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Short Review Paper

A review on behavioural finance and investment management

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Abstract

This paper investigates the background regarding the key objectives of behavioural finance and investment management research and the emergence of these two disciplines over time. The main idea of this paper is to identify some future scope of behavioural finance in correlation to investment strategies and management. The research is based on searching keywords in database in Google Scholar and Emerald on the basis of number of publications and times cited in the respective field to measure the contributions of active researchers. Considering behavioural finance as emerging area of research in relation with investment strategies many researchers are contributing, making it a significant field of study. The papers reviewed are mostly empirical or theoretical in nature with limited number of papers in review category, which are required to assist researchers and professionals. This paper highlights with limited number of literature survey that there is widespread interdisciplinary research and it is possible that a strong collaboration can exist between behavioural finance and traditional investment management. Most of the model used for analysis purpose in the literatures so far reviewed has some limitations to justify every factor and variables. Research related to factors which have association with varying time like time varying aggregate risk is to be analysed. Through the literature survey it is found that there is huge scope of research taking factors like attitude, personality, and perception as variables in the region like South-East Asian Countries.

Keywords: Behavioural Finance, Investment Management, Strategies, Psychology, Decision Making.

Introduction

It was Oscar Wilde who explained a cynic as one who “knows value of nothing but price of everything"[1]. Considering some equity research analysts and many investors having "bigger fool" theory of investing, which highlights that “the value of asset is irrelevant as long as there are “bigger fools” to buy the asset from them”. While this may give basis to some profit as there are the individuals who are sufficiently deceitful that the value is in the eyes of beholder and any price can be justified as long as there are other investors willing to pay that price[2].

There are many assets for which perception may be all that matter like painting or a sculpture, but a rational investor do not buy most of the assets for aesthetic or emotional aspects, financial assets are acquired for the expected cashflows from the. Modern finance works on assumption that markets are efficient and that agents of this market knows with greater probability the distribution of future market risk[3-5].

Behavioural finance models are normally created to clarify investor behaviour or market inefficiency when rational models provide no sufficient clarification[6]. Behavioural aspects and psychology often affects the investor’s decisions, which are evident from irrational decisions under the influence of overreaction, under-reaction, overconfidence, group behaviour etc[7].

In recent years, many researchers in the area of finance and investment have been very active in behavioural finance, and many of their research works have been accepted in the top journals in the field of financial economics[8]. This shows that behavioural finance is becoming an increasingly significant area for research.

This paper begins the review of past and recent studies to explore the relationship of psychological factors influencing the investment decision makings with the returns through investments. The findings through literature of the study are then presented and discussed to identify any gaps. This paper concludes with the main findings of the study, their implications and future scope of research, as well as a considering limitations of the study if any.

Broad literature survey

Behavioural Finance: Behavioural Finance is one of the dynamic and fully developed fields which have its own principle and methodology[9]. Behavioural finance came in existence due to limitations of traditional theories and finance to support the investment and saving decisions[10,11]. While traditional finance formulates the investment strategy whereas behavioural finance focuses on the decision process of its execution[12]. Many of the key variables in behavioural models are neither observable nor measurable directly to researchers analysing data, thus most of the empirical studies in the field of behavioural finance receive intermediaries in endeavour to catch or measure the impact of such factors[13].

Research in Behavioural Finance: Behavioural finance is one of the significant areas of research as many of the papers are new and emerging in nature and have limited review papers. With consolidation of financial market across the world the importance of behavioural finance is attracting many scholars and researchers. According to analysis of Huang Jim Yuh, during the period 1995 to 2013, in this period of 20 years, the study in the area of behavioural finance was in 124 journals and 347 articles in which 650 authors were involved. Participation in this field is limited to from USA, Germany, Spain, England, China Israel, Australia, but there are limited scholars from south East Asia like economy like India.

Behavioural Factors Considered for Research: Behavioural Factors like nervousness, interests in financial issues, choice styles, requirement for precautionary savings, and spending tendency as self stated attitudes and behaviours for a range of daily financial affairs[14]. Fund managers and financial institutions have to have in-depth study of the customers to retain them in this competitive world[15]. Group dynamics plays an important role in making decisions related to investment plan and strategies, thus there is need of specific business models to include group behaviour of individual investors[16].

Behavioural Finance: Theory and Financial Markets: Functioning of financial markets found to be strongly correlated with the financial behaviour of individuals which have been traditionally in experimentation phase with economics and psychology which motivates for empirical analysis and study[17]. To study behavioural finance Basic tools used for experiment includes direct observations, controlling variables; manipulate variables as per theoretical requirements[18,19]. In two companion review papers which highlighted the key strength of experimentation method, which provides its importance for its suitability to study behavioural finance. This method provides flexibility to researchers to use proxy variables which is not measurable or observable directly and thus provides an important weapon to manipulate the variables as per requirement.

Investment Strategies and Management: The research related to the theory of investment strategies under uncertainty and the related empirical works considering volatility and the trade cycle in various countries across the globe and for period of more than 120 years have been analysed[20]. For analysing the performance of investment plans various tools like Regression analysis[21], Multi Factor Model[22], GARCH and ARCH Model[23], CAPM Model[20], Cluster analysis has been used[14]. Major analyses of these researches are focused in countries like Japan, United States, France, United Kingdom, Switzerland etc where factors like wage income per worker, S&P composite returns, comparison of nominal investment and planned investment, retail investor portfolio, impact of diversification and the effect of behavioural factors on investment strategies are broadly covered in the papers reviewed.

Conclusion

This paper tries to evaluate the contribution to the area of behavioural finance and its relationship with investment management for individual as well as corporate institutions. The implications of the findings from the above literature review in the area of behavioural science and investments are as follows:

For last 23 years, behavioural finance has attracted many researchers and scholars considering its impact on investment management and decision making capabilities. It has been found that there is huge scope for further research in region and country specific as most of the research are concentrated in USA, China, Spain, Germany, Israel, Australia. Thus, provides scope for research in India and other South-East Asian countries.

Most of the papers reviewed have considered behavioural factors like overreaction, under-reaction, overconfidence and group behaviour. The factors like fear, perception, learning, personality and attitude has to be considered and should be studied in depth for taking investment decisions. This provides further scope for research taking these variables.

More research should be undertaken to examine the relationships between real behaviour with the self-expressed behaviour and the change in attitudes and behaviour over one’s life cycle which changes the risk taking capability related to investment strategies, also many behavioural aspects changes with ageing and time and hence for each individual all factors cannot remain same and changes will also be disproportionate. Further, categorisation related to earning capacity and profession will help to further find the impact of other factors on investment strategies.

Every model used for analysis purpose in the literatures so far reviewed has some limitations to justify every factor and variables. Research related to factors which have association with varying time like time varying aggregate risk is to be analysed. Nonlinearity in the model provides future scope of research in same area, other variables like bonds, commodity, forex, impact of unorganised variables and investment strategies should also be included for the given region of study.

The primary input to develop association between investment management and behavioural finance has been from basic experimental psychology to phase of implementation stage. Many papers reviewed so far, it is found that methods developed within sociology such as surveys, interviews, participant observation, focus groups have not had the same degree of influence on investment strategies as is expected. Behavioural finance in its nascent stage may have started as a multidisciplinary endeavour but it is now an interdisciplinary field with its own learned societies, journals and conferences. However, this discipline is still developing and continues to develop new methods, process and ideas from other disciplines.

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