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BEHAVIORAL FINANCE: EVALUATION OF INVESTORS IRRATIONAL BEHAVIOR ON STOCK MARKET

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Abstract

Although there are many Traditional financial theory, tools or techniques through which we can evaluate the risk and return in security market but still investor loose the money in security market. Why its happen? There are some other reasons that affect the investor decision these are the behavior factor. Behavioral finance is a part of finance that seeks to understand and explain the systematic financial market implications of psychological decision processes. It utilizes knowledge of cognitive psychology, social sciences and anthropology to explain irrational investor behavior that is not being captured by the traditional rational based models. The most basic psychological traits of human being (fear, anger, greed and altruism) stamp an indelible mark on their decisions about money. The intellect (understanding a situation), reason (long term consequences of the contemplated action) and emotion (the judge of the course of action) are all inter correlated resorts behind human decision making. This paper is structured as a comprehensive literature review of behavioral finance and includes analytical investigation of behavioral finance on stock market.

Keywords: *FAMA, EMH, CAPM, APT, Behavioral Finance, Investor Behavior, Stock Market, Psychological Traits.*

Introduction

The field of finance has been mostly based on "Traditional Theories" or the idea of "Efficient Market. Efficient Market hypothesis (EMH) has been considered the major milestone of financial economics. The term "Efficient Market" was firstly defined by FAMA (1965)in financial literature. Efficient market hypothesis is based on the idea that information is quickly and efficiently incorporated into asset prices at any point in time. According to FAMA market efficiency are classified into three forms namely weak form, semi strong form and strong form based on the type of information set that is reflect in the share prices. Weak form of efficiency explains that current security prices already reflect past prices and volume of information. In this form of efficiency investors are not able to earn more than average returns. In the semi strong form of efficiency public information includes not only past prices but also information like economic factors, company financial statements, company announcements etc. This form states that all publically available information is immediately incorporated into security prices and hence is fully reflected in a security's current market price. The third form Strong Market Efficiency includes private information or insider information too, is quickly incorporated in the market prices. The EMH also give focus on the law of one price, which means that there is only ever one price for an asset at any moment in time. The way of one price is neat and clean thinking but the real question that begs answering is whether or not the law of one price actually exists. Secondly if efficient market exits how can there be bubble in the stock markets? In addition how reasonable is it that all people rational decision maker as EMH posits?

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