ASSET MANAGEMENT

Behavioral Finance

Module 1

Are all **humans** rational?

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01

Scenario 1

A company is preparing for an economic downturn that is expected to impact its stock price, potentially causing a loss of 600 points in its stock value. Two alternative strategies have been proposed.

OPTION A

The stock's value will be protected, resulting in a gain of 200 points

OPTION B

There is a one-third probability that the stock will experience a gain of 600 points, and a two-thirds probability that it will not gain any value.

Which program to choose?

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Scenario **2**

02

A company is facing a challenging economic environment that could potentially lead to a significant decline in its stock price, causing a loss of 600 points. Two alternative strategies have been put forth.

OPTION A

400 points will be lost from the stock's value.

OPTION B

There is a one-third probability that no loss will occur, and a two-thirds probability that the stock will incur a loss of 600 points.

Which program to choose?

Scenario 1

Majority of people choose option A, even though both the options would have **saved 200 points.**

Scenario 2

Majority of people choose option B, even though both the options would have led to **loss of 400 points.**

“Personal finance is more **personal** than finance.”

- Tim Maurer

1987 Stock Market **Crash**

The **Crash**

The 1987 market crash questioned the efficient market idea and showed how herd behavior and market feelings play a role. Traditional models found it difficult to explain the sudden drop.

The **Result**

Researchers started thinking about how people's emotions and group actions affect financial markets. This showed that feelings and group behavior can really affect financial markets.

Chart Source: Bloomberg

Dot-Com **Bubble**

01

The Effect on **Market**

The dot-com bubble showed that when people are too hopeful and think things are worth more than they really are, and follows the crowd, it can mess up the market and cause it to crash.

02

The **Bust**

As the bubble burst, behavioral finance was considered as a framework to better explain irrational exuberance and subsequent downfall.

03

The **Lessons**

Investors and policymakers to consider the behavioral factors of market and protect against groupthink and overconfidence.

Global Financial Crisis- 2008

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Rational Choice Failures

The financial crisis many investors engaged in speculative and excessive risk-taking behaviors leading to contributed to the creation of asset bubbles and ultimately led to the crisis

A New Paradigm

It led to the development of new frameworks and models that incorporate psychological insights into traditional finance paradigms.

The Road Ahead

The 2008 financial crisis faced extreme market volatility and irrational. And Behavior Finance shows why individuals and institutions make decisions that deviate from rational expectations.

Investments and Dealing with **Irrationalities**

With Behavior Finance as a compass, one can navigate themselves towards rational investment decisions

Understanding the Psychology Behind Financial Decisions is Important

Humans are rational while making investment decision isn't always true because their biases filter their visions

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Why are Investors **irrational?**

Emotional Influences:

Emotions like fear, greed, and excitement play a pivotal role in shaping financial decisions.

Cognitive Biases:

Cognitive biases, causing individuals to make errors in judgment.

Social Influence:

Peer pressure push individuals to make decision based on others opinion.

Limited Information Processing:

The human brain has limitations in processing complex information, leading to oversimplification of decisions.

Why Behavioral **Finance**

Behavioral Finance unravels the connection between human psychology and finance, shedding light on how emotions, biases, and social influences impact financial decisions and market dynamics.

Traditional Finance vs **Behavioral Finance**

Traditional Finance Assumptions

- Portfolios designed per mean-variance theory.
- People follow a predictable saving and spending pattern.
- Efficient markets hypothesis: Prices align with values, hard to outperform.

Behavioral Finance Assumptions

- Acknowledges human irrationality due to cognitive and emotional errors.
- Expected returns influenced by factors beyond risk, such as social status and responsibility.
- Markets efficient in resisting easy beating, but not always in valuing accurately.

How Behavioral Finance **Helps?**

Mitigate Biases

Improve Financial Education

Enhance Investment Strategies

Understand Market Anomalies

Long-Term Wealth Preservation

Understanding Behavioral **Bias**

Behavioral Bias are non-logical beliefs that unconsciously affects the decision-making of individual.

In module 2, you will learn about Behavior Bias in detail.

Thank You

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