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A STUDY ON IMPACT OF PSYCHOLOGICAL AND SOCIOLOGICAL ISSUES ON INVESTMENT DECISIONS

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Abstract

*Conventional theory of finance emphasizes only on accumulating funds where as modern theory focuses on not only on accumulation of funds, but also on, investing funds in various projects, their net present value, profitability index, viability of projects and so on. Since many decades we are under the impression that, investment decision is affected by availability of funds, project yielding capacity and profitability of the project. But, the changing face of investment decisions are influenced by '**Psychological and Sociological'** factors of individuals, investors, firms, groups or organizations. Often we call this phenomenon of investment decisions influenced by the psychological and a sociological factor is called as '**Behavioral Finance'**. Behavioral Finance is an emerging field in 1990s in many journals, magazines and news papers. Behavioral Finance talks about reasoning pattern of investors, including the degree of emotional process involved in decision making by an investor. Essentially speaking, behavioral finance attempts to explain 'When-How-What-Why' of finance and investment made from human perspective. It is very common among the human beings to develop or feel inner anxiety or tension, what we call as '**Cognitive Dissonance'**. Here, we can correlate 'cognitive dissonance' with 'finance' and which we call it as '**Financial Cognitive Dissonance'** which states that, our internal tension or anxiety with regard to certain conflicting beliefs. And as an individual we should try to reduce the anxiety and tension leaving the past beliefs or rationalizing our thoughts. This theory can be applied to investors or traders in the stock market, as often they are influenced by this dissonance. This paper attempts to study the impact of psychological and sociological factors on investment decisions.*

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Keywords: Finance, Psychology, Sociology, Cognitive Dissonance and Behavioral Finance.

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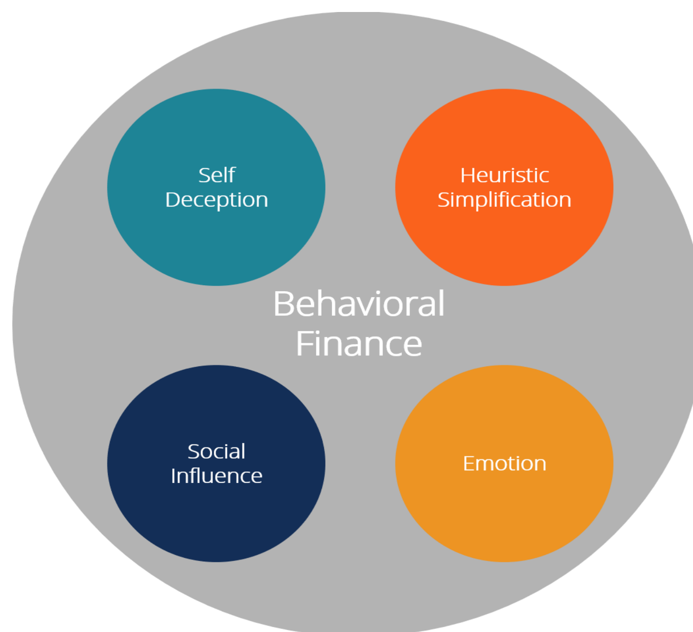
1.0 INTRODUCTION

Behavioral finance has been growing since twenty years, specially to observe the behavior of investors according to the assumptions made in the traditional finance theory.Behavioural researchers viewed that finance theory should take into account of observed human behavior.The traditional finance theory focuses on the trade-off between risk and return,where asbehavioural finance opines that investors are overconfident with regard to making returns and oversensitive to losses. Psychologists found that humans tend to have unwarranted confidence in their decision making. It means they have an inflated opinion on one's own abilities.

Investors with too much confidence in their trading skill often trade too much, with a negative effect on their returns. To address these issues, this study makes an attempt to discuss on the emerging importance of 'Behavioural Finance'.

Meaning of Behavioral Finance

Behavioral finance is the study of the influence of psychology on the **behavior** of investors or **financial** analysts. It also includes the subsequent effects on the markets. It focuses on the fact that investors are not always rational, have limits to their self-control, and are influenced by their own biases.It is explained in a nutshell from the below given figure.



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2.0 REVIEW OF LITERATURE

The views of various investors have been taken into consideration from the reviews made.

Author	Year	Concluding remarks on the reviews made
Basher Kokab	2018	He opined that investment decisions are influenced by the psychological factors such as overconfidence, faith, pessimism, herd behavior and confirmation bias.
Shashikala and Chitramani	2018	They emphasized on the subject matter of finance decision that influence the investor such as emotions and cognitive factors.
Copur	2015	The rationality of traditional finance theory is questionable because it cannot give proper explanation on investors behavior, as investors are rational, they follow the portfolio-based investments on the mean-variance rule.
Mitroi and Oproiu	2014	It is concluded that behavioral finance considers the human emotion associated in any financial decision making. Since, it is a new field of modern finance and assertion that along with motivation and feeling, emotion is indispensable in any human decision-making criteria
DeBondt et al.	2010	In the words of author, behavioral finance can be understood by three psychological stands. These are cognitive or behavioral psychology, emotional response, and social psychology.

3.0 NEED FOR THE STUDY

From the review made by various authors, it is concluded that, the investors of modern finance theory are rational in thinking, taking into consideration their beliefs, perceptions, emotions and cognitive factors. In fact, there are number of inherent elements that influence the investment decisions, though these factors are not taken into account for investment, they are imperative for an investor to consider. Hence, there is a need to study the relevance of ***Behavioural Finance*** with reference to ***'Financial Cognitive Dissonance'*** in this context.

4.0 OBJECTIVES OF THE STUDY

Based on the need for the study, the following objectives are taken for the current research on behavioral finance:

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1. To study the evolution of behavioral finance.
2. To focus on the importance of financial cognitive dissonance in the light of investment activities.

5.0 RESEARCH METHODOLOGY

This study is descriptive in nature. The data has been collected from journals, web sources, reputed articles and case studies of various investors.

6.0 EVOLUTION OF BEHAVIOURAL FINANCE IN INDIA

The financial markets were not considered as proper markets by economists as they were analogous to casinos as the returns were determined by pure speculative activity. It is Markowitz (1952) included a new element of 'risk ' and 'uncertainty'. His idea was to introduce the importance of risk and uncertainty in the finance decisions. All financial decisions in the traditional approach were mostly focusing on two factors i,e., Risk and Uncertainty.

EFFICIENT MARKET HYPOTHESIS [EMH]

As per the theory of Efficient ***Market Hypothesis (EMH)***, it is assumed that investors make decisions based on the rational expectations. According to this hypothesis, there is no significant difference in the views of investors in making investment decisions, as they invest making same expectations. This notion has been questioned by many experts in the field of financial decisions. The stock market operations of one investor selling the stock would influence the purchase by other investor, but, that occurs only in a particular stock. The assumption underlying behind EMH is that, all participants in the stock market have equal access to information, is also questionable.

Similarly, In US the market crash in October 1987, followed by unexplained increase in the real estate prices during the period 2000 to 2005, the high degree of volatility experienced in markets during 2008, etc., are all the instances that casted a serious apprehensions on the rationale behavior of investors. These apprehensions made the financial experts and researchers to focus

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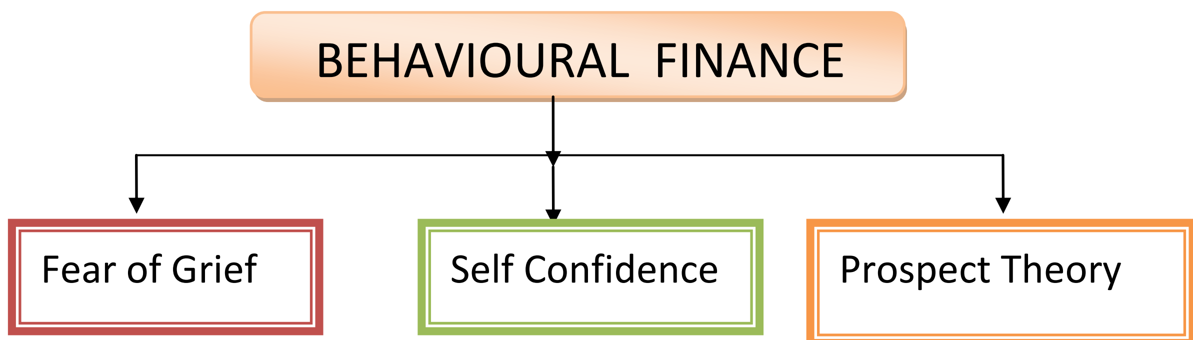
their attention on human behavior such as bias, greed, and irrational decision making with regard to their investment activities.

They opined that the influence of human emotions and beliefs on decision making is going to be a definite possibility. Though revolution of behavioral finance began in 1980s, its prominence was more geared up in the recent era, as there is increase in business, multinational companies, stock market awareness, increase in investments. Behavioral finance draws knowledge liberally from all most all social sciences that are capable of offering alternatives that are real and tangible.

Behavioral finance argues that investors possess a number of rational behaviors. A few of such irrational behaviors are shown by a flow chart:



Thus from the above chart it is evident that, firstly, investors have a general tendency to avoid selling a stock that incurs heavy losses. Secondly, Investors have a high level of confidence in the area of their investments. Thirdly, investors give more weightage to losses than profits. This is, in a way, risk avoidance. In the light of these facts, the behavioral finance has become prominent, stating that the investors are influenced by their behavior rather than concentrating only on only 'risk' and 'uncertainty'.

7.0 FINANCIAL COGNITIVE DISSONANCE

In the words of prolific behavior finance author Michael Pompian, it is stated as "when newly acquired information conflicts with pre-existing understandings, people often experience mental discomfort, what we often call it as "***Cognitive Dissonance***" It is no secret that behavioral

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finance is a thorn in the side of many financial traditionalists. Some of these negative perceptions might be due to one reason that, finance will regress to being perceived scientifically 'weak' before 1950s. Cognitive and emotional shortcuts turn into cognitive and emotional errors when they take normal people far from their best choices, solutions, and answers. Cognitive shortcuts that simplify choices turn into cognitive errors when they induce homeowners to save time and effort by failing to visit houses remodeled by the contractor. And cognitive shortcuts that simplify choices turn into cognitive errors when they induce investors to save time by failing to examine whether a fund's good recent performance indicates anything more than good luck. Emotional shortcuts stirred by feelings of affinity turn into emotional errors when they induce normal homeowners to hire a contractor who is an expert at affinity fraud. And emotional shortcuts stirred by feelings of affinity turn into emotional errors when they induce institutional investors to choose a poorly managed fund whose manager graduated from the same school as they did.

8.0 CONCLUSION

It is evident from the evolution of behavioral finance, that, the Efficient Market Hypothesis (EMH) has been criticized as it has ignored the human behavior and it concentrated only on common opinion of investors on stock market transactions. Some questions are un-answerable with EMH. The prominence is given to human behavior which effects the decision making of a rational investor. Many financial experts opined that, influence of human emotions and beliefs on decision making is going to be a definite possibility. Cognitive Dissonance is a vital element which needs attention in the present investment scenario, as the business is down with lockdown and many investors are not coming forward to make investments in new ventures, because, they might be coming across emotionally with a negative mindset on pandemic and tension in the mind about the future. Hence Behavioral Finance needs attention with the investors.

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