



Traditional Finance And Behavioral Finance- A Detailed Analysis

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Abstract: The base of finance has been studied or derived from the classical theories given by many writers, one of them being Scottish economist Adam Smith. Traditional finance related to human beings who could appropriately access the market conditions and took logical decisions regarding their investments and the risk associated with it. On an average, markets were considered efficient and unbiased. On the other hand, logic and reason is absent in case of behavioural finance. People are ruled by their beliefs, emotions, instincts and pre suppositions regarding the investment decisions. In this paper, we will basically focus on the factors that have led to a change from traditional finance to behavioural finance, also a comparative study on both the concepts and also the benefits and disadvantages of twin study. The findings of the study indicate that many variables such as heuristics, biases (representative bias, availability bias & investment bias), overconfidence, locus of control and various other variables have deeply affected the investment behaviour of individuals and firms. Hence the investor must rationally and wisely proceed for all such investment decisions.

Keywords: Traditional Finance, Behavioural Finance, Evolution, Analysis, Heuristics

1. Introduction

Finance is a term that is used from many decades which encompasses in itself basically the proper utilization of funds and further credit creation and overall related with the management of money. As mentioned below in the diagram it of three types. The term Finance evolved back in the 20th century. The contributions of Markowitz, Tobin, Sharpe, Treynor, Black, and Scholes, to mention a few, helped to establish finance as a separate subject of theory and practice from economics in the 1940s and 1950s. However, many aspects of finance, such as banking, lending, and investing, as well as money itself, have existed in some form or another since the dawn of civilization.

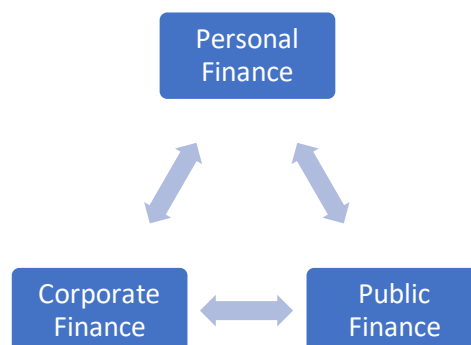


Figure:1- Types of Finance

Near around 300 B.C. the most historical presence of finance was felt. It can be mentioned as “start of civilization” with the introduction of the term finance. During Babylonian Empire the concept of Banking emerged as all the valuables, gold and precious materials were kept in temples and palaces as they were considered safe.

Behavior as the word suggests is a reaction or an act a person performs on happening of an event and the definition of finance has already been discussed before. So, the term “Behavior Finance” explains the effect of working of one’s mind on the markets, their investments made and all the other financial activities going on. In these personal biases overpower the original facts and figures prevailing in the market which can lead to both either the correct prediction of the financial Markets or the wrong prediction of the markets which can lead to huge losses depending upon the amount(value) of investments made.

2. Literature Review

Traditional finance was basically elaborated by the theory of Arbitrage invented by Modigliani & Millar, Capital Asset Pricing Model by William Sharpe’s, Portfolio principles by Markowitz etc. Behavioral Finance on the other hand was introduced in the 1980’s. The work of Le Bon “The Crowd: A Study of The Popular Mind” was a great work in the evolution of behavioral finance field. This concept basically talks about how the psychology and emotional aspect of an investor affects his ability to access the market, accordingly plan his investment and can make maximum gains. Also, the process of Arbitrage is also counted in this, as the investor predicts the behavior of the market and invests accordingly.

Lal (1992) examined the portfolios of 1,200 individual investors from various areas and regions of India using it as a sample size. In a study involving more than five companies, he discovered that Indian investors favor portfolios.

Financial Market Anomalies	Possible Investor Bias
Market Over-Reaction	Overconfidence
Market Under-Reaction	Conservatism/anchoring/availability/bias/confirmation Bias/representativeness/belief/perseverance
Excessive Volatility	Overconfidence
Momentum	Overconfidence/availability bias/confirmation bias/herding
Post-Earnings announcement drift	Overconfidence/availability bias/confirmation bias/herding
Panics and crashes	Overconfidence/availability bias/confirmation bias/herding
Holding Losers too long/selling winners too quickly	Disposition Effect/prospect Theory

Table 1. Financial Market Anomalies and Possible Investor Biases

Tseng (2006) proposed combining the traditional efficient market hypothesis, which focuses on individual and financial rationality, with neural finance. According to Tseng, the newly proposed Adaptive Market Hypothesis is more accurate than the Traditional Efficient Market Hypothesis. The following are the foundations of conventional finance:

- The risk and reward that can be expected
- CAPM is used to assess risk.
- Modigliani-Miller
- The claim that the price is contingent

The preceding is predicated on the rationality of investors. Traditional finance, on the other hand, does not provide an answer the following inquiries:

- What motivates and guides an investor's trading?
- How does an investor construct a portfolio? and
- Returns deviation due to risk?

Using empirical study, Sukheja G. (2016) investigated how emotions, biases, and moods influence investor behavior. Anchoring and overconfidence variables have an impact on decision making, according to this study. Mounika (2017) concluded in her study that, in practice, investors do not act rationally and are

influenced by behavioral biases while making investing decisions. Dhole (2014) conducted a study on medical students to investigate behavior features such as mental accounting, gambling, and herding, among others. For examining investor behavior, Neelakatan (2015) created a model utilizing structural model equations (SEM). The findings of his research revealed that the interaction between demographic characteristics and psychological biases had an impact on investors' investment decisions.

3. Objectives

1. To analyze the comparative study of traditional and behavioral finance.

4. Data and Methodology

The data considered is taken from various research papers, books and websites for a deep understanding of the topic and performing a comparative analysis of traditional and behavioral finance. A theoretical analysis i.e., a qualitative study of different kinds of literature is being performed in this study.

5. A Comparative Analysis:

Traditional Finance contributors: -

Traditional finance has its roots from the utility concept of economics which explains the amount of satisfaction derived from a commodity (Bernoulli, 1738). The theory of “invisible Hands” by Adam Smith in 1759 explains the social benefits derived by individuals (Samuels, 2011). John Stuart Mill in 1844, gave the concept as to how financial benefits are maximized with the given constraints. The Detailed contribution is given in the table below: -

Year	Theory Invented By	Theory	Findings
1759	Adam Smith	Theory of modern economics	Invisible Hand Theory
1844	John Stuart Mill	Influential Thinking	Homo Economicus or economic man theory.
1738,1944	Bernoulli	Utility Theory	Measures of Utility Concept
1906	Irvin Fischer	Neo-Classical Economy	Concept of equilibrium, rational individual.
1913	Wesley Clair Mitchell	Institutionalist theory	Induction Theory describing the concept and role of institutions.
1944	Morgenstern & John von Neumann	Expected Utility Theory	Economic equilibrium
1952	Harry Markowitz	Portfolio Theory	Optimal Portfolio position.
1958	Franco Modigliani and Merton	M.M. Approach	Dividend Policy theory and Capital Structure Theory
1959	Kenneth Arrow and John Debreu	Arrow – Debreu model	Rational Economic Equilibrium
1962-66	Treynor, Sharpe, Lintner and Jan Mossin	CAPM	Efficient Pricing, Portfolio development
1970	Eugene	Efficient	Efficient Asset pricing

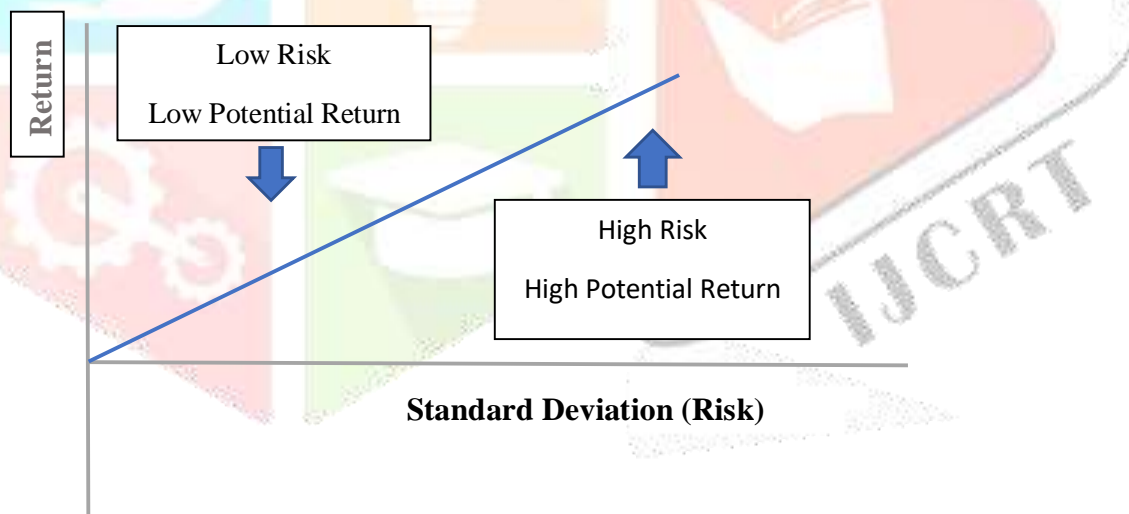
	Fama	market hypothesis	
1970	Richard	Futures	“Commodity Futures: Trends or Random Walks?” Title paper contribution
1973	Black Scholes	Black & Schole option pricing theory	Model for Options
1974	Meir Statman	Increasing Marginal Gains	Increasing Marginal gains.

Table 2. Authors, Theories and Findings

Traditional Finance with Risk Perspective

Shah (1997) has addressed some issues of risk associated with conventional finance which are as follows: -

1. The three basic classifications for decision makers' risk preferences and attitudes toward risk are those who prefer risk i.e., risk seekers, those who have no impact of risk i.e., risk neutral and the last those who avoid risk i.e., risk averse.
2. Risk is defined as the variation of return, risk is reduced through diversification, beta risk is important, and the CAPM is used.
3. The importance of change in options and the derivatives risk associated.
4. Hedging methods, validity of bond, change to market, and insurance of various portfolio items are examples of financial risk management tools.
5. Financial instruments have risks that are asset dependent out of which some are credit risk, interest rate risk and bankruptcy risk.



(Source-Self) **Figure:2** A perspective of Traditional Finance: trade off

Behavioural Finance

Behavioural finance to be considered as an emerging and trending topic which basically explains how psychology affects the decision making of various investors.

Behavioural finance, according to Ricciardi (2006), is a "science that aims to explain and improve insight into investors' overall decision-making process." This encompasses novice and experienced investors' cognitive biases as well as affective (emotional) components of decision-making". In an overall concept the decision-making process related to finance is based on some subjective (qualitative) variables such as problem-solving approach, emotions, and attitudes. In practise, behavioural finance research looks at " how investors make decisions to buy and sell securities and how they pick amongst options", according to Strong (2006), while Adams and Finn (2006) presented his viewpoint on behavioural finance.

In the domains of behavioural economics, psychology, and behavioural finance, behavioural decision theory (BDT) is considered a robust base and as a pillar for further knowledge in this area. As the concept of BDT has been originated from behavioural finance, new ideas including bounded rationality, cognitive biases, heuristics (rules of thumb), and affective reactions have been accepted into academic finance (emotional

issues). A sample of four important variables of behavioural finance, along with an explanation are as follows:

1. **Loss aversion & Bias:** This is a common occurrence that may be seen in many parts of judgments, especially when people are prone to losses and want to prevent them. The essential tenet of this concept is that people place a higher value on losses than profits. In many cases, this behaviour manifests as a greater readiness to take risks in order to avoid losing money. Investors are less likely to sell assets at a loss than they are to sell assets that have gained in value, even if the predicted returns are comparable.
2. **Prospect theory:** Decision-making processes taken in risky situations is being measured by this theory. Its name comes from the concept that risk entails some degree of loss. The behaviour of loss aversion, rather than risk aversion (as advocated in traditional finance literature), is a primary premise of prospect theory, and it takes into consideration the behavioural primacy of relative positioning. The hypothesis proposes that the decision-making process is divided into two parts. The first is "framing," which refers to how the arrangement or perception of the scenario in which decisions must be made affects the decision maker's preference for certain possibilities over others, the second step is "assessment," in which the decision maker compares losses and gains to a variable reference point based on the individual's analysis.
3. **Heuristics:** The shortcut that helps people to solve problems and through which decisions are taken effectively and without wasting time is called heuristics. These "rule-of-thumb tactics" shorten the time it takes to make a decision and allow people to go about their daily lives without having to stop and think about what they should do next. While heuristics can be useful in a variety of situations, they can also lead to judgement errors or biases.
4. **Overconfidence effect:** It describes how novices and experts alike have a strong desire to believe that abilities, beliefs, their decisions, estimates, and cognitive accuracy are appropriate. Overconfidence is based on a large body of academic research that shows that people in experiments and surveys overestimate their own knowledge or abilities while simultaneously overestimating the accuracy of their information.
5. **Risk and Behavioural finance perspective**
 - a. The nature of risk is multi-attribute. Feelings of control, terror, and knowledge are all part of it.
 - b. Social and cultural elements such as trust, justice, and democratic principles influence risk perceptions.
 - c. There is always an emotional or affective component to risk.

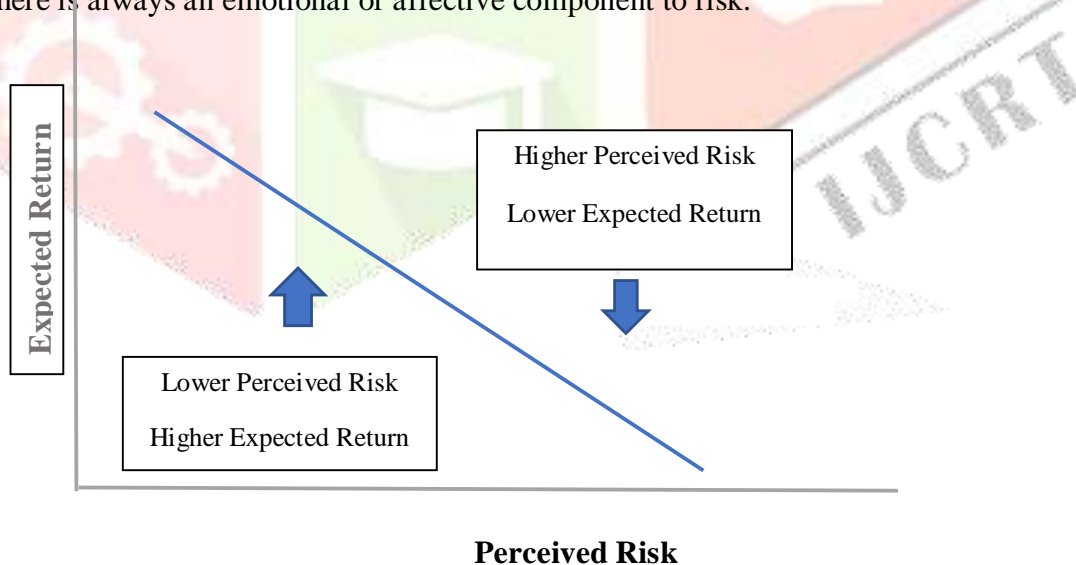


Figure:3 Negative relation between Perceived and Expected Risk

According to Olsen (1998), proponents of behavioural finance employ assumptions and conceptions based on psychology and financial theory to improve investment judgments rather than just detecting poor subjective (qualitative) choices or decision-making errors.

6. Conclusion

This paper has provided an in-depth look at risk from a variety of perspectives and disciplines. According to the literature, scholars have differing opinions on how to define, quantify, and evaluate risk. The author also discussed both traditional finance and behavioural finance approaches to risk assessment and measurement in academic finance. The concept of risk, according to traditional finance, is based on objective (numerical) metrics such as standard deviation and beta. Some of the traditional finance theories used to measure risk

include rationality, classical decision theory, risk-averse behaviour, current portfolio theory, and the capital asset pricing model. A positive relationship between risk and expected return is a key premise in traditional finance.

Behavioural finance, on the other hand, offers a comprehensive view of risk that considers both subjective (cognitive and emotional) and objective criteria (that is, mathematical variables). Bounded rationality, behavioural decision theory, heuristics, prospect theory, and loss aversion are the major assumptions of behavioural finance for risk analysis. The study of an inverse (negative) relationship between perceived risk and expected return has been a promising topic of research in behavioural finance (perceived gain). Finally, both traditional and behavioural finance perspectives improve risk knowledge.

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