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# WHAT IS BEHAVIORAL FINANCE??

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**Kata Kunci: Keuangan Perilaku, Prinsip Umum Keuangan Perilaku, Terminologi Psikologis**

## ABSTRAK

*Behavioral Finance* adalah ilmu tentang perilaku, aspek psikologis bagi investor dalam mengambil keputusan investasi. *Behavioral Finance* menjelaskan penyimpangan/bias dengan terminologi psikologis. Selama empat puluh tahun terakhir, keuangan tradisional telah menjadi teori dominan dalam komunitas akademik. Namun, para sarjana dan profesional investasi mulai menyelidiki teori alternatif keuangan yang dikenal sebagai keuangan perilaku. Keuangan perilaku berusaha untuk menjelaskan dan meningkatkan kesadaran publik tentang faktor emosional dan proses psikologis individu dan entitas yang berinvestasi di pasar keuangan. Keuangan perilaku berkembang dan apresiasi untuk penelitian interdisipliner ini adalah fondasi yang mendasari disiplin yang muncul ini. Ada empat prinsip umum *Behavioral Finance*, yaitu *Overconfidence, Financial Cognitive Dissonance, Theory of Regret dan Prospect Theory*.

***Keywords: Behavioral Finance, General Principles of Behavioral Finance, Psychological Terminology***

## *ABSTRACT*

*Behavioral Finance is the science of behavioral, psychological aspects for investors in making investment decisions. Behavioral Finance explains deviation/bias with psychological terminology. Over the past forty years, traditional finance has been the dominant theory in the academic community. However, scholars and investment professionals are beginning to investigate an alternative theory of finance known as behavioral finance. Behavioral finance seeks to explain and increase public awareness of the emotional factors and psychological processes of individuals and entities investing in financial markets. Behavioral finance is evolving and an appreciation for this interdisciplinary research is the underlying foundation of this emerging discipline. There are four general principles of Behavioral Finance, namely Overconfidence, Financial Cognitive Dissonance, Theory of Regret and Prospect Theory.*

## INTRODUCTION

During the 1990s a new field known as behavioral finance began to appear in academic journals, business publications and even local newspapers. Several original books were written in the 1800s and the early 1900s marked the beginning of the behavioral finance school. Originally published in 1841, *MacKay's Extraordinary Popular Delusions And The Madness Of Crowds* presents a chronology of various panics and schemes throughout history. This work shows how group behavior applies to today's financial markets. The uniqueness of behavioral finance is its integration and foundation from many different schools of thought and fields. Bachelors, theorists, and practitioners of behavioral finance have backgrounds from a variety of disciplines. The foundation of behavioral finance is an area based on an interdisciplinary approach including undergraduates from the social sciences and business schools. From a liberal arts perspective, it covers the fields of psychology, sociology, anthropology, economics, and behavioral economics. On the business administration side, it covers areas such as management, marketing, finance, technology and accounting (Ricciardi & Simon, 2015).

Behavioral finance explores how investors make decisions with irrational biases. Investment decision making is a complex and challenging activity because it results from combining investment choices with psychology, sociology and cognitive theory. (Kumari, 2017). There is a problem that the reality of the market scenario or the real behavior of the market is contrary to financial theory before the 90s. Then in the 90s modern financial theory was urged to predict the reality of the discrepancy between theory and markets earlier. Modern finance includes psychology in finance as behavioral finance is known and suggests that behavioral finance also controls market behavior. In the scenario of aggregation finance the behavior is familiar with traditional finance but traditional financial theories such as rational behavior and profit maximization do not adequately consider individual behavior. (Singh, 2012). Behavioral finance attempts to investigate the psychological and sociological issues that affect the investment decision-making process of individuals and institutions. Behavioral financial factors such as overconfidence, fear, cognitive and emotional also affect investment strategy and investment decision-making process. Behavioral finance does not only affect traditional theory but is integrated with investment returns because investment decision making depends on intrinsic factors of investor behavior. (Right Budhiraja, 2018).

Behavioral finance is a paradigm in which financial markets are studied using a less narrow model than one based on the expected utility of Von Neumann–Morgenstern theory and arbitrage assumptions. Specifically, behavioral finance has two building blocks: cognitive psychology and boundary arbitrage. Cognitive refers to how people think. There is a large body of psychology literature that documents that people make systematic errors in the way they think: They are overconfident, they overburden themselves with new experiences, etc. Their preferences can also create distortion. Arbitration limits refer to predictions under the circumstances of whether arbitral powers will be effective, and when they will be ineffective. Behavioral finance uses a model in which some agents are also not fully rational because of preferences or because of erroneous beliefs. An example of his assumption of preference is that people don't like losses—a $2 gain might make people feel better in as much as a $1 loss might make them feel worse. Modern finance has the building blocks of the Efficient Market Hypothesis (EMH). EMH argues that competition between investors seeking abnormal returns pushes prices to their “true” values. EMH does not assume that all investors are rational, but

assumes that the market is rational. EMH does not assume that the market can predict the future, but it does assume that the market makes unbiased forecasts about the future. In contrast, behavioral finance assumes that, in some circumstances, market finance is not information efficient. However, not all misjudgments are due to psychological bias. Some are simply due to a temporary supply and demand imbalance. (Ritter, 2003).

## RESEARCH THE RESEARCH

Methods Method in this scientific article is a descriptive method, which only briefly describes the results of thoughts from the explanation of the results of previous studies. This research method also uses an inductive structure, which explains the basic ideas followed by the developer's ideas.

## DISCUSSION

What is the basic framework or *traditional finance*?

The basic framework of standard/traditional finance is often associated with modern portfolio theory and the efficient market hypothesis. The standard financial basis is associated with modern portfolio theory and the efficient market hypothesis. In 1952, Harry Markowitz created modern portfolio theory while a doctoral candidate at the University of Chicago. Modern Portfolio Theory (MPT) is the expected return of a stock or portfolio, standard deviation, and its correlation with stocks or mutual funds held in the portfolio. With these three concepts, an efficient portfolio can be created for each group of stocks or bonds. An efficient portfolio is a group of stocks that have the (highest) value or expected return given a given amount of assumed risk, or, conversely, contain the lowest value with possible risk for a given return. (Ricciardi & Simon, 2015). There are three main things that underlie modern portfolio theory, namely: a. Expected rate of return on individual/portfolio securities (security's or portfolio expected rate of return), b. Standard deviation of return, c. The correlation of these securities with other securities in the portfolio. Based on these three things, an efficient portfolio can be formed of various groups of securities, such as stocks or bonds. An efficient portfolio is a portfolio of securities that have the highest (maximum) return/expectation at a certain level of risk or vice versa. (Atif Sattar et al., 2020; Hirshleifer, 2015; анов & Rymanov, 2018). Furthermore, Treynor, Sharpe and Litner introduced a model in the valuation of securities prices, by describing the relationship between risk and expected return. This model is a development of portfolio theory proposed by Markowitz by introducing new terms, namely systematic risk and specific risk/unsystematic risk. In 1970, William Sharpe won the Nobel Prize in Economics for the theory of the formation of financial asset prices which was later called the Capital Asset Pricing Model (CAPM). (Widyastuti, 1990). Another topic of discussion expressed in Standard Finance is the efficient-market hypothesis developed by Eugene Fama in 1965, which assumes that in an efficient market the price of a security that is formed is a reflection of all available and relevant information about the security. In other words, the price formed is a fair value. As a result, theoretically, active market participants are unlikely to get abnormal returns (beat the market) continuously because other investors will immediately know the actions taken by an investor. So the only way to get a higher rate of return on investment is to buy investment assets that are more risky. (Widyastuti, 1990).

Fundamentals of Behavioral Financial Planning

Discussions of behavioral finance appear in the literature in various forms and viewpoints. Many authors have provided their own interpretations and definitions of the field. It is our belief that the key to defining behavioral finance is to first establish strong definitions for psychology, sociology and finance (please see diagram below).

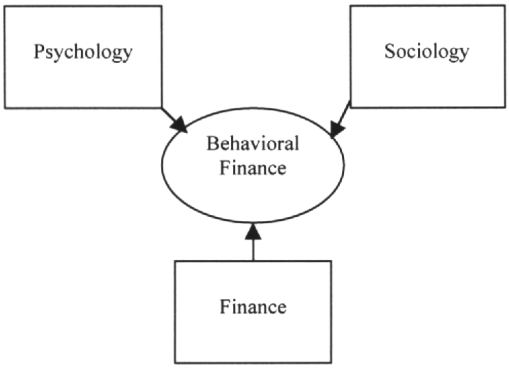


**Figure 1 shows the important interdisciplinary relationships that integrate behavioral finance.**

When studying behavioral finance concepts, traditional finance is still the center of attention; However, behavioral aspects of psychology and sociology are integral catalysts in this picture. Therefore, people studying behavioral finance should have a basic understanding of the concepts of psychology, sociology, and finance to become acquainted with the overall concept of behavioral finance. What is Behavioral Finance? Behavioral finance attempts to explain and improve understanding of investors' reasoning patterns, including the emotional processes involved and the extent to which they influence the decision-making process. Basically, behavioral finance tries to explain the what, why, and how of finance and investing, from a human perspective. For example, behavioral finance studies financial markets and provides explanations for many stock market anomalies (such as the January effect), speculative market bubbles (the recent Internet retail craze of 1999), and crashes (the crashes of 1929 and 1987). There has been much debate about the true definition and validity of behavioral finance since the field itself is still developing and perfecting itself. This evolutionary process continues to occur because there are many scholars who have such diverse and broad academic and professional specializations. Finally, behavioral finance studies psychological and sociological factors that influence the financial decision-making process of individuals and groups. (Ricciardi & Simon, 2015). Behavioral finance enriches understanding of economics by incorporating these aspects of human nature into financial models." Robert Olsen (1998) describes a "new paradigm" or school of thought known as an attempt to understand and predict systematic behavior so that investors are more accurate and correct in investment decisions. He further states that there is no cohesive theory of behavioral finance yet, but he notes that researchers have developed many sub-theories and themes of behavioral finance. (Ricciardi & Simon, 2015). General Principles of Behavioral Finance are as follows:

1. *Overconfidence*

   It is undeniable that humans have a tendency to be overly confident in their abilities and predictions to succeed. This condition is a normal thing which is also a reflection of a person's level of confidence to achieve/get something. As stated by researchers in the field of marketing*: "an overestimation of the probabilities for a set of events. Operationally it is reflected by comparing whether the specific probability assigned is greater than the proportion that is correct for all*

*assessments assigned that given probability".* (Mahajan, 1992). Rubin (1989: 11) illustrates the aftermath of the failed Challenger shuttle launch. For those who already understand the success rate of rocket launches where it is agreed that the failure rate of a rocket launch is 1 for every 57 launch attempts, the disaster that occurs when the Challenger explodes is not something extraordinary or unpredictable. Nasa a year before the Challenger exploded convinced the public and government that the Challenger launch failure was 1:100,000. This example shows that experts are too confident that experts are actually aware that the failure rate of a project is high, but still believe that the failure rate can be kept as low as possible. (Rubin, 1989). Research Fishchhoff et al (1977) shows that the occurrence of excessive belief is commonplace in human life. Experiments were carried out by asking respondents a number of questions where the questions were designed in such a way that the respondents actually did not know too much about the expected answers. In addition to the questions asked, respondents were also asked to give a confidence score to the truth of their answers. Research conducted by Fishchhoff et al. found consistent evidence that the reliability of the answers and the degree of overconfidence remained the same. (Fishchhoff, B., Slovic P., and Lichtenstein, 1977). The subject of overconfidence in financial behavior was studied by Daniel and Titman (1999) who explained that investors' excessive belief in themselves can affect stock price movements, especially in stocks that require further interpretation of their valuation, such as shares of companies that are currently trading. grow. (Daniel. Kent, nd). Barber and Odean (2000) examined overconfidence from a gender perspective. Their research uses household investors as objects covering 35,000 investors for 6 years, and has evidence that men have higher overconfidence than women in terms of skill level and men have a higher trading frequency (45% - 67% higher than investors). woman). The consequence of this higher trading frequency is that male investors are more likely to experience inappropriate trading conditions and incur higher transaction costs than female investors. This has an impact on the net profit received where the net profit for male investors is reduced by 2.5%, while for female investors it is 1.72%. (Barber, BM, and Odean, nd).

2. *Financial Cognitive Dissonance*

Festinger's theory of cognitive dissonance (Morton, 1993) states that people feel internal tension and anxiety when experiencing conflict. As individuals, we seek to minimize our inner conflicts (reduce our dissonance) in one of two ways: 1) we change our past values, feelings, or opinions, or, 2) we seek to justify or rationalize choices. This theory may apply to investors or traders in the stock market who try to rationalize contradictory behavior, so that they seem to follow naturally from a value or personal point of view. (Morton, 1993). The examination work of Goetzmann and Peles (1997) demonstrated the role of cognitive dissonance in mutual fund investors. They argue that some individual investors may experience dissonance during the mutual fund investment process, particularly the decision to buy, sell, or hold. (Goetzmann, 1993). Other research has shown that investors' dollars are allocated more quickly to mainstream funds (mutual funds with strong performance gains) than outflows from lagging funds (mutual funds with poor returns). Fundamentally, investors in underperforming funds are reluctant to admit that they made "bad investment decisions." The correct course of action is

to sell the underperforming ones sooner. However, investors chose to keep this bad investment. By doing so, they do not have to admit that they made a mistake in investing (Ricciardi & Simon, 2015).

3. *Theory of Regret*
   Another common theme in behavioral finance is the "regret theory." Regret theory states that the individual evaluates his or her expected reaction to a future event or situation (e.g. a $1,000 loss from the sale of IBM stock). Bell (1982) describes regret as an emotion caused by comparing the outcome or state of a given event with the state of a previous choice. (Bell, 1982). For example, "when choosing between an unfamiliar brand and a familiar brand, consumers may consider regret at discovering that the unknown brand performs worse than the familiar brand and thus tend to choose the unfamiliar brand" (Inman. J. and McAlister L, 1994). Regret theory can also be applied to the psychology of investors in the stock market. Whether an investor has considered buying a declining stock or mutual fund or not, actually buying the securities in question will cause the investor to experience an emotional reaction. Investors can avoid selling stocks that have fallen in value to avoid regret for making poor investment choices and the inconvenience of reporting losses. In addition, investors sometimes find it easier to buy "hot or popular stocks of the week." The point is that investors only follow "the crowd". Therefore, investors can rationalize their investment choices more easily if a stock or mutual fund drops in value substantially. Investors can reduce emotional reactions or feelings (reduce regret or anxiety) because a group of individual investors also lose money on the same bad investment (Ricciardi & Simon, 2015).

4. *Prospect Theory Prospect*
   theory is concerned with the idea that people are not always rational. This theory argues that there is a persistent bias motivated by psychological factors that influence people's choices under certain conditions of uncertainty. Prospect theory considers preferences as a function of "decision weights," and assumes that these weights do not always match probabilities. In particular, prospect theory suggests that weighted decisions tend to be greater than low-probability and *under-weigh* medium and high probabilities. Hugh Schwartz (1998, p. 82) articulates that "subjects (in investors) tend to evaluate prospects or possible outcomes in terms of gains and losses relative to some reference point rather than the final state of wealth." (Schwartz, 1998)
   To illustrate, consider the investment tween
   optionsOption 1: A definite gain (profit) of $5,000 or
   Option 2: 80% chance of earning $7,000, with a 20 percent chance of receiving nothing ($0).
   Question: Which option would you choose? The opportunity to maximize your profit?
   Most people (investors) choose the first option, which is basically "a sure profit or bet." Two prospect theory theorists, Daniel Kahneman and Amos Tversky (1979), found that most people become risk averse when faced with the expectation of financial gain (Kahneman, D., Slovic, P. and Tversky, 1982). Therefore, investors choose Option 1 which is a definite gain of $5,000. Basically,

this appears to be a rational choice if you believe there is a high probability of loss. However, it is actually lacking in traction selection. If the investor chooses Option 2, the overall performance cumulatively will be a better choice. good because there is a greater return of $5,600. In the investment (portfolio) approach, the return will be calculated as: ($7,000 x 80%) + (0 + 20%) = $5,600.

Prospect theory suggests that if investors face the possibility of losing money, they often take risky decisions aimed at avoiding losses (although sometimes they refrain from investing at all). to reverse or substantially change their disposition to risk. Lastly, this error in thinking relative to investment may ultimately result in large losses in investment portfolios, as individuals invested in mutual fund groups. (Ricciardi & Simon, 2015).

## CONCLUSION

*Behavioral Finance* is the science of behavioral, psychological aspects for investors in making investment decisions. *Behavioral Finance* explains deviation/bias with psychological terminology. Over the past forty years, *traditional finance has* been the dominant theory in the academic community. However, scholars and investment professionals are beginning to investigate an alternative theory of finance known as behavioral finance. Behavioral finance seeks to explain and increase public awareness of the emotional factors and psychological processes of individuals and entities investing in financial markets. Behavioral finance is evolving and an appreciation for this interdisciplinary research is the underlying foundation of this emerging discipline.

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