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Impact of Heuristics and Prospects on Investment Decision of Rational Investors - Review of Literature of Behavioral Finance

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Abstract

Purpose- The paper emphasizes the classification of the literature and provides a comprehensive view of behavioral finance. It aims to analyze the findings and results of studies for review.

Design/methodology/approach- A number of sources were searched to review the existing literature on behavioral finance, and out of hundreds of papers, 18 papers are based on the impact of behavioral biases on the decision making of individual investors. To know the state of research on this topic, these articles are classified based on variables such as Heuristics and Prospects.

Findings - This paper classifies the literature on behavioral finance and finds that behavioral finance research is still in demand in developed countries and that coverage of behavioral finance in emerging economies has increased in recent years.

This article provides a collection, classification and comprehensive literature on behavioral finance to help academics, professionals and future researchers.

JEL CLASSIFICATION: G4, G40, G41,

Keywords- Behavioral finance, Heuristics, Propects, Investment Decision

I. Introduction

BEHAVIORAL FINANCE

Behavioral finance, a subfield of behavioral economics, proposes theories based on psychology to explain stock market anomalies, such as sharp increases or decreases in stock prices. The purpose is to identify and understand why people make certain financial decisions. Within the framework of behavioral finance, it is assumed that the information structure and characteristics of market participants systematically influence the investment decisions of individuals and the market.

BEHAVIORAL FINANCE CONCEPTS

HEURISTIC DRIVEN BIASES

OVERCONFIDENCE People tend to be overconfident and therefore overestimate the accuracy of their predictions. Overconfidence stems in part from the illusion of knowledge. The human mind may be designed to extract as much information as possible from what is available, but it may not be aware that the available information is not sufficient to make an accurate prediction in uncertain times.

ANCHORING After forming an opinion and opinion, people are often unwilling to change it, even though they receive new information that is relevant. Suppose investors have formed the opinion that a company has above-average long-term earnings prospects. Suddenly, A reports much lower earnings than expected.

FAMILIARITY People are satisfied with things that are familiar to them. The human brain often uses familiar shortcuts when choosing investments. Familiarity really breeds investment. Therefore, people tend to invest more in shares of their employer company, local company and domestic companies.

CONFORMATION LEAD People tend to overlook information that contradicts their beliefs in favor of information that confirms their beliefs. Investors often only hear what they want to hear. They spend more time looking for reasons supporting their views and less time looking for reasons against their views.

INNUMERITY People have trouble with numbers. People confuse nominal changes with real changes. Economists call this the money illusion. People have trouble figuring out true probabilities. In other words, chances are they don't know what the odds are. People tend to pay more attention to large numbers and less weight to small ones.

PROSPECT THEORY Proposed by Kahneman and Tversky, prospect theory, perhaps the most important concept in behavioral finance, provides an alternative account of how people make and evaluate decisions involving uncertainty. According to this account, utility does not depend on the level of wealth as in the standard traditional theory, but on changes in wealth from the current level. The utility function is concave hostile profits.

MENTAL ACCOUNTING Traditional finance holds that wealth in general and money in particular must be considered fungible and every financial decision should be based on a rational calculation of its effects on the overall wealth position. However, in reality, humans do not have computational skills and will be able to evaluate decisions in terms of their impact on overall wealth.

NARROW FRAMEWORK Ideally, investors should pay attention to changes in their overall wealth. Narrow framing in a cross-sectional sense means that investors tend to look at each investment in isolation, rather than the portfolio in its reality. Therefore, they focus more on price changes of individual shares and are less interested in the behavior of the entire portfolio.

THE SHADOW OF THE PAST After people have experienced a profit, they are willing to take more risks. After winning money in a gambling game, amateur players somehow do not consider the winnings to be theirs, and therefore are tempted to risk it further. Gamblers refer to this as the house money effect. After suffering a loss, people are less inclined to take risks. This is sometimes referred to as the snakebite effect. Loss is similar to a snake bite that makes one more cautious.

EMOTIONAL AND SOCIAL INFLUENCES EMOTIONAL EFFECT Emotions affect risk tolerance and risk tolerance affects portfolio selection. Investors experience a range of emotions as they consider alternatives, decide how much risk to take, watch their decisions play out, assess whether their original strategy needs to be adjusted, and ultimately see how far they have come in achieving their financial goals.

HEARING INSTINCTS / INFORMATION CASCADE There is a natural desire on the part of human beings to be part of a group. So people tend to cluster together. However, moving with the herd amplifies psychological biases. It makes one make decisions based on herd feel rather than rigorous independent analysis. This tendency is accentuated in the case of decision making with high uncertainty.

II. Objective of the Study

This paper's primary objective is to study behavioral finance's present status and organize the available literature by reviewing the past and existing published research work in the same theme in a well-orderedmanner to provide quick and easy access to future researchers from the same field.

The effort represents an attempt to understand behavioral finance research better. Another objective of the present study is to classify the preceding literature and provide a comprehensive bibliography on behavioral finance and analyze the studies' findings and results for review, which will help researchers and practitioners alike. Furthermore, we have also tried to comment on the present status of the research on the same subject matter and suggest future research prospects on the same topic.

III. Data and Methodology

A. Data

This paper is based on the review of 44 articles which are research papers and review papers on behavioral finance. These are published in Scopus indexed journals in various developed and developing countries around the world.

B. Methodology

This paper will present a review of behavioral finance research published in indexed.Books, journals that are based on behavioral finance and websites. It is an excellent contribution to the practitioner's publications, working papers, and papers presented in the conference and books.

Therefore, this final sample set of 18 research papers represents the selected databases' actual behavioral finance literature population. The full texts of these 18 papers were carefully studied, and based on review, the entire literature on behavioral finance was classified using a systematic review matrix. Based on the literature, we found that the study's objective can be achieved by classifying whole behavioral finance literature data based on this literature review matrix. As shown in the review matrix, the entire behavioral finance literature can be classified into the following categories:

. Year-wise classification of study.
. Type of study.
. Econometric/methodology tools used for data analysis.
. Findings/Conclusions of the study.

S.No	Author(s), Year	Title of the Study	Journal	Primary or Secondary Study	Methodology/tools adopted for data analysis	Findings and Conclusions
1	Sahi and Arora (2012),	"Individual investor biases: A segmentation analysis"	Qualitative research in financial markets	Primary	Cluster analysis	Four main segments of individual investor's biases, which have been termed as the Novice Learner. The Competent Confirmer, the Cautious Anticipator, and the Efficient Planner. This typology haspredictive validity about financial satisfaction and perceived financial market knowledge.
2	Sahi (2013),	"Demographic and socio-economic determinants of financial satisfactionA study of SEC-Asegment of individualinvestors in ".	International Journal of Social Economics	Primary	One-way ANOVA, t-test, and Correlation	Empirical results show that: investors are risk-seeking; optimal portfolio not depend on preferences, and there is no positive impact of preferences on wealth/return.
3	Kumar and Goyal (2015),	"Behavioral Biases in Investment decision making-A Systematic Literature Review."	Qualitative Research in Financial Markets	Secondary	Literature Review	The dominance of secondary data-based empirical research, the lack of empirical research on individuals who exhibit herd behavior, the focus on equity in home bias, andindecisive empirical findings on herding bias
4	Prosad, Kapoor and Sengupta (2015),	"Behavioral biases of n investors: A survey of Delhi-NCR region."	Qualitative Research in Financial Market	Secondary	Chi-square test and t-test	It is observed that behavioral biases are dependent on investors' demographics as well as their trading sophistication.The highest influencing factors amongst these variables are age, profession, and trading frequency. Another interesting observation is that respondents with the highest trading experience (more than seven years) and highest trading frequency (intraday traders) are prone to all the biases.
5	Prosad, Kapoor, and Sengupta (2015),	"Exploring optimism and pessimism in the n equity market."	Review of Behavioral Finance	Secondary	Time series regression	Conclusion of the study shows that the n equity market has been predominantly pessimistic from the period 2006 to 2011. The interaction of this bias with market indicators also unveils some exciting insights. Pessimism bias significantly associated withhigh past volatility and vice versa in n equity market. High risk and high return relation for rational investors, while it tends to be harmful for irrational investors. The impact of investors' irrationalities on asset valuation has also been accounted for by Brown and Cliff (2005).
6	Mishra and Metilda (2015),	"A study on the impact of investment experience, gender, and level of education on overconfidence and self-	IIMB management review	Primary	ANOVA, Correlation, and regression	Findings of the study shows that(1) the level of overconfidence increaseswith investor's experience and withan increase in the level of education;(2) self-attribution bias increases with thelevel of education;

		attribution bias”.				(3) men are moreoverconfident than women; (4) there is anassociation between overconfidence biasand self-attribution bias, and self-attributionis a significant predictor ofoverconfidence bias. This study confirmsthat investor experience, level ofeducation, and gender impactinvestor bias. This study contributes to theexisting literature on bias, especially theinfluence of demographic variables onoverconfidence and self-attribution bias.
7	Kumar and Goyal (2016),	“Evidence on Rationality and Behavioural Biases in Investment DecisionMaking”.	Qualitative Research in Financial Markets	Primary	t-test, ANOVA,LSD, and SEM	At the time of investment investors follow a rational decision-making process. It further explores that gender and income have a significant difference concerning the rational decision-making process. Information search has a positive relation with overconfidence bias. Overconfidence is positively and significantly associated with the disposition effect—additionally, a significant difference between overconfidence bias and individual investors' income. The conclusion of this study show that age is significantly indifferent concerning the rational decision-making process.
8	Prosad et al (2017),	“Overconfidence and Disposition Effect in n Equity Market: An Empirical Evidence”.	Global business review	Secondary	Bivariate and trivariate vector. autoregression (VAR)	There are three findings based on this study. First is the presence of the biases, overconfidence, and disposition effect is detected in the n equity market; for their sample period, second, the impactof these two biases can be distinctly segregated for 20 companies. Among the companies in the indexand third, the overconfidence bias is predominant;

9	Zahara and Bansal (2018),	"Do investors exhibit behavioral biases in investment decisionmaking? A systematic review".	Qualitative Research in Financial Markets	Secondary	Literature Review	The study is more inclined toward the study of individual and institutional investors and financial advisors' investors but the behavior of intermediaries through which some invest.
10	Kansal and Singh (2018),	"Determinants of overconfidence bias in n stock market."	Qualitative Research in Financial Markets	Secondary	t-test, ANOVA,standard ordinary least square regression	As the experience in trading increases, the age also increases.And investors seem to disappear from the market in the late 50s because of their reduced risk appetite.
11	Baker et all (2018),	"How financial literacy anddemographic variables relate to behavioral biases"	Managerial Finance	Primary	One-way ANOVA. Factor analysis andmultiple regression analysis.	The results also show that financial literacy negatively correlates with the disposition effect and herding bias, positive relation with mental accounting bias, but no significant relation with overconfidence and emotional biases. Age, occupation, and investment experience are the most important demographic variables related to the behavioral biases of individual investors in thesample. Regarding gender, males are more overconfident than are females about their knowledge of the stock market.
12	Raut, Das and Kumar (2018),	"Extending the Theory of Planned behaviour: Impact of Past behavioural Biases on the Investment Decision of n Investors".	Asian Journal of Business and Accounting	Primary	SEM	This study indicates that attitude toward behavior, subjective norms, and perceivedbehavioral control are significantly associated with behavioralintentions.

13	Baker, Kumar and Goyal (2018),	"Personality traits and investor sentiment."	Review of Behavioral Finance	Primary	SEM	According to the results, having an extrovert personality trait positively correlates with all the behavioral biases studied. Neuroticism trait is emotionally unstable and is likely to be depressed, anxious, and have higher risk tolerance. Openness trait has a statistically significant link with only mental accounting. Agreeableness is unrelated to overconfidence, the disposition effect, and herding bias.The conscientious trait has a statistically significant relation with overconfidence bias but not with herding bias.
14	Mushinada and Veluri(2019),	"Elucidating investors rationality and behavioural biases in n stock market."	Review of Behavioral Finance	Primary	SEM	A statistically significant positive covariance between self-attribution and overconfidence involves an increase/decrease in self-attribution, increasing/decreasing in overconfidence, and vice versa. It also observed that an investor's personal or demographic features such as gender, age, occupation, annual income, and trading experience impactbehavioral biases.
15	Sharma and Kumar (2019),	"A review paper on behavioral finance: study of emerging trends".	Qualitative Research in Financial Markets	Secondary	Literature Review	The literature review from both points of view has helped understand the market efficiency issue and the changing dynamics of the asset pricing approach. This is achieved by highlighting the gaps in market efficiency and suggesting how these gaps can be bridged with a superior approach such as behavioral finance. By further discussing emerging trends I behavioral finance, the paper also points out gapsand how these can be abridged, for behavioral finance to be accepted as a mainstream alternative approach to EMH.

16	Mittal (2019),	"Behavior biases and investment decision: theoreticaland research framework".	Qualitative Research in Financial Markets	Secondary	Literature Review	Based on literature behavioural finance is the emerging area in finance. This indicates the limited valuable research in developing the economy in this area's behavior biases and their impact on individual investors' investment decisions in .
17	Zahera and Bansal (2019),	"A study of prominence for disposition effect: a systematic review".	Qualitative Research in Financial Markets	Secondary	Literature Review	Individual investors, institutional investors, and mutual funds behave differently in response to the disposition effect. Mutual funds are less affected by the disposition effect than other categories of investors. Demographic variables like age, gender and experience, and investor sophistication also impact the disposition effect's occurrence. The great majority of the study was based on the developed markets, especially those of the USA and Europe, anda little concern was given to the less developed nations.

IV. CONCLUSION

Many studies have been conducted on behavioral finance. However, the field of behavioral finance is so rich that it still has various dimensions to be explored in different contexts. Behavioral biases and their impact have been investigated in developed as well as developing countries. However, most of the research studies are concentrated in the developed economies like the U.S, U.K, and Europe. The developing economies like are still not fully tapped where the research is still growing. Most of the studies in are also survey-based. Although there is a need to understand investors' psyche through surveys, it is also essential to understand the influence of behavioral biases on markets as a whole. The present study attempts to contribute to the body of knowledge in behavioral finance by understanding behavioral-finance-macro (through analysis of secondary data or Literature review).This study will be specifically beneficial for portfolio managers, investment advisors,and investors. By understanding investors' decision-making process and behavioral biases, Portfolio managers and investment advisors will be able to serve their clientele better.

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