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Behavioral Finance: The Importance of Psychological Factors in Financial Decisions

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ABSTRACT: Behavioral finance acknowledges that varied psychological factors impact financial decisions made by investors or financial analysts. As a result, it raises concerns about the rationality of financial decisions made by them.

How accurate are the predicted results? Do we always follow the expected utility theory when making decisions? In real life, the financial decisions made by consumers, users, and investors are influenced by various biases, for instance, bandwagon bias, anchoring bias, endowment bias, hindsight bias, the pain of paying, nudging, and more.

Hence, in this paper, we have covered essential concepts and biases for financial decision-making, outcomes after making a decision, as well as an innovative decision-making approach for explaining the subject matter in depth.

KEYWORDS: Behavioral Finance, Psychological Factors, Financial Decisions, Rationality, Investors and Financial Professionals

I. INTRODUCTION

The assumptions of "rationality and the perfect market" are the foundation of traditional economic and financial models. The fundamental assumption of financial theories (Loxton, Truskett, Scarf, Sindone, Baldry, & Zhao, 2020) outlines that all investors are rational and securities markets are efficient. However, psychologists contend that all investors cannot be rational because cognitive behaviors and extreme emotional biases affect their investment decisions. They, therefore, challenged this fundamental principle of conventional finance. As per psychologists, investors' investment decisions, customers' buying decisions, and users' consumption patterns in the real world are steered by their emotions, biases, sentiments, and psychological and sociological appeals. Under the concept of a perfect market, there are no transaction costs and no taxes, and economic agents have access to all publicly available information.

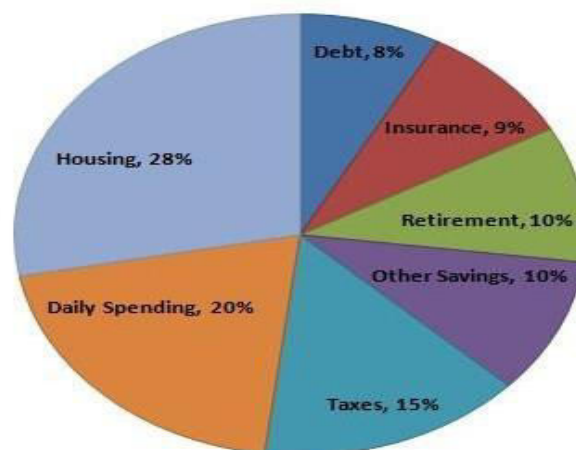


Figure 1: An ideal financial pie chart with different viable parameters

Economic theory (Bavel, Baicker, Boggio, Capraro, Cichocka, Cikara, ... & Willer, 2020) generally assumes that people make decisions based on expected utility theory, taking into account all probabilistic outcomes and choosing the best course of action for a maximum utility after weighing benefits and disadvantages.

Nevertheless, in practice, unexpected events like fire in an apartment necessitate quick responses (Lunn, Belton, Lavin, McGowan, Timmons, & Robertson, 2020), making the rationality concept insignificant. People may not be irrational, but their behavior is solely dependent on the situation. Behavioral economics and finance have emerged to support neoclassical economics and financial theory.

Behavioral finance (Mehta, Saxena, & Purohit, 2020) applies the psychological behavior of humans to financial decision-making. It focuses on emotional, societal, sentimental, psychological, and cognitive factors in decision-making. This implies that people intend to optimize their decisions on the basis of personal satisfaction and bias.

II. IMPORTANT CONCEPTS AND BIASES

People have to constantly make varied decisions throughout their lifetime. One area of cognitive psychology that has drawn attention is how people make decisions. Theories have been developed to explain how individuals make decisions and the types of variables that will continue to affect decision-making in the future.



Figure 2: Investment Process - Roller Coaster of Emotions

1. **Prospect Theory:** Kahneman and Tversky developed prospect theory in 1979. It suggests that investors (Ruggeri, Alí, Berge, Bertoldo, Bjørndal, Cortijos-Bernabeu, ... & Folke, 2020) are more averse to losses than gains due to the greater emotional impact of losses.
2. **Disposition Effect:** Hersh Shefrin and Meir Statman coined the 'Disposition effect' in 1985. It explains that investors (Trejos, van Deemen, Rodríguez, & Gomez, 2019) tend to sell stocks that increase in value but hold on to those that decline in value to avoid losses. However, it is more logical to sell the declining stocks to avoid further loss and hold on to the appreciating ones to earn profit.
3. **Mental Accounting:** In 1985, Thaler introduced the concept of mental accounting. According to this theory, people separate (Kremer, Rao, & Schilbach, 2019) their wealth into non-transferable separate compartments and assign

different levels of utility to every group. This irrationally impacts consumption and other decisions. For instance, prioritizing saving for children's education over paying off debt can have negative financial consequences. This behavior is irrational and can have detrimental effects on decision-making.

4. **Anchoring:** An anchor (Nagtegaal, Tummers, Noordegraaf, & Bekkers, 2020) is a heuristic used in decision-making, often based on the first piece of information received. For example, the jewelry industry creates a diamond engagement ring as a symbol of love. Conventional wisdom suggests that it costs the groom around two months of his salary. Two months' salary is a huge sum of money, so it is an irrelevant reference point established by the jewelry industry to increase its profitability. A diamond ring is not evidence of love for the other person.

5. **Bandwagon Bias:** People tend (De Pasquale & Valcher, 2022) to conform to the actions of a group to feel a sense of belonging, even if the group may not be right. This especially happens when individuals lack prior experience. For example, in Bangalore, roadside sellers use a group of "pretending buyers" to attract real customers. The sellers announce prices loudly, and the pretending buyers rush to buy, creating a sense of urgency that also prompts other passersby to buy. Once the true customers leave, pretending buyers return the items to the seller.

6. **Endowment Bias:** People are likely to overvalue their possessions (Collard, Walford, Vernon, Itagaki, & Turk, 2020), regardless of their actual worth, which can lead them to demand more to give up on the object than others would be willing to pay for it. For instance, in the virtual online market, companies offer free trials and money-back guarantees to capture the market on the basis of endowment bias. When we order something with a money-back guarantee scheme, it is very rare to return the goods, and we do it only when they are not worth using. That is because we instantly attach sentimental value to goods upon receiving them.

7. **Hindsight Bias:** It is the belief of the people (Howes, Kausel, Jackson, & Reb, 2020) that they know the outcome of events before they happen, leading to hindsight bias or overconfidence. Overconfident investors may believe they have extraordinary abilities, which leads to excessive trading and costs. Examples include the 2008 financial crisis and the dot-com bubble show of the late 1990s. People now may state every sign indicated to them that such a situation would come. However, in reality, warnings from analysts or investment professionals who were screaming that there was a problem at that time were not listened to.

8. **The Pain of Paying:** When people make payments (Jain, Gajjar, & Shah, 2021) in hard cash, the pain is maximum because people do not want to part with hard cash. To reduce the pain of payment, some people use online transfers through debit cards, credit cards, Paytm, Amazon pay, mobile transactions, and so forth. However, rationally there is hardly a difference between these.

9. **Nudging:** Nudges are plans (Reñosa, Landicho, Wachinger, Dalglis, Bärnighausen, Bärnighausen, & McMahon, 2021) that direct people in a particular direction and also allow them to go their own ways. Nudges usually affect us subconsciously and are used to achieve the desired results. Famous brands, logos, taglines, and slogans play a significant role in creating an emotional appeal that can influence prospective customers to purchase a product. Richard Thaler was awarded the Nobel prize for his Nudge theory in 2017. For example, in 1994, Kannada film actor Dr. Rajkumar inaugurated "Dr. Rajkumar Eye Bank" and donated his eyes. After his sad demise in April 2006, his corneas were collected. This movement was heart-touching and motivated many people to follow him. Thus, there has been a great increase in the number of people who have pledged to donate their eyes from since then.

III. OUTCOMES AFTER MAKING A DECISION

After a decision is made (Wu, Liu, Zhou, Yu, Li, Zhan, ... & Wang, 2021), people experience a variety of reactions. In addition, decisions made in the present time influence future decision-making. Several outcomes may result from a decision, including regret or satisfaction, both of which can influence decisions to be taken in the coming time. Regret or disappointment is a potential outcome of a particular decision made by people. Interestingly, regret may play a pivotal role in shaping the decision-making process. According to Abraham and Sheeran, anticipated regret is the belief that the decision will be a result of inaction. Anticipated regret can prompt a certain behavior, meaning that if a person expresses their intention to do something, like exercise, they are more likely to follow through with their decision to avoid experiencing regret later on. After making a decision, if a person feels regret, then that feeling can have a

significant impact on their future decisions. People can often get consumed with examining other available options, the path not taken (Mojzisch, Häusser, & Leder, 2020).

According to economic theory, the decision-making process, the number of options available, and the contrast between those options influence the extent of regret experienced by individuals after making a decision. Moreover, they may regret their decision if they believe they could have made a better decision by considering the consequences of each option and additional information that was previously overlooked. It is interesting to note that those unsatisfied with their decision accept it to relieve their anxiety.

People can feel satisfaction or regret due to their choices depending on multiple factors. They will experience satisfaction if they make decisions for themselves and are less happy when they have unfavorable options only to make a decision. That is because decision-makers are accountable for every decision they make. Consequently, if there are bad options, decision-makers will blame themselves for making poor decisions.

Also, an effective decision-making technique emphasizes weighing the benefits and drawbacks of options. This technique is used by younger as well as older adults. Elderly people list more positive features in comparison to fewer negative features of every choice, and they are more satisfied upon using this technique. Intriguingly, when people (Shiva, Narula, & Shahi, 2020) did not compare their options by listing positive and negative aspects, the satisfaction was the same across all age groups.

As aforementioned, past decisions can influence present decisions. However, in a plethora of cases, especially when a decision can be reversed, people are likely to consider the possibility of reversing their decisions. So, people are willing to pay more to obtain an opportunity to change their minds to attain satisfaction. For instance, people who prefer shopping from catalogs follow two steps to make purchases. They initially decide which items to buy. Subsequently, once they receive the items, they choose which items to keep.

IV. AN INNOVATIVE DECISION-MAKING APPROACH

Decision-making (Wei, Hai, Zhu, & Lyu, 2021) contributes to our sense of success and contentment, and it serves as the basis of everything we do. However, the decision-making process can be challenging and overwhelming. Effective decision-making and problem-solving abilities can aid us in ultimately making a final choice. Problem-solving approaches can include but go far beyond written remediation plans, cost-benefit analysis, brainstorming, and an examination of available options. Therefore, it is helpful for people to adhere to a model that is applicable to both everyday and major life decisions.

A goal and plan-based decision-making model is a worthwhile approach to take when making decisions. In this model (Smith, Seo, Warty, Payne, Salih, Chin, ... & Wallace, 2020), individuals are encouraged to focus on goals rather than happiness or usefulness. So, they formulate plans to achieve one or more goals. In other words, people consciously or unconsciously make plans to achieve their objectives. For instance, individuals who attend a sporting event with a friend may achieve multiple objectives, including friendship and camaraderie, emotional stimulation from competitive sport, and possibly gaining beneficial social knowledge from watching the game. As per this model, the established goals are dependent on context, which essentially serves as the background for making a decision, assists in the formulation of tenable plans, and decision-making rules are implemented and have an impact on the plan that is ultimately chosen. These plans are effective in plenty of spheres, including the insurance business.

V. CONCLUSION

Decision-making is a pivotal arena of research in the context of cognitive psychology to comprehend how people make decisions. A multitude of factors influences the process followed by people to make decisions. Some of these factors are past experiences, age and personality differences, cognitive biases, a sense of personal relevance, and a rise in commitment. The possible outcomes after making choices are regret and satisfaction. In addition, reversibility may not yield desirable or satisfying results, so people are willing to pay a premium for reversing their decisions. Myriad decision-making models developed by cognitive psychologists explain how people make decisions. One such model is based on planning and setting goals.

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