perspective. For instance, behavioral finance studies financial markets as well as providing explanations to many stock market anomalies (such as the January effect), speculative market bubbles (the recent retail Internet stock craze of 1999), and crashes (crash of 1929 and 1987). There has been considerable debate over the real definition and validity of behavioral finance since the field itself is still developing and refining itself. This evolutionary process continues to occur because many scholars have such a diverse and wide range of academic and professional specialties.

In reviewing the literature written on behavioral finance, our search revealed many different interpretations and meanings of the term. The selection process for discussing the specific viewpoints and definitions of behavioral finance is based on the professional background of the scholar. The discussion within this paper was taken from academic scholars from the behavioral finance school as well as from investment professionals. (Ricciardi & Simon, 2000)

1.4 BEHAVIORAL FINANCE

A relatively new financial sub discipline, behavioral finance, has achieved impressive strides in explaining the behavioral aspects of investment decisions. Behavioral finance investigates choice under uncertainty. Three major elements frame behavioral finance-

Within behavioral finance it is assumed that information structure and the characteristics of market participants systematically influence individuals’ investment decisions as well as market outcomes. According to behavioral finance, investor market behavior derives from psychological principles of decision making to explain why people buy or sell stocks. This chapter discuss about the origin, theoretical aspects of the Behavioral Finance and various factors for investing in equity market. It also includes theories of Investors behavior.

The current state of research from the efficient market and behavioral perspectives therefore suggests that an inclusive and diverse approach in the choice of theoretical explanations of the behavior of financial markets will be the pragmatic response to the inconclusive results on either side of the debate. While, on the one hand, investors are not making large sums of money from market anomalies, not many people will disagree that the stock market bubble burst of 2000 or in 2008 is better explained by hubris and irrational exuberance grounded in behavioral finance than by the efficient markets theory. (Rezaei, 2013)

1.5 ORIGIN AND HISTORY

Empirical studies of the behavior of individual investors first appeared in the 1970s. The Wharton Survey, one of the more comprehensive studies of investor behavior, examines how demographic variable influence the investment selection and portfolio composition process.

1.6 DETERMINANTS OF INVESTOR BEHAVIOR

As the literature suggest an extensive investigation into the various aspects of investor behavior are investigated. Further various theories to justify and predict the investment
behavior have been proposed. In this section an attempt is made regarding compilation of various theories and studies pertaining to individual investor behavior.

1. Risk Aversion and Portfolio Selection

The risk factor could be one of the crucial determinant of individual investor behavior and portfolio allocation. Further the construct of risk aversion may be function of various socio demographic attributes. Moreover Cohn et al. provide tentative evidence that as risk-aversion decreases investor wealth increases. (R. A. Cohn, 1975). Riley and Chow find that risk-aversion decreases with increase in age, wealth, income and education. (Riley & K. V. Chow, 1992). The future is uncertain, and you must determine how much risk you are willing to bear since higher return is associated with accepting more risk. (Lobes, 1987). LeBaron, Farrelly and Gula counter that individuals' risk-aversion is largely a function of visceral rather than rational considerations(D. LeBaron & Gula., 1992).

2. Demographics and Factors influencing portfolio selection

Lewellen, Lease and Schlarbaum determine that age, sex, income and education affect investor preferences for capital gains, dividend yield and overall return.(Lewellen, Lease, & Schlarbaum, 1977). Warren et al. predict individual investment choices (e.g., stocks, bonds, real estate) based upon lifestyle and demographic attributes.(Warren, Stevens, & C. W. McConkey, 1990.). Baker and Haslem, find that dividends, expected returns and the firm's financial stability are critical considerations for individual investors.(Baker & J. A. Haslem, 1974).

3. Lifestyle Characteristics

Barnwell finds that individual investor behavior can be predicted by lifestyle characteristics, risk-aversion, control orientation and occupation.(Barnewell, 1987).

1.7 THEORIES REGARDING INVESTMENT BEHAVIOR

In this section an attempt is made to understand the various theories regarding the investment behavior and the underlying rationale behind this theories. The theories
though may differ in the premises that they are build upon but more over are crucial in building the platform of the present study.

A. Economic Utility Theory

Behavioral finance is the paradigm where financial markets are studied using models that are less narrow than those based on Von Neumann–Morgenstern expected utility theory and arbitrage assumptions. Specifically, behavioral finance has two building blocks: cognitive psychology and the limits to arbitrage. Cognitive refers to how people think. There is a huge psychology literature documenting that people make systematic errors in the way that they think: They are overconfident, they put too much weight on recent experience, etc. Their preferences may also create distortions. Behavioral finance uses this body of knowledge rather than taking the arrogant approach that it should be ignored. (Fama, 1965)

Economic utility theory views the individual's investment decision as a tradeoff between immediate consumption and deferred consumption. The individual investor weighs the benefits of consuming today against the benefits that may be gained by investing unconsumed funds in order to enjoy greater consumption at some point in the future. If the individual chooses to defer consumption, he will, according to theory, select the port-folio that maximizes long-term satisfaction. The axioms of utility theory, developed by Von Neumann and Morgenstern, argue that investors are

(1) Completely rational,

(2) Able to deal with complex choices,

(3) risk-averse and

(4) wealth-maximizing.

Utility theory further assumes that investors maximize expected utility-measured in terms of anticipated returns and variances from these expectations (the mean/variance approach). That is, each investor selects the port-folio that maximizes expected return while minimizing risk.(Markowitz, 1959)

Competing theories have argued that investors
(1) Seek investments that maximize geometric mean return,

(2) Concentrate on avoiding "bad" outcomes (safety-first models) or

(3) Make investment decisions free of assumptions about utility functions or probabilities (stochastic dominance).(Obenberger, 1994).

The literature on utility theory does not typically address individual investor decision processes. Rather, it focuses on the development and refinement of "macro" models that explain aggregate market behavior. Baker, Hargrove and Haslem find that investors behave rationally, taking into account the investment's risk/return tradeoff.(H. K. Baker, 1977).

**B. Limits to Arbitrage**

Limits to arbitrage refer to predicting in what circumstances arbitrage forces will be effective, and when they will not be. According to economic theorists', investors think and behave —rationally when buying and selling Stocks. Specifically investors are presumed to use all available information to form —rational Economy Expectations about the future in determining the value of companies and the general health of the Economy. Consequently, stock prices should be accurately reflect fundamental values and will only move up and down when there is unexpected positive or negative news, respectively. Thus Economists have concluded that financial markets are stable and efficient, stock prices follow a "Random walks and the overall economy tends toward —general equilibrium. (Fama, 1965)

In reality however, according to Shiller, (1999) investors do not think and behave rationally. To The contrary, driven by greed and fear, investors speculate stocks between unrealistic highs and Lows. In other words, investors mislead be extremes of emotion, subjective thinking and the

**C. Prospect Theory**

Choices among risky prospects exhibit several pervasive effects that are inconsistent with the basic tenets of utility theory. In particular, people underweight outcomes that is
merely probable in comparison with outcomes that are obtained with certainty. This
tendency, called the certainty effect, contributes to risk aversion in choices involving sure

gains and to risk seeking in choices involving sure losses. In addition, people generally
discard components that are shared by all prospects under consideration. This tendency,
called the isolation effect, leads to inconsistent preferences when the same choice is
presented in different forms. An alternative theory of choice is developed, in which value
is assigned to gains and losses rather than to final assets and in which probabilities are
replaced by decision weights. The value function is normally concave for gains,
commonly convex for losses, and is generally steeper for losses than for gains. Decision
weights are generally lower than the corresponding probabilities, except in the range of
low probabilities. Overweighting of low probabilities may contribute to the attractiveness
of both insurance and gambling. Thus, people are expected to exhibit more risk seeking
in deciding whether to accept a fair gamble than in deciding whether to purchase a
gamble for a fair price. (Kahneman & Tversky, 1979)

Experienced and knowledgeable investors would readily admit that the structure and
relative weights of the chosen categories reflect on the average, a still unsophisticated and
immature investor profile. The results revealed by our sample of 150 respondents confirm
that there seems to be a certain degree of correlation between the factors that behavioral
finance theory and previous empirical evidence identify as the influencing factors for the
average equity investor, and the individual behavior of active investors in the Athens
Stock Exchange (ASE) influenced by the overall trends prevailing at the time of the
survey in the ASE. (Merikas, Merika, Vozikis, & Prasad)

Prospect theory deals with the idea that people do not always behave rationally. This
theory holds that there are persistent biases motivated by psychological factors that
influence people’s choices under conditions of uncertainty. Prospect theory considers
preferences as a function of “decision weights,” and it assumes that these weights do not
always match with probabilities. Specifically, prospect theory suggests that decision
weights tend to overweigh small probabilities and under-weigh moderate and high
probabilities. (Schwartz, 1998) articulates that “subjects (investors) tend to evaluate
prospects or possible outcomes in terms of gains and losses relative to some reference point rather than the final states of wealth.”

D. Theory of Regret

Another prevalent theme in behavioral finance is “regret theory.” The theory of regret states that an individual evaluates his or her expected reactions to a future event or situation (e.g. loss of $1,000 from selling the stock of IBM). Bell (1982) described regret as the emotion caused by comparing a given outcome or state of events with the state of a foregone choice. For instance, “when choosing between an unfamiliar brand and a familiar brand, a consumer might consider the regret of finding that the unfamiliar brand performs more poorly than the familiar brand and thus be less likely to select the unfamiliar brand” (J. & McAlister, 1994)

E. Modern Portfolio Theory

Current accepted theories in academic finance are referred to as standard or traditional finance. The foundation of standard finance is associated with the modern portfolio theory and the efficient market hypothesis. Modern Portfolio Theory (MPT) is a stock or portfolios expected return, standard deviation, and its correlation with the other stocks or mutual funds held within the portfolio. With these three concepts, an efficient portfolio can be created for any group of stocks or bonds. An efficient portfolio is a group of stocks that has the maximum (highest) expected return given the amount of risk assumed, or, on the contrary, contains the lowest possible risk for a given expected return.

Another main theme in standard finance is known as the Efficient Market Hypothesis (EMH). The efficient market hypothesis states the premise that all information has already been reflected in a security’s price or market value, and that the current price the stock or bond is trading for today is its fair value. Since stocks are considered to be at their fair value, proponents argue that active traders or portfolio managers cannot produce superior returns over time that beat the market. Therefore, they believe investors should
just own the —entire market‖ rather attempting to —outperform the market. This premise is supported by the fact that the S&P 500 stock index beats the overall market approximately 60% to 80% of the time. Even with the preeminence and success of these theories, behavioral finance has begun to emerge as an alternative to the theories of standard finance.

Altfest (2004) continued his investigation into financial planning theory into the field of finance. He cites Modern Portfolio Theory (MPT) (Markowitz, 1952) as another foundational theory. MPT is a normative theory that asserts that investors choose investments based on discounted future expected returns and that for maximum risk adjusted return; investors should diversify across industries and asset classes.

**F. Means-End Theory**

Means-end theory addresses consumer perceptions of value, and as such, may be helpful in understanding life choices made by baby boomers based on multiple personal experiences. For example, a means-end model allows for the consideration of possible increased health needs in the future, exploration of the value placed by individuals on their health in retirement, and a discussion regarding subsequent financial planning for those needs in the future. (Hurst & Lusardi, 2007)

**1.8 BEHAVIORAL DETERMINANTS**

**1.8.1 Investment Planning and Home Economics**

In the first half of the twentieth century, some economists started to apply classical economic theory to the management of the household, using the term “home economics.” This origin in home economics is surprising to some in the academic disciplines of business administration and finance, who do not usually think of home economics in those terms. However, if it is noted that many, if not most, of the early leaders of the home economics movement were either government economists or economic professors who were simply applying their discipline to the home, it becomes more a more understandable origin.” (Miller & Montalo, 2001)
1.8.2 Modigliani and Friedman: Expenditure, Savings, and the Life Cycle

Modigliani postulated that decisions on consumption and savings were made by the individual consumer based on anticipated lifetime earnings and consumption, not just on that year’s needs. This premise would explain the almost universal consumption beyond their means of many young people, not in terms of immaturity but in their high expectations.

1.8.3 Transformative Change: Readiness for Change

“The concept of readiness has changed since its origin in the 1930s when psychologists and educators became convinced that children can learn only after attaining a specified level of ‘readiness,’ which generally meant the physical maturity and neurological development sufficient to negotiate an unfamiliar situation or learn a new task”8 (Walker, 2004, p. 26). The “readiness for change [that] denotes how people manage, endure, or cope with life changes over which they have little or no control” (p. 27).

Walker’s transformative change theory provides a developmental construct that may assist in explaining baby boomers’ response to the inevitable life transition of aging and planning for anticipated needs associated with this change.

1.8.4 Asset Allocation

While the results clearly indicate that the assumed time horizon for a client is an essential element for a proper asset allocation, this may indicate another aspect of this study which warrants further inquiry. While variables such as age, marital status, gender, and number of children are observable, time horizon, which appears to have the greatest explanatory power of risk tolerance, may be a random variable in-and-of-itself, which has its own sets of determinants. (Riley & Russon, 1995)

1.9 SEGMENTATION OF INVESTORS ON BASIS OF BEHAVIOR

Indian investors have been exposed to a plethora of investment opportunities in the past decade and a half, after the liberalization process which commenced in 1991. Over the
years, the increased competition has brought a wind of change, not just in the economic environment within the country, but also a radical change in the choices and preferences of the financial consumers. In the endeavor to provide more personalized advice to the financial consumers, financial service providers need more insights into the minds of the consumers. However, little work has been done to understand the Indian individual investor. A cluster analysis of data, collected from individual investors was conducted in India \((n=377)\), yielded four main segments of individual investors biases, which have been termed as the Novice Learner, the Competent Confirmer, the Cautious Anticipator and the Efficient Planner. This typology has predictive validity with regard to financial satisfaction and perceived financial market knowledge. (Sahi & Arora, 2012).

1.10 THE ROLE OF BEHAVIORAL FINANCE WITH PRIVATE CLIENTS

Private clients can greatly benefit from the application of behavioral finance to their unique situations. Because behavioral finance is a relatively new concept in application to individual investors, investment advisors may feel reluctant to accept its validity. Moreover, advisors may not feel comfortable asking their clients psychological or behavioral questions to ascertain biases, especially at the beginning of the advisory relationship. One of the objectives of this book is to position behavioral finance as a more mainstream aspect of the wealth management relationship, for both advisors and clients. As behavioral finance is increasingly adopted by practitioners, clients will begin to see the benefits. There is no doubt that an understanding of how investor psychology impacts investment outcomes will generate insights that benefit the advisory relationship. The key result of a behavioral finance enhanced relationship will be a portfolio to which the advisor can comfortably adhere while fulfilling the client’s long-term goals. This result has obvious advantages—advantages that suggest that behavioral finance will continue to play an increasing role in portfolio structure.

1.11 MODERN BEHAVIORAL FINANCE

By the early twentieth century, neoclassical economics had largely displaced psychology as an influence in economic discourse. In the 1930s and 1950s, however, a number of important events laid the groundwork for the renaissance of behavioral economics. First,
the growing field of experimental economics examined theories of individual choice, questioning the theoretical underpinnings of Homo economics. Some very useful early experiments generated insights that would later inspire key elements of contemporary behavioral finance. Real investors are influenced by where they live and work. They tend to hold stocks of companies close to where they live and invest heavily in the stock of their employer. These behaviors lead to an investment portfolio far from the market portfolio proscribed by the CAPM and arguably expose investors to unnecessarily high levels of idiosyncratic risk.

1.12 PSYCHOGRAPHIC MODELS USED IN BEHAVIORAL FINANCE

Psychographic models are designed to classify individuals according to certain characteristics, tendencies, or behaviors. Psychographic classifications are particularly relevant with regard to individual strategy and risk tolerance. An investor’s background and past experiences can play a significant role in decisions made during the asset allocation process. If investors fitting specific psychographic profiles are more likely to exhibit specific investor biases, then practitioners can attempt to recognize the relevant telltale behavioral tendencies before investment decisions are made. Hopefully, resulting considerations would yield better investment outcomes.

In light of the above theoretical considerations and underlying constructs an attempt is made in the present study to understand the various factors governing the investor choice to stay invested or trade in a particular stock. Further an attempt is also made to understand the investment behavior patterns such as investment frequency, frequency of trading, monitoring of investment, types of stock selected for investment to name a few. The number of factors are based on various theoretical underpinnings available and elaborated in further chapters.

1.13 EXPECTANCY-VALUE THEORY

Expectancy-value theory incorporates the idea of values driving individual decisions. Expectancy beliefs are outcome-based and, as such, indicate that specific behaviors will lead to specific outcomes.
REFERENCES:


