



BBA

Semester V

Calicut University

Behavioural Finance

Course Code: BBA5CJ302 • Module 1 Notes

1. Nature, Scope, Objectives, Significance, and Applications

Behavioural Finance is an interdisciplinary field of study that combines cognitive psychology, microeconomic theory, and financial economics to analyze how psychological, emotional, and social factors influence the financial decision-making processes of individuals, investors, and institutions. Traditional financial theory assumes that market participants are fully rational agents (*Homo Economicus*) who process all available information instantaneously and make optimal, risk-adjusted decisions. Behavioural finance challenges this paradigm by demonstrating that real-world investors systematically deviate from rationality due to cognitive biases, heuristics, and emotional impulses.

Core Objectives of Behavioural Finance

The primary objectives of behavioural finance in modern academic and applied investment contexts include:

- **Explaining Market Anomalies:** Investigating persistent empirical phenomena—such as equity premium puzzles, momentum, and market crashes—that cannot be accounted for by the Efficient Market Hypothesis (EMH).
- **Mapping Cognitive Biases:** Identifying and cataloging systematic errors in human judgment that lead to asset mispricing and sub-optimal portfolio allocation.
- **Enhancing Portfolio Management:** Designing investment strategies and risk management protocols that account for investor psychology and market irrationality.
- **Improving Corporate Financial Decisions:** Helping corporate managers recognize internal biases when making capital budgeting, merger, and dividend policy choices.

Significance and Practical Applications

Understanding behavioural finance provides valuable operational insights across multiple financial domains:

1. Wealth Management & Financial Advisory

Enables wealth advisors to diagnose client risk profiles accurately, prevent panic selling during market downturns, and construct portfolios tailored to emotional loss tolerance.

2. Quantitative Trading & Alpha Generation

Allows quantitative hedge funds to exploit systematic mispricings caused by investor overreaction, underreaction, and sentiment swings.

3. Regulatory & Nudge Policy Formulation

Helps financial market regulators design default savings frameworks (e.g., automatic retirement enrollment) and clear disclosure rules that protect retail investors.

4. Corporate Capital Allocation

Assists executive CFOs in recognizing CEO hubris, overconfidence in earnings projections, and empire-building tendencies during M&A evaluations.

2. Psychology of Financial Markets and Investor Behaviour

Financial markets are complex adaptive systems populated by human decision-makers whose collective interactions generate market cycles of euphoria and panic. Analyzing the psychological foundation of market participants requires comparing traditional financial models with behavioural insights.

Traditional Finance vs. Behavioural Finance Paradigm

The structural divergence between classical economic theory and behavioural finance can be synthesized across key operational dimensions:

Dimension	Traditional Financial Paradigm (EMH)	Behavioural Financial Paradigm
Investor Rationality	Investors are perfectly rational, objective, and unbiased decision-makers.	Investors exhibit bounded rationality, influenced by cognitive biases and emotions.
Market Efficiency	Markets are perfectly efficient; prices reflect all available fundamental information instantly.	Markets are often inefficient; prices deviate significantly from intrinsic value due to noise trading.
Risk & Utility Theory	Evaluated using Expected Utility Theory; investors are consistently risk-averse.	Evaluated using Prospect Theory; investors exhibit loss aversion and reference dependence.
Limits to Arbitrage	Arbitrage is instantaneous, riskless, and fully eliminates any temporary asset mispricing.	Arbitrage is costly, risky, and constrained by noise trader risk and capital limits.
Portfolio Construction	Mean-Variance Portfolio Theory (Markowitz); diversification across asset covariance.	Behavioural Portfolio Theory (Statman); layered mental accounts built for specific life goals.

Building Blocks of Investor Psychology

Individual investor decisions are shaped by three core psychological dimensions:

- **Cognitive Processing Limits:** The human brain relies on simplifying heuristics to evaluate complex probabilistic financial data.
- **Emotional Reactions:** Affective states such as fear, hope, regret, and pride alter risk perception dynamically during market cycles.
- **Social Influences:** Group dynamics, social proof, and word-of-mouth narrative transmission amplify individual biases into aggregate market trends.

3. Behavioural Finance Market Strategies

Practitioners of behavioural finance leverage psychological insights to design market strategies aimed at capturing excess returns (alpha) by exploiting market inefficiencies generated by systematic investor errors.

Key Behavioural Market Strategies

1. Momentum Investing Strategy

Exploits investor **underreaction** to new fundamental information (such as positive earnings surprises). Investors slowly digest news, creating a multi-month trend where recent winning stocks continue to outperform.

2. Contrarian Investing Strategy

Capitalizes on investor **overreaction** driven by herding and emotional extrapolation. Contrarians buy deeply undervalued "out-of-favor" stocks that have suffered excessive panic selling.

3. Post-Earnings Announcement Drift (PEAD)

Takes long positions in companies experiencing extreme positive earnings surprises and short positions in negative surprise firms, capturing the delayed price adjustment drift.

4. Value Anomaly Exploitation

Systematically buys stocks with low Price-to-Earnings (P/E) or Price-to-Book (P/B) ratios, capturing the premium generated when investors over-extrapolate past low growth rates into the future.

4. Prospect Theory, Mental Accounting, and the Disposition Effect

Developed by Daniel Kahneman and Amos Tversky (1979), Prospect Theory revolutionized economic science by providing an empirically validated descriptive model of how human beings actually make decisions under uncertainty, replacing traditional Expected Utility Theory.

Core Tenets of Prospect Theory

Prospect Theory identifies three fundamental psychological principles governing decision-making:

- **Reference Dependence:** Individuals evaluate outcomes not in terms of absolute wealth state, but as gains or losses relative to a psychological *reference point* (typically the initial

purchase price).

- **Loss Aversion:** The psychological pain of experiencing a financial loss is approximately 2 to 2.5 times more intense than the pleasure derived from an equivalent financial gain.
- **Diminishing Sensitivity (S-Shaped Value Function):** The value function is concave for gains (producing risk aversion when holding profits) and convex for losses (producing risk-seeking behavior when facing losses).

Mental Accounting (Richard Thaler)

Mental Accounting describes the cognitive propensity of individuals to categorize, evaluate, and track financial activities in separate, non-fungible "mental buckets" rather than managing a unified total wealth balance:

Mental Account Type	Cognitive Behavioral Characteristic	Financial Consequence
Source-Based Bucketing	Treating money differently based on its origin (e.g., spending tax refunds or gambling wins recklessly as "house money").	Sub-optimal risk-taking with non-salary income; failure to treat all capital as fungible.
Use-Based Bucketing	Segregating funds into rigid categories (e.g., emergency fund earning 2% while holding credit card debt at 18%).	Net interest margin loss due to artificial liquidity compartmentalization.
Sunk Cost Fallacy Account	Refusing to terminate a failing investment or project because time and capital have already been committed to it.	Throwing good money after bad, worsening cumulative financial losses.

The Disposition Effect

First identified by Hersh Shefrin and Meir Statman (1985), the Disposition Effect is the systematic tendency of retail and institutional investors to **sell winning investments too early** (to lock in the pride of a gain) while **holding losing investments too long** (to avoid the painful recognition of a loss).

1. **Psychological Driver:** Driven jointly by loss aversion (seeking risk in the loss domain in hopes of breaking even) and regret minimization.

2. **Market Impact:** Creates artificial supply resistance when stock prices rise toward historical highs and delays price corrections when assets decline.

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