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Behavioural Finance and Investor Decision - Making in the Indian Capital Market

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ABSTRACT :

The study of behavioural finance explores how are the psychological biases of humans impact or influences the decision making of the investor contradicting various traditional theories. Investors sentiment are the key driver of the volatility of prices of the stock in the market. The dissertation examines various biases that are prevalent in the Indian capital market which incorporates primary market like companies issuing capital through Initial Public Offering (IPO) and secondary market which includes securities which are traded among investor in stock exchanges , where the increase in number of retail investors and wider accessibility of has influenced the investors behaviour. Some of the common biases are herding mentality , loss aversion , overconfidence biases , regret aversion and many more which may or may not significantly affect the market volatility and may influence the decision making of the investor leading to investors loss.

The primary data is collected by conducting the empirical survey which examines and identify various behavioural biases that are present in the Indian capital market and a secondary data analysis from the regulatory bodies like SEBI , NSE, BSE for the same. The study's finding highlights what are the biases which drives the investor decision making.

Keywords : Behavioural Finance, Indian capital market , Biases , Retail Investor , Herding bias , Overconfidence bias , Loss Aversion.

Introduction

The traditional finance theories are focused more on the decision making of the investor were the assumption is that the investor are rational and the decision made are purely based on the financial data available and expected return and the theory of a field of study which challenges this notion is behavioural finance where investor are often influenced by the cognitive biases , emotional and psychological factors , leading to irrational decision making. To study the impact of behavioural finance on the decision making of the investor hence the topic of the research "Behavioural Finance and Investor Decision – Making in the Indian Capital Market".
The rapid growth of retail participant in the capital market could be analysed through understanding rise of digital platform providing an accessibility of financial market to the investor. There are various biases and anomalies prevalent in the Indian capital market which can be understood through trends happening in the market which is the aim of the research to understand those aspects. As the number of investor increases in the market there is also an increase in development of digital platform.
The research's focus is to identify the key behavioural biases present among the investor in the Indian capital market with the population parameter specified and understanding what are the biases influencing the decision making of the investor and the volatility in the market.

2. Objectives of the Study

The objectives of the study gives an overview of what is that needs to be studied and those are :

1. **Identifying Prevalent Behavioural Biases Among Indian Investors**

The investors decision making may often be influenced by the psychological biases that can lead to irrational financial choices which may also lead to loss if the decision is irrationally. The objective of the research is to identify some of the most common behavioural biases in Indian capital market which includes overconfidence , loss aversion , herd behaviour and some of the anomalies like calendar effect or deposition effect.

2. **Assess the Impact of Behavioural Biases**

The traditional theories assumed the rational behaviour of the investor and considering the market efficient which is challenged by the theory of behavioural finance and the impact of the these biases could be reflected in the decision making of the investor and the volatility in the market. Evaluating the impact of these biases are important for various stakeholder , for policy maker to understand these biases gives an upper hand in formulating the policy accordingly reducing the negative consequences of irrational behaviour or biases of the investor in the market and the same goes for the financial profession.

3. **Developing Mitigation Strategies**

The third objective of the study is to develop or evaluate what are the strategies that could be implement to reduce the biases in the capital market and improve the decision making of the investor as well as the market efficiency. The bias mitigation strategies may improve the market efficiency and help the policy maker, financial advisor and investor to develop a disciplined investment culture in the Indian capital market.

3. Literature Review

The theories and studies by various researchers gives an understanding of the field and help move forward to the conclusion where the studies conducted suggest a challenging notion of traditional theories such as Efficient Market Hypothesis (EMH) having an assumption where the investor are rational and markets are efficient. Some of the literature review by the key researcher stated out are :

a) **" Prospect Theory – Loss Aversion"**

– By Kahneman & Tversky , 1979

The traditional theories were wholly based on the assumption of investor being rational and market being efficient but the prospect theory which was introduced by Kahneman & Tversky, 1979 suggest that people view the gains and losses differently where one of the aspect of this theory is " Loss Aversion ".

b) **" Herding Behaviour "**

– By Abhijit V. Banerjee , 1992

The herding behaviour can be seen in everyone even in investor where they follow the large crowd rather that conducting independent analysis of the investment. The "Herding Behaviour" proposed by Abhijit V. Banerjee ,1992 suggests that herding behaviour are present among the investor which shows how investor follow the majority.

c) **" Overconfidence Bias "**

– By Barber & Odean , 2001

The theory of ' Overconfidence Bias ' was proposed by Barber & Odean 2001, suggest in their paper titled "Boys will be Boys : Gender, Overconfidence , and Common Stock Investment" that overconfidence biases may occur in investor when an investor overestimates his/her knowledge, skill or ability to predict the market and trade more frequently which may lead to excessive risk taking and lower net return.

d) **" Anchoring Bias "**

– By Kahneman & Tversky , 1974

The theory of ' Anchoring Bias ' was proposed by Kahneman & Tversky , 1974 which suggest that investors rely too heavily on the initial news or reference point that they get and go on making decision based on that information.

e) **" Risk Aversion "**

– By David Bell , 1982

The theory of ' Risk Aversion ' was identified by David Bell 1982 , which suggest that the investor hesitate or all together avoid making any decision that could lead to a future regret.

f) **" Disposition Effect "**

– By Shefrin & Statman , 1985

The theory of 'Disposition Effect ' was introduced by Shefrin & Statman 1985, which suggests that the investor may have tendency to sell a winning stock too early which could have shown gain in future and holding on to a losing stock for too long hoping for it to recover in the future which may not be the case.

g) “ Mental Accounting ”

– By Richard Thaler , 1985

The concept like ‘ Mental Accounting ’ was introduced by Richard Thaler 1985 , which suggest that an individual mentally separates money into different category based on the sources which it comes from or where will it be used.

h) “ Representative Biases ”

– By Kahneman & Tversky , 1985

The theory of ‘ Representative Bias ’ was introduced by Kahneman & Tversky 1985, which suggest that when an individual represent the past pattern to judge or justify the probability of future event were the fundamental and realistic statistical aspects are ignored.

i) “ Home Bias ”

– By French & Poterba , 1991

The theory of ‘ Home Bias ’ was founded by French & Poterba 1991, Which suggests that it is often found in investor that they prefer domestic stocks over foreign stocks like a company’s stock or mutual funds even when an international diversified investment could provide a better return with reduced risk.

j) “ Availability Bias ”

– By Kahneman & Tversky , 1973

The theory of ‘ Availability Bias ’ was introduced by Kahneman & Tversky 1973, which suggests that investor rely more on the information easily available to them rather than having a through independent research

Research Methodology

The way to analyse the data plays a vital role in analysing the data and researching for any research topic which describes any procedure or technique that will be implemented which can be used to analyse the data and generate prospective output.

Research Design

The research design lays the foundation for the conducting the research , the method of collecting the data analysing it efficiently where the research design used for the research are categorised into two :

Descriptive Research Design

In this research design the primary source of data is considered to evaluate the characteristic of the collected data which answer questions like what, why , when. The descriptive analysis for the study is bifurcated into two category that is demographic profile and behavioural biases & investment decision making.

Correlational Research Design

The correlational design used to analyse the relationship between two or more variable and here for the research two variable through chi square test is conducted to identify the relation.

Data Collection Method

The data is collected taking into consideration a diverse demographic profile with different age , education level , experiences in the investing capital market and the data collection method employed were primary which is the key sources of data for the study. The primary data was collected through a structured and self-administered questionnaire which was designed specifically to assess the influence of behavioural biases on decision making in Indian capital market.

The other source of data was secondary source of data which can provide a contextual relevance and theoretical backing. The source of the data was from the renowned institution like SEBI and NSE and BSE to understand behavioural pattern.

Rationale for Methodological Choice

The rationale behind adopting a survey based analysis was to get an real time and accurate data which are reported by the investor themselves giving the an first-hand investors behaviour and perception approach for analysing the data. The method for analysing the data used that is descriptive analysis which enables a detailed analysis of the population characteristics and the correlational analysis provides an a relational analysis of two key variable without manipulation of the data and specifically the chi square is chosen to test the hypothesis.

Limitation of the Study

The limitation of the study are :

- The sample size is limited to a specific number to 46 responses which may not reflect the entire Indian investor population.
- As the time changes the external environment changes so does the behavioural patter of the investor where one time survey may not capture all the pitfall of the market.
- Due to limitation of sample size there also a limitation of the diversity that can be captured through the survey question.
- The questionnaire may not have accounted for the geopolitical event that may have impacted the investors behaviour during the data collection period.

Ethical Consideration

The data collected from the participant where all the participant were informed about the nature of the nature of the study and what is the purpose of the study. A proper care was take while collecting the data where the response from the participant were to be stayed anonymous and the usage of the data collected for solely used for academic purpose. The survey was voluntary participant where the questionnaire was distributed that could be responded by the participant.

Data Analysis

The study includes the data that is collected from the primary source via Google form questionnaire requiring the participant to respond into two categories that is demographic profile and behavioural biases present among the participant. The information gathered is analysed in two research forms that is descriptive analysis and correlational analysis.

The Descriptive Analysis

In descriptive analysis the data can be used to analyse the pattern and trend in the market through the response which were provided by the participant which answer the 'What is', 'Why is', 'How is 'question and it also analyse the measure of central tendency in the data that is "mode" of the data. The descriptive analysis dives into the survey which were divided into two sections :

a) Respondent Demographic Profile Survey Analysis

In this section the demographic profile of the participant are analysed like the age , educational level , type of investor and the experience of the investor in the Indian capital market.

b) Behavioural Biases & Decision Making

In this section various behavioural biases present among the investor like herding bias, overconfidence bias many more and also analysing anomalies like calendar effect or deposition effect can be identified through a series of question and how are those biases impacting the decision making of the investor.

The Correlational Analysis

In correlational analysis two or more variable is tested whether there is a relationship between the variable without manipulation of the data and the various hypothesis are tested for analysis through usage of most appropriate tool like Chi Square Test. Those hypothesis which are tested are :

- Hypothesis 1: The Relationship between Age Group and Belief in Behavioural Biases
- Hypothesis 2: Investors with higher financial literacy are less prone to behavioural biases
- Hypothesis 3 : The Relationship between Investor Type and IPO Decision Making
- Hypothesis 4 : Overconfidence bias leads investors to take excessive risks in the stock market.
- Hypothesis 5 : Behavioural biases contribute to stock market volatility in India.

Result and Findings

The key findings from the analysis of the data into two section are :

Descriptive Analysis Findings

- One key observation was most of the participant under the study were retail investor which accounted for 67.4 %.
- Some of the dominant behavioural biases prevalence among the participant observed were herding bias where majority of the participant rely on market news and trends for decision making which may mirror the crowd actions.
- The familiarity bias was exhibited through analysing whether the participant prefer well-known company or a lesser known one where majority of the participant responded with "Yes , most of the time".
- From the overall descriptive analysis of the question in depth various key findings can be stated out is the majority of investor are of the age below 25 that is 40% of the respondent which reflects the young and tech-savvy interest in the Indian capital market.

Correlational Analysis Findings

- The correlational analysis explores the relationship between the variables though there is limitation of the population parameter for the study.
- The first hypothesis was accepted suggesting that young investor are demonstrated a high level of awareness which may possibly be due to exposure to digital platform.
- The second hypothesis was rejected which indicating that impulsive behaviour may occur among the investor regardless of education level.
- The third hypothesis was also rejected suggesting that the herding bias not just impact retail investor but also other category or type of investor.
- The fourth hypothesis was rejected indicating there is no relation between return expectations & reaction to falling prices
- The fifth hypothesis was rejected which suggest there is no specific relationship between the Belief in Past Price Trends of the respondent and reaction to market volatility.

Conclusion

The study is conducted to identify various behavioural biases that are prevalent in the market among the investor which can shape their investment decision making in the Indian capital market. The behavioural finance studies the how are the biases like overconfidence , herding , anchoring bias impact the decision making and it also challenges the notion of traditional theories that investor are rational and the market are efficient but the real world analysis of the investor biases help make decision effectively .

Recommendation

Some of the recommendation and mitigation strategies that implemented could help mitigate the biases in the market and those are :

- Introduction of educational awareness program which are more structured and related for behavioural biases in academic module , professional course which cover all the major biases and coping strategies would help investor to be more aware about those biases.
- The other strategy could be providing an alerting system of the various biases on the trading platform making the investor aware of the these biases like overtrading or herding bias.
- Taking professional guidance could give an insight investment strategies that are not driven by the behavioural bias who may recommend appropriate investment option and the certified financial advisor could also help construct portfolio during volatile period.
- Simulating all the required scenario could and investing challenges which exposes the user to market volatility and making the investor aware about the all real-world biases helping them in making decision.

Future Research Direction

The future direction explores in depth analysis of the topic that is "**Behavioural Finance and Investor Decision - Making in the Indian Capital Market**" which are :

- Including more larger and diverse range of sample across different region and age group category to reduce the limitation of the study.

- The other future direction for the study is a comparative analysis of the Indian market and global market and how are they related to each other and what are the common biases.
- Understanding what role does the external factors like social media and news have impact on the decision making.

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