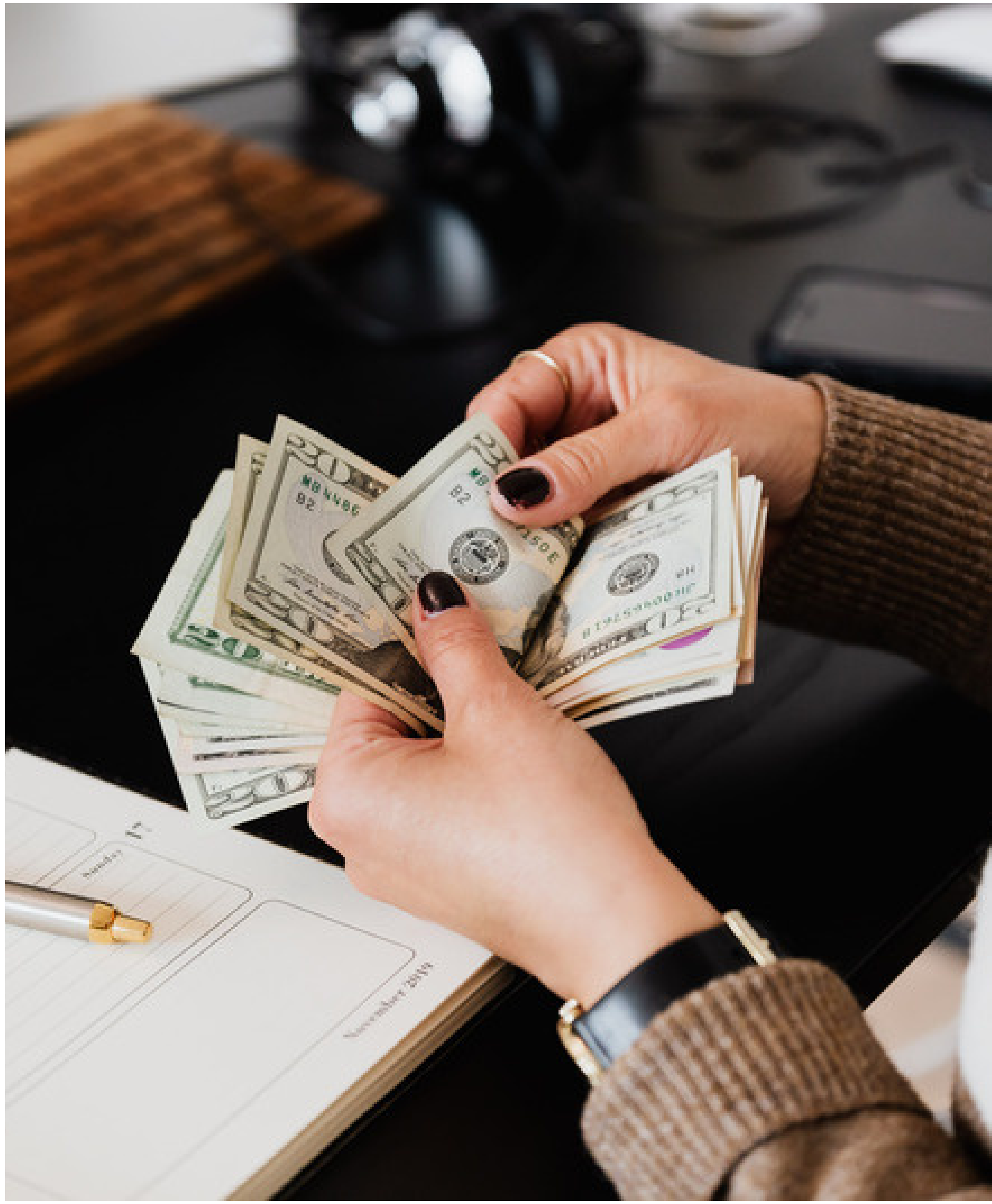
BEHAVIORAL FINANCE IN FINANCIAL ENGINEERING

INTRODUCTION

- Behavioral finance is the study of the effects of psychology on investors and financial markets. It focuses on explaining why investors often appear to lack self-control, act against their own best interest, and make decisions based on personal biases instead of facts.

UNDERSTANDING BEHAVIORAL FINANCE

Behavioral finance can be analyzed from a variety of perspectives. Stock market returns are one area of finance where psychological behaviors are often assumed to influence market outcomes and returns but there are also many different angles for observation.



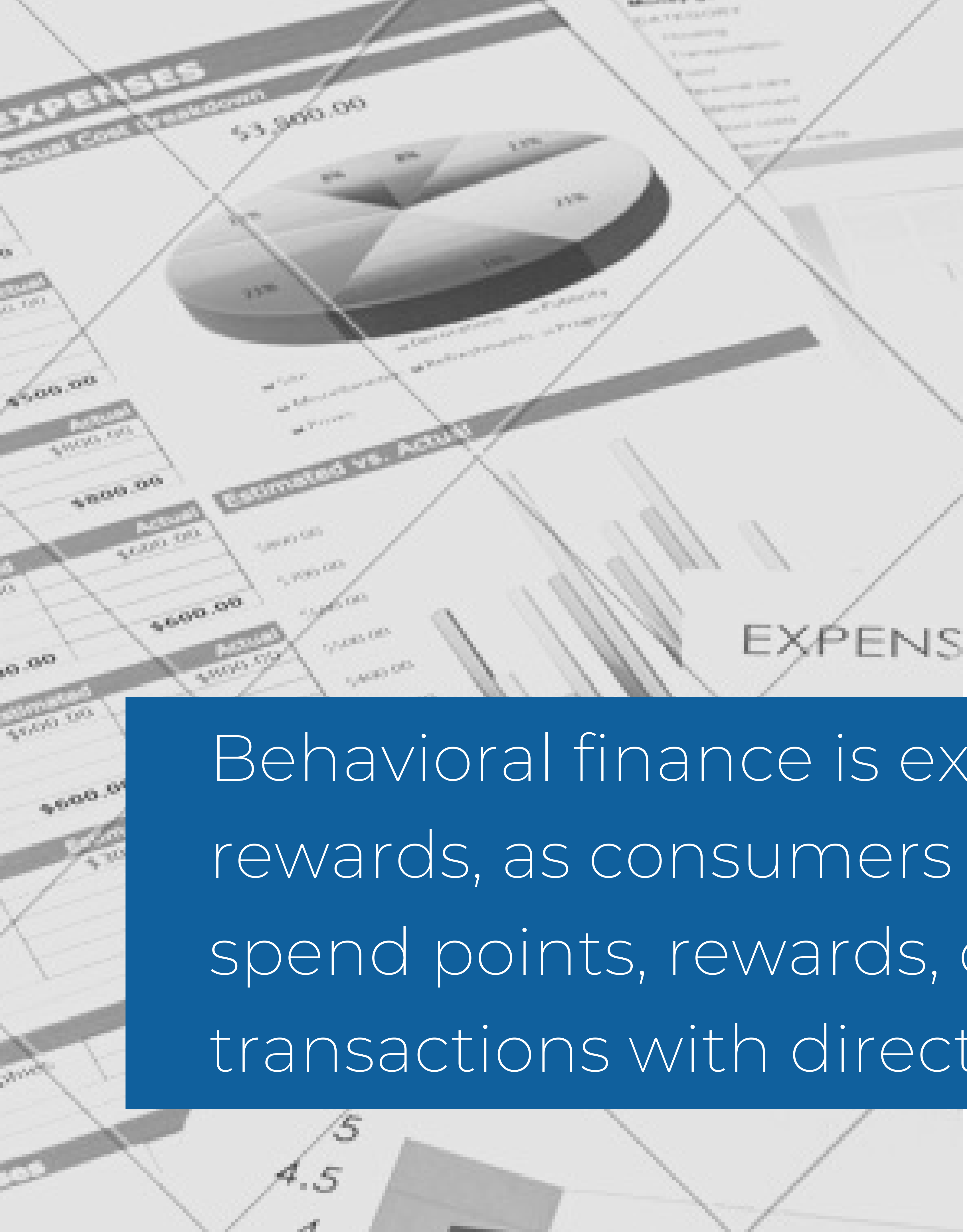
- Behavioral finance originated from the work of psychologists Daniel Kahneman and Amos Tversky and economist Robert J. Shiller in the 1970s-1980s. They applied the pervasive, deep-seeded, subconscious biases and heuristics to the way that people make financial decisions.

In the past decade, behavioral finance has been embraced in the academic and financial communities as a subfield of behavioral economics influenced by economic psychology. By showing how, when, and why behavior deviates from rational expectations, behavioral finance provides a blueprint to help everyone make better, more rational decisions when it comes to their finances.

Behavioral finance typically encompasses five main concepts:

- Mental accounting: Mental accounting refers to the propensity for people to allocate money for specific purposes.
- Herd behavior: Herd behavior states that people tend to mimic the financial behaviors of the majority of the herd. Herding is notorious in the stock market as the cause behind dramatic rallies and sell-offs.

- Emotional gap: The emotional gap refers to decision-making based on extreme emotions or emotional strains such as anxiety, anger, fear, or excitement. Oftentimes, emotions are a key reason why people do not make rational choices.
- Anchoring: Anchoring refers to attaching a spending level to a certain reference. Examples may include spending consistently based on a budget level or rationalizing spending based on different satisfaction utilities.
- Self-attribution: Self-attribution refers to a tendency to make choices based on overconfidence in one's own knowledge or skill. Self-attribution usually stems from an intrinsic knack in a particular area. Within this category, individuals tend to rank their knowledge higher than others, even when it objectively falls short.



Fast fact

Behavioral finance is exploited through credit card rewards, as consumers are more likely to be willing to spend points, rewards, or miles as opposed to paying for transactions with direct cash.

TRADITIONAL FINANCE VS BEHAVIORAL FINANCE:

The standard finance theory considers risk as an objective term that risk can be quantified. Risk can be calculated as beta, or risk can be calculated from the standard deviation.

But behavioral finance theories say that risk is subjective. One person can have a different level of risk-taking capacity than another person, and it cannot be objectively measured.

Based on the behavior, standard finance theories say that the decision-maker is rational. In contrast, the behavioral finance theory states that human beings are irrational, and he would take all the decisions based on irrationality.

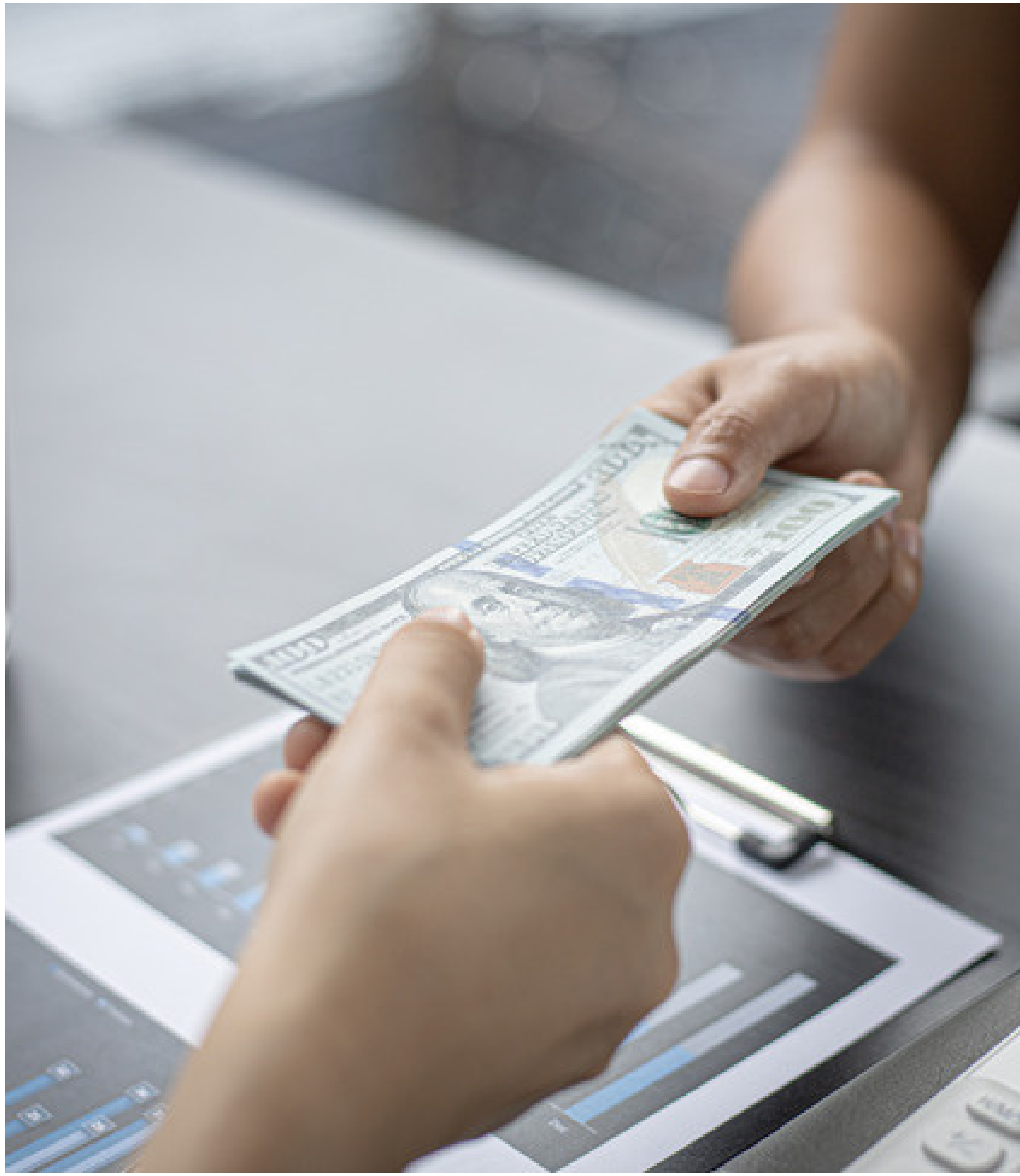
EXAMPLE OF BEHAVIORAL FINANCE

- For example, if a person notices others are investing in a certain stock, it may motivate them to do the same. To avoid herd behavior, individuals could do their own research to make financial decisions and measure their risk. Historically, herd behavior can start large sell-offs and market rallies in the stock market.

WHAT IS THE NEED OF BEHAVIORAL FINANCE AND IT'S IMPORTANCE:

Do you remember the Dot Bubble that happened in the year 2000 or the global financial crisis in 2007?

Well, we were all affected by that. But traditional finance models failed to predict the market. It was identified by various economists and the governments of several different countries that we lack behind on something. Later it was found that behavioral finance gives all the answers related to these mishappenings.



CONCLUSION

You might have heard a common phrase that "Even smart people make Big Money mistakes." Well, this is true Because IQ has nothing to do with money mistakes. It's the heart and emotions that are essential, explained in different behavioral finance theories

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Behavioral finance suggests that the structure of information and characteristics of participants of the market can play an essential role in the decision making of the investor as well as the overall outcome of the market.

Behavioural Finance is about making the right decisions that are free from any kind of biases and errors. It helps in understanding investor behavior better and helps in improving the financial capability of individuals.

People can earn better returns if they know what the biases which are affecting their decision making are, and thus they can make better decisions.

Sources

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