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Behavioral Finance in Financial Activities

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Abstract: Behavioral finance has emerged as an important field in understanding how psychological and emotional factors influence financial decision making. Behavioral finance offers a new perspective that explains various market anomalies that cannot be explained by conventional financial theory. The type of data used is secondary data, namely data that is not directly provided to data collectors, this data is obtained from books, scientific articles and internet sites, materials related to behavioral finance. The data collection technique in this research is a literature study that is directly related to behavioral finance. This research aims to explore existing literature regarding the role of Behavioral Finance in financial activities, with a focus on how cognitive biases, emotions, and other psychological factors influence investor behavior and the market as a whole. Through a systematic literature review, this research seeks to identify key trends, research gaps, and practical implications of findings in this domain, so as to provide more comprehensive insights for academics and practitioners in the field of finance.

Keywords: Behavioral finance, Financial activities, SLRs

Introduction

Behavioral finance has become an increasingly important area of research in recent decades, as it provides insight into how psychological factors influence individual financial decisions and the market as a whole. This field combines economic principles with psychology to explain market anomalies that cannot be explained by conventional financial theory. This is important because it provides insight into non-rational behavior that traditional financial theory often cannot explain. Behavioral finance theory provides a realistic picture of actual investor behavior and the factors that influence investor behavior in different situations. Organizations that implement Behavioral Finance avoid issuing securities that do not produce the required returns. This allows individuals to reduce the impact of biases that contribute to incorrect judgments. Financial education is a prerequisite for making positive capital market decisions.

Behavioral finance helps explain why investors often act based on emotion rather than logic, such as selling shares when the market is down (panic selling) or buying when prices are high (herd behavior). Behavioral finance also identifies various cognitive biases that influence financial decisions, such as overconfidence,

anchoring, and loss aversion, which can lead to less than optimal decisions. By understanding how human behavior influences markets, financial professionals can design investment strategies and financial products that better suit investors' needs and behavior. Knowledge of behavioral finance can help policymakers design regulations that encourage healthier financial behavior, such as encouraging retirement savings or reducing excessive risk taking. Increasing awareness about financial biases and behaviors can help individuals make better financial decisions, reduce costly mistakes, and improve overall financial well-being.

Financial activities refer to various activities related to financial management, investment, financial planning, etc. Financial activities encompass a broad spectrum of operations and strategies used by individuals, corporations, and governments to manage their monetary resources, ensure fiscal stability, and achieve specific economic goals, including but not limited to, budgeting, which involves careful planning and allocation. Funds to various departments or projects to optimize financial efficiency; investments, where an entity allocates capital to different asset classes such as stocks, bonds, real estate, or new business ventures with the goal of generating profits over time; fundraising, which requires sourcing capital through various means such as issuing shares, bonds, or obtaining loans to support large projects or operational needs; risk management, an important process that involves identifying, analyzing, and mitigating financial risks through instruments such as insurance policies, hedging strategies, or diversification to protect against potential losses; accounting, which requires the systematic recording, reporting, and analysis of financial transactions to ensure transparency, accuracy, and compliance with regulatory standards; and financial planning, a forward-looking process that helps individuals and organizations set financial goals, assess current financial health, and develop comprehensive strategies to achieve long-term financial success, all of which play an important role in sustaining economic growth, increasing financial stability, and encourage efficient allocation of resources in an economy.

This research explores existing literature regarding the role of Behavioral Finance in financial activities, with a focus on how cognitive biases, emotions and other psychological factors influence investor behavior and the market as a whole. Through a systematic literature review, this research seeks to identify key trends, research gaps, and practical implications of findings in this domain, so as to provide more comprehensive insights for academics and practitioners in the field of finance.

Method

Apart from using appropriate methods, this research also requires selecting relevant data collection techniques so that adaptive process research can handle relevant data and results. The data collection technique used in this research is literature study. This technique is carried out with the aim of revealing various theories that are relevant to the problems being faced/researched as reference material in discussing research results.

Results and Discussion

Literature Review

Literature on Behavioral Biases

The expected utility theory and efficient market hypothesis as explained by the traditional finance theory is not able to clear the picture regarding the investing patterns and preferences of the investors under certain circumstances. This has led to a further research into the field of finance to pursue the reasons of varying individual behavior under different circumstances.

The expected utility theory was challenged by a new theory: prospect theory by Kahneman and Tversky (1979). The expected utility theory assumes that the investor decides between risky assets by comparing the utility values weighted by probabilities of their occurring and that utility is dependent on the current state of the wealth. On the contrary, prospect theory describes that people decide between alternatives that involve risk and return in terms of expected utility of returns. The utility of returns is based on the potential value of losses and gains rather than the final outcomes and investors apply certain heuristics while making decisions. Investors are willing to gamble less with profits than with losses. They are risk averse toward gains and risk taking toward losses. An alternative to efficient market hypothesis has been explained by Soufian et al. (2014), the adaptive market hypothesis. The advantage is that this theory explains loss aversion, overreaction and behavioral biases. It doesn’t assume the scenario of purely rational investors who make the optimal capital allocation. It supposes that finance theory and its various theories have the power to drive the entire economy and so any change in the

financial theory has an impact on the entire economy. The economy is ever changing and so the economy. Ultimately the market is able to adapt itself to its inefficiencies and then quickly recover to function according to the functioning to its participants.

Benartzi and Thaler (1995), has propounded the concept of the "myopic loss aversion" and has explained the equity premium puzzle through a series of behaviors. The term "myopic" added to the loss aversion refers to those investors who have investments in the longer horizon but prefer short-term gains and losses. Loss aversion is the tendency of the decision-makers to weigh their losses heavily, i.e. double than their gains. The feeling of loss aversion in the investors is studied by Godoi et al. (2005), through the deep qualitative interview. The interview is conducted because loss aversion is an aspect of human subjectivity and so shouldn't be quantified. The results reveal that familiar influence, investment objectives, risk dimension, the feeling of guilt, rationalization, fear and anguish are the factors associated with the feeling of loss aversion. A qualitative approach has been used by Kleinubing et al. (2005), to understand loss aversion its influence and meaning to the investors. The loss aversion as a feeling involves the human emotions and desires. This bias could not be studied extensively through quantitative methods. The interpretative paradigm is used for the study, as it provides an epistemological base for the study of a given phenomenon. It shows the ideal investor behavior apart from their actual behavior. It also captures the hidden feelings of the interviewees that cannot be studied through other methods. The feelings associated with the loss aversion are organized into various categories like familiar influence on decision-making, financial investment and driving investment, loss and risk, guilt, defense mechanism and rationalization, fear anguish and aversion.

The herding behavior of investors on the Chinese stock markets has been studied by Demirer and Kutan (2006). The Shanghai and Shenzhen Stock Exchanges are studied and the results have shown the non-existence of herd behavior in these markets. It suggests that when the market is extremely down, then the return dispersions are low and the stock value also decreases during downside markets. The herd behavior and the investor behavior are different in both the stock exchanges because of the size of market and types of firms working there. Furthermore, a non-financial sector with lower rates of capitalization and a small number of traders are more exposed to the herding bias. The results are based on the assumptions that in the period of market stress, the investors are likely to follow the market than to follow their private information. Both non-firm- and sector-level data provide support for these results. The absence of herding behavior in the markets provides evidence of a stabilized market and indicates that the investors in both the exchanges have complete information about the market. Thus, it proves that if the market is efficient and investors are well informed, then the same market information is communicated globally within a short span of time. According to Messis and Zapranis (2014), the existence of herding is an additional risk factor for the investors. So, the volatility measure is positively affected by the presence of herding behavior.

Barber et al. (1999), study the presence of disposition effect in the individuals with reference to the proportion of gains realized (PGR) and proportion of losses realized (PLR). A large difference in PLR and PGR indicates a greater tendency in investors to acquire either losses or gains. Linnainmaa (2010) finds the impact of the limit order on the trading frequency of investors. He states that even if the limit orders of buy-sell are equal, a positive news of the market behavior results in the execution of the limit order. So it gives an impression of the disposition effect. Richards et al. (2011), investigate the impact of stop losses on the disposition effect. The results indicate that the use of stop losses results in a lower disposition effect. Jhandir and Elahi (2014), find the possible impact of investor type on the investment decisions. He concludes that the investor type has a negative impact on the disposition effect and herding, while it has a positive effect on overconfidence. Aspara and Hoffmann (2015), represent that the disposition effect can be minimized by generating an inclination toward the overall saving goal in the investor.

The format in which the information is presented to the investors has a significant impact on their choice of investments, which has been explained by Glenzer et al. (2014). They further explain that the risk seeking abilities of the investors is effected when the information is presented in absolute numbers rather than in terms of rate of return. This is due to the framing effects in investor behavior. Nwogugu (2010), points out the inefficiency in the net present value (NPV) and internal rate of return (IRR) models, as there is a difference in the market values and present values. This is due to the presence of framing and cognitive biases in the investors. The weighted average cost of capital doesn't measure the operational risk in the capital structure which further adds to the framing problems. Regret theory finds a solution to the problems that are faced in the project selection in NPVIRR model. Mittal (2010), with the study of 330 investors, concludes that the salaried class is more prone to framing effects than the business class investors. The results are drawn with the help of a self-structured questionnaire.

The paper by Daniel et al. (1998), seeks to highlight the effect of the biases, i.e. investor overconfidence and biased self-attrition on the security market under and overreactions. The effects of these biases have been identified by its impact on autocorrelations, volatility returns and pattern based on past and future returns. The economists are of the viewpoint that there are various possibilities about the presence of several irrational behavioral patterns that cannot be studied through a single theory. This paper shows that investors overestimate their abilities in various ways under various circumstances. It defines that an overconfident investor relies on the information that he gathers rather than the information that is generated in the market. This paper thus explains that the market has a tendency to under-react to public information but overreact to private information. The investor psychology has a direct impact on the functioning of the stock market. Fisher and Statman (2003), find the possible association between the overconfidence in the investors and returns on the company's stock. The overconfidence in the investors is reduced on a negative stock return. The low stock price doesn't result in low stock returns, but surprisingly, it results in high stock returns.

Glaser and Weber (2007), study the overconfidence in online stock broker and concludes that overconfidence is not related to the trading volume when measured by calibrated questions. The heterogeneous agent model is used by Fischer (2012), to study the impact of overreaction and under-reaction of investors in the financial markets. The efficiency of the financial markets can be increased if the investors have a high degree of rationality and critical thinking. Glaser et al. (2013), measures overconfidence through interval estimates. This method measures overconfidence at an individual investor's level. The results show that expertise in professionals doesn't mitigate the losses. The investors can be both overconfident and under confident, depending on the task they have to perform. They can be confident toward some decisions, while they remain uninformed and under confident toward other decisions. Duxbury (2015), presented a systematic synthesis of the experimental studies is conducted to clarify the effect of heuristics and biases (underoverreaction and overconfidence), the influence of moods and the emotions of the investors. The experimental studies have been used because it increases the originality of the study by isolating the impact of the previous studies and setting the result targets that has to be achieved. The correlation between equity market returns and the moods of the investors has emerged as a subject of great interest in psychology-based proxies. This relates to those investor moods that have to be studied by experimenting on the relations among them and to study its impacts on another. It is always assumed that biased managers can make decisions having an adverse impact on the firm's position.

Omondi (2016), explores the possible effects of optimism/pessimism bias on the reaction of investors toward information collection, processing and decision-making. The ignorance, peer influence, media information and broker's recommendation has a significant impact on the decision to invest. Mohlmann (2013), explains how the difference in behavior of investors with regard to the different the tax collectors is associated with home bias. The investors prefer to invest in domestic companies, as the tax collection is comparatively easier with respect to the foreign country and the investors have a trust on the tax collection of their own government. Additionally, Daly and Vo (2013), finds that capital control policies, transaction costs, trade governance and market size determine the preference of investors toward their domestic investment compared to the international diversification. The presence of home bias is studied by Fellner and Maciejovsky (2003), using an experimental study on 144 students in various disciplines. The social factors, group affiliation and optimism toward domestic portfolio drive the investor behavior toward domestic securities.

Zhou and Pham (1984), investigate the possible reasons of investors' different orientation toward different investment opportunities. The investor makes separate investment decisions keeping separate mental accounts for both profit and loss. The promotion and prevention decisions act as separate stimuli in choosing the two options. This was tested across four sets of experiments.

Literature on Behavioral Finance in Financial Activities

Overview of Behavioral Finance in Financial Activities

The systematic literature review (SLR) on "Behavioral Finance in Financial Activities" integrated findings from various studies, including those by Kahneman and Tversky (1979) and Shefrin and Statman (1985), laying the foundation for understanding behavioral biases in financial decision-making.

Influence of Behavioral Biases on Investment Decisions

Building upon seminal works, subsequent research by Barberis and Thaler (2003) and Odean (1999) demonstrated the pervasive influence of behavioral biases, such as overconfidence and loss aversion, on investment decisions, contributing to the understanding of investor behavior in financial markets.

Behavioral Factors in Budgeting and Expenditure Patterns

Studies by Thaler (1985) and Tversky and Kahneman (1981) elucidated the role of behavioral finance in budgeting and expenditure patterns, revealing how mental accounting and framing effects shape individuals' financial choices and consumption behavior.

Behavioral Finance and Risk Perception

Empirical studies by Slovic (1987), Tversky and Kahneman (1974) provided insights into the psychological underpinnings of risk perception, informing research on behavioral finance's implications for risk management strategies in financial decision-making.

Methodological Approaches and Research Trends

Methodological diversity characterized research in behavioral finance, as evidenced by studies employing experimental designs (Thaler et al., 1997), surveys (Barber & Odean, 2001), and empirical analyses of market data (Fama & French, 1992). This methodological richness facilitated a nuanced understanding of behavioral phenomena in finance.

Implications for Financial Practitioners and Policymakers

Research by Mullainathan and Thaler (2001), Benartzi and Thaler (2004), underscored the practical implications of behavioral finance for financial practitioners and policymakers, advocating for the design of interventions and products that account for investors' behavioral biases and preferences.

Future Directions and Research Opportunities

The SLR identified avenues for future research, inspired by the works of Shiller (2003) and Loewenstein and Thaler (1989), suggesting the exploration of interdisciplinary approaches and the integration of emerging methodologies, such as neuroeconomics, to deepen our understanding of behavioral finance phenomena.

By synthesizing insights from seminal and contemporary research, the SLR on "Behavioral Finance in Financial Activities" illuminated the multifaceted influence of behavioral biases on financial decision-making processes. Drawing upon a rich tapestry of studies, the review underscored the significance of behavioral finance in shaping investment behavior, budgeting practices, and risk management strategies, while also highlighting avenues for future research and practical implications for stakeholders in the financial ecosystem.

Conclusion

This research shows that financial behavior plays an important role in individual and organizational financial decisions. The main findings of this research include:

Cognitive and Emotional Biases: Individuals are often influenced by various cognitive biases such as overconfidence, anchoring, and herd behavior, as well as emotional factors such as fear and greed. This bias can lead to irrational decision making and deviation from traditional financial theory based on the assumption of rationality.

Social and Cultural Influences: Social and cultural factors also have a significant impact on financial behavior. Social norms, pressure from peer groups, and local culture can influence how individuals and organizations make financial decisions.

Education and Financial Literacy: Low levels of financial literacy often result in poor financial decisions. Effective financial education can help individuals identify and overcome behavioral biases and improve their ability to manage their finances more rationally.

Applications in Various Financial Activities: Behavioral finance is not only relevant in capital market investments, but also in portfolio management, retirement planning, and credit decision making. Research shows that strategies that consider behavioral aspects can improve performance and risk management.

Implications for Practitioners and Regulators: A better understanding of behavioral finance can assist practitioners in designing financial products that better suit consumer needs and behavior. For regulators, these findings can be used to develop more effective policies in protecting consumers and ensuring market stability.

Recommendations

There is a need to increase Financial Literacy:

Education and Training: Comprehensive financial education programs should be introduced at various levels of education and for various age groups. Training materials should include an understanding of cognitive and emotional biases and how to overcome them.

Public Awareness Campaigns*:* Governments and financial institutions need to launch public awareness campaigns regarding the importance of financial literacy and the impact of behavioral biases on financial decisions.

Broader Empirical Studies: Conduct more empirical research to understand how behavioral biases affect different segments of the population and how certain interventions can help reduce them.

Innovation in Financial Technology: Developing and testing new technology that can help identify and overcome behavioral biases, such as personal financial management apps that use AI to provide personalized advice.

Scientific Ethics Declaration

The authors declare that the scientific ethical and legal responsibility of this article published in EPESS Journal belongs to the authors.

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