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# Behavioral Finance and Investment Advisers

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***Abstract:****Behavioral finance, whichis claimed to be the most comprehensive investment theory compared to the traditional financial model, studies the effect of psychology, biases, stereotypes and cognitive and emotional errors on investment decision making processes. Recognizing the impact of psychology on investment processesbasicallyimpliesapproving of the behavioral theory. Provided that this assumption is made by knowledgeable, experienced and influential investment advisers, the significance of the behavioral theory is enhanced in interpreting irrational investment behavior and, overall, investmentprocesses.*

***Keywords:*** *Behavioral Finance, Investment Advisers, Stock Market, Psychology.*

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## I. Introduction

Behavioral finance, the new financial theory about investment decisions,originated from the weaknesses of the mainstream theory,which holds thatthose involved in investment processes always act rationally, and capital and stock marketsare always efficient and predictable.

Behavioral finance research has demonstrated that psychological factors, biases, and cognitive and emotional errors hamper rational thinking and efficient investment decisions. Ithas also emphasized the significance of all types of investors, of individual investment processes, anddiversification in stock market investments.

Irrationalityin psychological particularities can be encounteredonly if the importance in making investment decisions is recognized. In addition, the awareness of emotional and cognitive errors implies approving of the new theory of investment behavior.

The present paper investigates the significance of behavioral finance in making investment decisions and offering investment advice. The first part describes the concept of behavioral financial and its relationshipwith the stock market and decision making processes. Subsequently, itexamines the relationship between cognitive and emotional errors and investment advisers in the Greek stock market. Finally, it discusses the results in terms of the answers given by the subjectsconcerning the impact of psychology on investment decisions and advice in the case ofGreek stock market advisers. In this framework, the present research investigates the significance of psychology in investment processes and, consequently, the approval of the new behavioral model.

**Behavioral Finance and Investment Advisers**

Behavioral Finance is "the study of how psychology affects financial decisions and financial markets" (Shefrin, 2001). Endorsed by other disciplines, such as Statistics, Mathematics, Sociology, Psychology, and Anthropology, Behavioral Finance attempts to describe how human psychology, and in particular, human behavior, affects investment decisions.It investigates the application of psychology in finance, with emphasis on cognitive biases (Hirshleifer, 2014). In Sewell's (2005) terms, it is "the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets".It relies on a traditional approach of the economy in conjunction with psychology and results in empirical analyses using behavioral models (Duxbury, 2015).

In the great work of two distinguished psychologists, Kahneman and Twersky, the pioneers of the new theory, it is stated that heuristics and biases shape financial decisions under uncertainty. In addition, Thaler (1980), whohas also contributed to the establishment of the new emerging paradigm, argued that investors frequently act rationally;hesuggested that the Prospect Theory be the basis of an alternative descriptive model.

The proponentsof the new financial theory assumethat Behavioral Finance has come to fill the gaps in the traditional theory and, in addition, to highlight its weaknesses. This alternative approachpostulates thatsome financial processes are likely to depend upon the investors' less rational behavior(Barberis, 2007).

The standardfinancial model perceives a world of programmed, "cool" investors aiming atmaximizing profits. It was the simplest rather than the 'right' model, "easier to formalize and practically more relevant"

(Thaler and Mullainathan, 2000).Behavioral Financethrived precisely in the simplified and unobtrusive form of the mainstream model.

Before the emergence of the new behavioral paradigm, financial research was based on efficient markets and rationality,whichis typical of investors.Critics of the standard financial modelargue that the stakeholdersof investment processes and the stock marketare described and addressed,under the theory of Efficient Market, as soldiers.

The new financial approachargues that investors' perceptions and decisionsare based on their emotional state at a specific time."People do not always make choices in a rational and calculated way. In fact, most human decision-making uses thought processes that are intuitive and automatic rather than deliberative and controlled"(Erta, Hunt, Iscenko, Brambley, 2013).

**Behavioral Finance and the Stock Market**

Since emotion is a regulatory factor in all forms of investments made by individuals during their lifetime (investing in family, knowledge, career), why be an exception in the less abstract but literal financial investment.In terms ofShefrin (2000), financial markets are governed by fear and greed. The fact that emotions combined with the investors'biasesis the most significant reason for deviating from rational investments. What is not worth mentioning in the framework of the Efficient Market theory is the cornerstone of Behavioral Finance.

Disputesagainst the Efficient Markettheory made by behavioral theorists are also related to information availability and its directeffect on stock prices.Traditionalfinancial models assume that stock prices respond quickly to new information and accurately reflect their fundamental value. Recentresearchdemonstrates that capital market frictions and the psychological limitationsof stock market investors can cause asset prices to deviate from their fundamental values for a considerable length of time(Gokhale, Tremblay, Tremblay, 2015).

On the other hand, opponents of the standard financial theory hold that investingprocesses havedemonstrated that sometimes information is available in closedinvesting groups, andis also available to speculators long or shortly before it reaches the general public.They are also skepticalabout how information is disseminated and they question the valid and unbiased way of informationdissemination considering that capital markets (both in terms of availability and access) are inefficientas far as information is concerned.

Shefrin (2000)states that the three mainstays of behavior are:

- Heuristics: the non-rational processes under which investment decisions are made
- Framing : the context, the investors'stancetowards a problem, and the available information
- Market anomalies: market anomalies cause inefficient markets.

**Psychology, biases and investment advisers**

According to Behavioral Finance, the effect of psychology, biases, and emotional and cognitive errors onan individual's decisions is substantial and fundamental. Similarly, it is essentialto decisions directly related to investments. In effect, the emotional and cognitive errors of investment professionalswho manage customer portfoliosin the stock market are crucial toensuring the best function of the market.

Investment adviserscaninfluence and guideclients. Their role is critical in influencing clients'final decisions and, accordingly, the stock market progress;it becomes, thus,evident that the impact of psychology on investment advisers'decisions is essential.

To avoid unreasonable investment choices due to biases and cognitive and emotional errors,investment decision making should be based on the common view that biasesand emotional and cognitive errors can produce irrational thinking. Followed by the study and awareness of mental, emotional and psychologicalconditions,the specific perception directs to rational investment decisions.

Awareness of heuristics, cognitive and emotional errors andbiasesdetersirrational thinking and contributes to preventing it. Recognizingthat an individual can develop special features during investment decisions is vital tocorrect decision making processes.

**The Survey**

Provided that investment advisers are able to appreciate the effect of psychology on investment decisions, they cancope with irrational thinking, and,consequently, appreciate the role ofbehavioral finance.

In this framework,the present survey was based on the following question addressed toinvestment advisers: "How do you think your psychology, emotions and biases can affect your investment decisions?"

The question was addressedby the Capital Market Commission tocertified executivesworking in stock market companieslocated in Athensin the periodfrom 6February to 19 March 2015.

The survey samplinghas ensuredthe satisfactory dispersion and representativeness of the researched population:

• 23 paticipatingcompanies (43% -of the total number of 53 companies)

• Representativeness of companies: eligible for managing ~ 75% of the total value of stock market transactions, (ASE, HELEX - March 2015).

The corpus of data includes 81 answers to the survey questionmeasuring on a 9-point scale, as applied by a large number of scholars (Derek, Tanniru, 2000, Vavra, 1997), who consider large scales with nine and ten points as acceptable. A 9-point scale enableselicitingmore truthful / spontaneous answersand also neutral answers. In addition, whenrespondents are absolutely negative or positive, items9and1, can replace "Yes"/ "No" answers, respectively.

## II. Research Results

Data collection demonstrated that40%of the survey participants (the total sum of percentages forpoints 7 (22%), 8 (12%) and 9 (6%)) do not make investment decisions and choicesbased on logic and rationality. Adding the positive gradient of point 6,scores are rated at 59% (40% + point6 = 19%). The respondentshold that their investment behavior and the methodsemployed to restructure or construct portfolios are made in the light of socio-psychological factors and biases.

Based on heuristics, emotional processes, culture and biases, the respondents' investment choices are differentiated and shaped accordingly. 60% of the respondents are not rational decision makers on account ofthe psychological processes involved in decision making.

In addition, the executives' emotions, psychological state and biases are perceived as a regulatory factor for clients'investments. Thus, the organized and efficient function of the stock market is jeopardized, since investment misplacements, bubbles and irrational decisions result in market failures and imbalance.

Overall, the specific high scoresdemonstrate awareness of human weaknesses. The respondents are basically human beings and prone to cognitive and emotional errors. Those whoare able to recognize weaknesses, biases and errors can improve their professional profiles and rationalize irrational behavior. Self-awareness results in self-improvement and self-control.In addition, the specific results in relation to the impact of emotions demonstrate the appreciation and approval of the new behavioraltheory.

18% of the subjects (the total sumof points1 (6%), 2 (5%) and 3 (7%), or 25% if point 4 (7%) involving neutral attitudes is added)claim that they are notinfluenced by upsurge of emotion and biases, thus, providing evidence that the specific results reflect either the rational part of the capital market or those who act under the influence of rational illusions.

As regardsimperfect knowledgeand misconceptions about correct decisions, the executives and clients involved in such circumstancesare more liable, since failure to recognize errorsimplieserror repetition.

Neutral answers (point 5), estimated at 16%, are also considered answers in favour of rationalityconcerning the specific survey question, and are added to the total number of scoresrelated to rational decision making.

The analysis of the results demonstrated that 47% of the participating executives ofa higher educational statusrecognise their weaknesses and biases, 52% of those whooffer investment advice are affected by their psychological state, whereasof those who manage portfolios, only 16% are unaffected by emotions and biases, similarly tostockbrokers. In addition, 41% and 48% of those who are affected by emotions apply conservativeand aggressive financing policies, respectively.

Recognition of emotions and biases in investment decision making processesimpliesapprovingof the new financial theory and aiming at rationality.

## III. Conclusions

Rational investment decision making is the result of implementing the new behavioral theory which has come to remedy weaknesses of the traditional paradigm. Recognizing the impact of psychology, biases, and emotional and cognitive errors on investment decisions enables coping up with investment misconceptions.

The behavioraltheory emphasized that irrationality and non-rational choices and decisionsare the result of investors'emotionaland cognitive errors. Thus,recognition of the significance of psychology in decision making processes basicallyimplies approving of the new theory of behavior.

It is worth noting that the stakeholders of investment processesexercise influence and manage portfolios of other investors, and also provide expert advice and guidance. Thus,the research investigating their contribution and support is particularly crucial.

To investigate whetherpsychology, emotions and biases can affect investment decisions made by certified executives of stock market companies in Athens, the present research attempts to determinewhether the subjects,who are stock market experts with a sound stock market background,approve of the new financial theory. The research analysis demonstrated that 59% of the respondentsadmit that investment suggestions and adviceare affected by their psychological stateat a specific time, and,thus,they are likely to beirrational.

Recognizing the effect of emotional and cognitive errors results toexamination and awareness of psychological, emotional and mental status; thus, the study of the investment behavioral model contributes to controllingirrationality and achieving profitability.

However, the analysis results demonstrated that about 25% of the research participantsare not affectedby biases and psychological conditionswhen they make investmentdecisions, which may imply that the specific numberreflects either the rational part of the capital market or thosewho act underthe influence of rational illusions.

Overall, more than half of the sample recognize the importance of the new theory of behavior and,as a result, the shortcomings of the traditional paradigm. As the role of psychology is critical in stock market decisions, the significanceand dominanceof behavioral finance is great.

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