ISSN 2616-5902 Vol. 3, Issue 11: 99-102, DOI: 10.25236/AJBM.2021.031119

Behavioural Finance Versus Mainstream Finance

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Abstract: *This paper introduces behavioral finance and mainstream finance. Behavioral finance is a more extensive and inclusive field, because it combines economy, finance, behavior and cognitive psychology to effectively explain and explain why investors in the market engage in irrational financial decision-making Zion manufacturing process. When mainstream finance considers all information, investors are more likely to participate in the rational decision-making process, this in turn helps to better achieve the goal of wealth maximization, in addition, bias is an "illogical preference or irrational hypothesis that affects the decision-making process". Considering this, we can see that when an investor has behavioral bias, he / she is more likely to ignore the evidence, especially the evidence inconsistent with the assumptions he / she holds in decision-making. Confirmation deviation is one of the main deviations witnessed by investors.*

Keywords: *Behaviour finance, Maninstream fiance, Confirmation Bias*

1. Introduction

Behavioural finance is an emerging field that has been largely developed because of some of the limitations of the mainstream finance (Chen et al., 2017). Although, to a greater extent, the mainstream finance provides an explanation for the rational behaviour that investors exhibits within a particular market, however, the closer analysis of the investor behaviour could reveal that there are numerous situations where the investor is engaged in apparently irrational behaviour (Baxter and Macleod, 2008). Such behaviour could not be effectively explained by the mainstream finance. Contrary to this, the field of behavioural finance comprised of behavioural and cognitive psychological theories, in addition to the conventional economic and finance field (Abdin et al., 2017). This in turn means that unlike the mainstream finance that only contain the economic and finance aspects, the behavioural finance is a much broader and inclusive field as it combined economic, finance, behavioural and cognitive psychology to effectively explain and elaborate the why investors in the market is engaged in irrational financial decision making process (Cecchetti and Schoenhholtz, 2018).

2. Behavioural finance and Mainstream Finance

In case of the mainstream finance, the investor behaviour is explained by taking the rationality perspective (Brigham and Houston, 2019). One of the major theories that are thus used is the efficient market hypothesis that stressed that the changes in the securities prices reflect the available information (Fiberck et al., 2017). Thus, whether it is an increase or decrease in the price of certain stocks, this is largely explained through changing information context of the market. However, there are numerous situations, where the efficient market hypothesis could not be witnessed and instead market anomalies could be experienced (Henskei, 2017). Particularly, structural factors could influence market prices, which may include unfair competition, lack of market transparency, actions from regulatory authorities etc. all of which could result in the price variations However, these different factors are not part of the information rather they exhibits the behavioural biases that influence the market prices (Kaplanski and Levy, 2017). The mainstream finance could not effectively explain the behaviour thus witnessed in the market, however, the behavioural finance that relies on a range of different disciplines could effectively explain the irrational behaviour witnessed in the market (Chen et al., 2017).

In the behavioural finance a greater stress is made on the psychology-based theories, where anomalies are established for explaining the stock buying and selling behaviour. This in turn means that the behavioural finance is mainly concerned with the studying the impact of psychological, social, cognitive, and emotional factors on the investor and the institution's decisions and the consequences for the market prices, returns, and resource allocations (Hommes and Veld, 2017). Thus, the mainstream finance

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provides an explanation that how a market might function efficiently, however, the behavioural finance field has been developed to provide an explanation that 'why' and 'how' market might be inefficient. The 'why' are explained through the cognitive psychological factors, while the explanation for 'how' are provided by establishing anomalies between the investor behaviour and psychological factors (Siganos, Veganes-Nanos and Verwjmeren, 2017).

For example, an investor could be making stock decisions in a particular day on the basis of 'prefrontal cortex'. A 'prefrontal cortex' stressed that as a human, biologically, we make decisions based on the emotions and feeling we held (Abdin et al., 2017). Considering this basic principle, the 'Somatic Maker Hypothesis' has been developed that stressed that fear and greed held by an investor is not equal to trade risk and return. The hypothesis could be stated that the bigger the stakes, the greater is the chances of influence of emotion on the decisions that an investor could be made within a particular market (Grosse, 2017). This is because most of the investors like risk aversion, however, they have strong greed as well. The process is thus two ways, and when there is breakeven, the investor could not witness loss. However, when pleasure is the 'stronger emotion' the investor is more likely to engage in activities like sex, drugs, and more risky investment initiative (Kapoor and Prosad, 2017).

The behavioural finance could be used to explain the reaction to risks that different investors exhibit in a market. As per the assertions made by Fiberck *et al.* (2017), like animals, human instinct plays a crucial role in the risk taking process. The basic human instinct is to measure the perceived risk and match it (Filz, Nahmer and Spiwoks, 2019). The investor could thus exhibit a defensive behaviour, where he/she could stand tall, puff his/her chest to show him/her bigger than what he/she actually is. If defensive strategies are used, the investor could be expecting to either over reacting or under-reacting to a particular situation. In such sort of situations, there are greater chances between perceptions and reality (He, Chen and Hu, 2019). For example, short-term volatility could take place in a given market that could be resulting from the overreaction to a risk witness in the market. Such a reaction is actually emotionally induced, as the reaction that an investor could be showing could be taking place because the cognitive part of the mind could be governing investor behaviour before the rational part of the mind takes into play (Aney, Applebaum and Banerji, 2019).

3. Confirmation Bias in Behavioural Finance

William Feather once said 'one of the funniest things in the stock market is that one buys and the other sells, and both think they astute' reflect the biased think that investors exhibits in the financial market (Grosse, 2017). As it is an established fact that one's thinking and feeling strongly influenced his/her decision making process, the behavioural finance field has been developed to develop a deeper and broader understanding of the decision making process and the major factors that influence investor's decisions (Baxter and Macleod, 2008). In this regard, there is a range of biases that an investor experienced that influence his/her decision making process. According to Him, Chen and Hu (2019), a bias are an "illogical preference or irrational assumption that influence the decision making process". Considering this, one could see that when an investor goes through behavioural bias, he/she is more likely to ignore evidence, particularly those that do not line up with the assumptions that he/she held while making decisions. Confirmation bias is one of the major biases that an investor witnessed. According to Hommes and Veld (2017), a confirmation bias could be defined as "the tendency to interpret new evidence as confirmation of one's existing belief or theory". This in turn means that an investor is more likely to get an account of the information or evidences that confirm the belief that they already held and undervalue information that contradict their viewpoint.

The confirmation bias could be better explained through a hypothetical example. For example, an investor has been selling a certain number of stocks that he held in a given market, as he believes that the current Covid-19 pandemic has been increasing the economic and social uncertainties that have been taking place in different parts of the world. The decision that he has thus made has been strengthened by the confirmation bias. For example, in the second week of the December 2021, the UK health authorities have reported that spread of a new virus that has 70% faster mutation rate than the other. Furthermore, he is also more likely to take notes on the challenges related to the development of the Covid-19 vaccines, particularly the success rate of the vaccines and the emerging problems associated with the vaccines. On the other hand, the mentioned investor if confronted the confirmation bias is more likely to ignore the facts and the emerging dynamics that point toward the end of the Covid-19 and the restarting of the normal social and economic activities within and outside the UK. Such information is more likely to be ignored because it contradicts the social and economic views that he held that have served as the basis of his investment decisions (Chen et al., 2017). As the investor has been suffering from the confirmation

bias, the investment decisions that he has been making could not be classified as rational decision making (Yurttadur and Ozceilik, 2019).

The investor is more likely to take note of such information and the dynamics that confirmed the assertions that he/she held rather than looking for the information that disconfirmed the belief that he/she held (Aney, Applebaum and Banerji, 2019). The major reasons for this could be that everyone believes that he is ‘Mr Perfect’ and to actually prove that he is Mr Perfect, the individual suffers from the confirmation bias. Furthermore, He, Chen and Hu (2019) are of the views that the major reasons for the confirmation bias is that investors first formed a viewpoint and then look for the information. The process that is thus used is exactly the opposite of the rational behaviour viewpoint that is explored in the mainstream finance. Theories like the efficient market hypothesis stressed that an investor look and analyse the available information carefully and based on the analysis of available information he/she made the investment decisions (Filz, Nahmer and Spiwoks, 2019). However, when an investor suffers from the confirmation bias, he/she first form an opinion and then look for the information, where he/she is more likely to ignore or undermine the information that simply contradict his/her opinion and the take greater notice of information that confirmed the stance that he/she held (Kapoor and Prosad, 2017). The same is the case with the news channel that an individual watch, whereas the channel that he/she has usually watched is the one that is most likely to confirm the viewpoint that he/she held and simply ignore the channel that contradict his/her stance.

When an investor is suffering from the confirmation bias, the decision making process that he/she could be making will be irrational (Aney, Applebaum and Banerji, 2019). The rational decision making process is witnessed when an investor takes an account of the information regarding different aspects of the decisions and after careful analysis based on the information, he/she makes the decisions (Hommes and Veld, 2017). However, in case of the confirmation, the information that contradicts one’s viewpoint are simply ignored, which to undermine the decision that the individual could be made (Siganos, Veganes-Nanos and Verwjmeren, 2017).

When an investor is suffering from the confirmation bias, he/she may not be engaged in rational decision making. The ultimate objectives of an investor in a given market are wealth maximisation, which could be realised through the rational decision making process (Chen et al., 2017). However, when an investor suffers from the confirmation bias, the decision making process is more likely to be irrational, which in turn could negatively influence the wealth maximisation goals that an investor could be chasing (Abdin et al., 2017).

4. Conclusion

In the mainstream finance, an investor to be rationale is believed to act under the efficient market hypothesis. The efficient market hypothesis reflects that the changes in the market price reflect the changing information, which could be related to both positive and negative aspects of investment/ divestment (Cecchetti and Schoenhholtz, 2018). When all the information is taken into consideration in the mainstream finance, the investor is more likely to be engaged in the rational decision making process, which in turn could help in the better realisation of wealth maximisation objectives (Brigham and Houston, 2019). However, when confronting the confirmation, a range of information that contradicts the belief held by an investor is ignored, this could lead towards irrational decision making process (He, Chen and Hu, 2019).

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