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Behavioral Finance: A Conventional and Modern Finance Paradigm

Shalini Kakkar[1], Vinod K. Bhatnagar[2]

[1]Research Scholar, Jiwaji University, Gwalior, M. P.
[2]Head & Associate Professor, Department of Management, IPS College of Technology and Management, Gwalior, M. P.

ABSTRACT

The current research tracks evolution of behavioural finance throughout the progression of financial history. It offers the initial instances of peculiar stock market behaviour that scholars have observed. It starts by discussing traditional finance and, when those concepts are deemed inadequate, evaluates conventional theories. The paper then discusses the relevance of behavioural finance and its special role in bridging the gaps between actual circumstances and conventional thinking.

Keywords: Behavioral Finance; Conventional Finance Theories; Rational Investment Decision; Market Efficiency;Behavioral Anomalies.

INTRODUCTION

Behavioral finance is a vibrant and quickly developing field of inquiry in the domain of economics and finance. The behavioral finance revolution was initiated by Daniel Kahneman & Amos Tversky in the early 1970s.The field of behavioral finance attempts to explain why investors make poor decisions by blending classical finance and economics with cognitive functions and decision-making processes. When people make financial or investing decisions, behavioral finance studies how biases in this area may influence the decisions they makBehavioral finance holds that investors' psychological composition affects their ability to make financial decisions. We know that emotions affect the decisions that people make. These judgments frequently have an inefficient and illogical nature and can result in stock market catastrophes. [1] lists what may be the most historic occurrence of such catastrophes. Both the 1719–1720 Mississippi Company Bubble and the Sea Company Bubble are provided by him. Of them, the narrative of the three occurrences known as the "tulip bubble," or tulipomania, dates back to the 1630s; of these, the 1711–1720 South is arguably the most frequently cited. Speculative bubbles, overreactions to new insights, and underreactions to it are instances of market anomalies that suggest financial decision-making is not solely the domain of a separate, analytical agent. Behavioral finance emerged as a result of the need to understand these abnormalities and the errors in human judgment they entailed. A relatively new school of thinking called "behavioral finance" examines how psychology affects how financial professionals behave and how that affects stock markets [2]. It indicates the role that behavioral biases play as well as the particular behavioral impacts that they have on investment decisions. Psychological biases like overconfidence [3], self-attribution bias [4], and herd behavior [5–6] have been implicated by behavioral specialists as contributing to these oddities. Given this, behavioral finance is a very relevant topic in the present day.

When deciding to invest in the security market, psychological considerations are key. It is essential to conduct in-depth research on each of these factors to comprehend how they impact the current circumstance. Research on behavioral finance has demonstrated that investing decisions are influenced by psychological factors. The current literature study thus attempts to be the first to perceive investor biases when making investment decisions, both individually and collectively.

The behavioral finance revolution was started by Daniel Kahneman and Amos Tversky in the early 1970s [7]. As with many ostensibly surprising positive stories, this one has been in the works for quite some time[8]. The field of "behavioral economics," which combines psychology with economics, has seen a rise in interest in recent years. Overconfident investors exaggerate the precision of their knowledge of the pricing of financial security, as well as the chance that their assessments of the investment's price are more accurate than those of others [9]. People don't always behave rationally, and while these deviations can be random, they are frequently systematic, as shown by the fact that a lot more people overestimate than underestimate their driving skills [10]. We all know that people have feelings, and those sentiments can influence their decisions. The field of "behavioral economics," which combines psychology with economics, has seen a rise in interest in recent years. Decisions influenced by emotions have the potential to become irrational and cause a huge stock market crash. The traditional finance school and the current finance school are the two

schools of thinking in behavioral finance. Traditional finance assumes that everyone involved in the market is rational and does not require any advice or recommendations from outside parties. In contemporary finance, we discuss how investors make mistakes while making financial decisions and how psychological factors influence financial decisions. For more than 50 years, the idea of a rational investor has dominated the field of behavioral economics. A reasonable person would expect to be cost-effective, rational in their decision-making, skilled at evaluating the chances of each potential replacement, and pick the option that provides the best utility at the lowest cost [7]. Myopic investors analyze past results narrowly and continuously assess their gains and losses. A myopic investor tends to make narrow decisions and narrowly focuses on the outcomes of those decisions[11].Due to inefficiencies in implementing rules, investors trade a lot, buy or sell at the incorrect time, let emotions dominate their decisions, and underestimate probability[12].

According to conventional economic and financial theories based on the assumption that people behave rationally, families should maximize their utility function throughout their lifetimes [13]. A recent, unusual incident called COVID-19 left the financial markets of several countries severely impacted and left people suffering from a deadly pandemic throughout the world. The world recently witnessed an extraordinary event known as COVID-19, which resulted in a deadly epidemic that impacted people everywhere and negatively impacted the financial markets of many nations. Because everything in our world is a new news event that follows a predictable pattern, it is possible to compare past markets as they traverse these significant anomalies even though there is no way to foretell a "black swan" occurrence [14]. The COVID-19 pandemic has had a unique effect on the global financial market, and as a result of the market disruptions seen globally, India's financial system has also experienced market turmoil [15]. We decided to research the impact of COVID-19 on the Indian commodity and stock markets as well as compare the volatility of stock markets in other South Asian countries [16] because of the unpredictability and volatility in the stock and commodities markets. It was difficult to figure out both medium- and long-term rates of growth as no one knows how long COVID-19 will continue to affect the economy. The subject Company has lost attraction to potential buyers due to a reduced predicted growth (as the future transpired) as the uncertainties that could harm the company rise with time [17]. The existence of anomalies has been widely acknowledged in financial markets over the past two decades [18].

Anomalies occur when there is a surplus of buyers over sellers of a particular stock, which results in a decline in stock price. There are numerous behavioral finance biases at play in this epidemic of investment errors. Many behavioral finance biases, such as risk aversion, herd behavior, overconfidence, a false sense of control, inappropriate response, and self-attribution, became common during this pandemic. These prejudices have a direct impact on the investments that investors make. Since the majority of investors lost their solid portfolio investments due to the pandemic and the economies of many countries experienced a decline in GDP growth from their prior high GDP growth rates, investors are now savvier and more willing to take risks.

The information efficiency of the market in our locality is weak. The market is inefficient because, as research has proven since 1960, investors are entirely irrational and regularly make bad financial judgments due to behavioral finance biases. Investors must thus comprehend these market oddities since they have a direct impact on their selection of investments. In the rapidly expanding field of behavioral finance, scholars can investigate new psychological finance fallacies and educate investors on how to make better investment decisions. Researchers in the field of behavioral finance are cognizant of certain behavioral biases and recommend that investors avoid them while making financial choices.

Conventional Finance Versus Modern Finance& Inception Of Behavioural Finance

Conventional financial theories were thoughtfully crafted to assist individuals in taking sound investment decisions and beliefs that investors are completely logical and have the ability tochoose wisely among their investment options. Some people define themselves as "rational expectations wealth maximizers," indicating that they set measurable objectives for buying and selling things at prices they believe will improve the value over time. It is assumed that investors exercise complete self-discipline in their investment choices and are not cognitively or informationally disorganized. Conventional finance is predicated on modern portfolio theories and the idea of a competent market. Classical finance theories failed to explicate the stock market turbulence, though. Occasionally, these anomalies or disturbances show themselves as bubbles in the stock market, overreactions or under-reactions in the market, shifts in momentum, and reversals. This paradigm led to the development of behavioral finance, which sought to use behavioral principles to explain these abnormalities. Psychologists are credited with pioneering work in behavioral finance [20]. In 1979, they formulated the prospect theory notion for risk-averse decision analysis, which laid the groundwork for behavioral finance. The value function in the prospect theory takes the place of the utility function in the expected utility theory.

The function indicates that certain benefits and losses are felt more intensely than others. Furthermore, there are situations when the joy of a similar amount of gain outweighs the anguish of a loss. This is known as loss aversion, since losses seem more likely than rewards. The value function is therefore 'S' shaped, concave for profits but convex for losses. According to the second proponent, a recognized criterion should be used to assess a prospect's worth. People are generally more inclined to desire to prevent losses than to gain advantages. Prospect theory, a seminal piece of work in behavioral finance, provides the groundwork for biases like as loss aversion, framing, and the disposition effect. The literature mentioned above shows that efforts to include behavioural elements in conventional theories

began to receive attention in the late 1970s and early 1980s. The works of [22–25] offer the expected utility theory an option. [21] argues that while classic asset pricing models like the CAPM calculate a security's expected returns at a specific point in time, they do not take into account those same returns over an extended period, which can explain stock market bubbles. The behavioural asset pricing model (BAPM), which was created by [26], is a model that is comparable to this one. The informational trader and the noise trader interactions on the market are explained by this paradigm. [26] also create the behavioural portfolio theory (BPT), a rival to Markowitz's portfolio theory. The informational trader and the noise trader interactions on the market are explained by this paradigm. [26] also create the behavioural portfolio theory (BPT), a rival to Markowitz portfolio theory. To optimise the trade-off between risk and return, investors build a mean variance for the portfolio using the Markowitz model. The BPT, in contrast, takes into account behavioural investors, who build their portfolios as asset pyramids with each layer representing a different goal and risk tolerance Researchers like [27-28] disputed the efficient market hypothesis in the 1990s and 2000s. [27] offers behavioural models that help to explain a variety of market anomalies, including the superior performance of value stocks, the closed-end fund mystery, the high returns on stocks included in market indices, the persistence of stock price bubbles, and the 1998 collapse of several well-known hedge funds. [28–29] further demonstrates the EMH's inconsistencies. The author demonstrates in 1981 that stock prices are significantly more volatile than could be explained by conventional financial theory.[28] focuses on how investor perception affects stock market bubbles, in addition to psychological and cultural issues. In a different study, [30] also offer persuasive evidence for momentum.They found that over a period of six to twelve months, the prices of specific stocks tend to predict the direction of future price movement. This discovery goes against even the most basic definition of market efficiency.[31]

Utilizing an artefact field experiment with financial experts and students, analyze the prediction of risk preferences of others. The subjects are given data on a variety of demographic traits and a self-evaluation of the target's risk-taking behavior in order to make their prediction. Three major impacts emerge from our analysis of the predictions: subjects stereotype based on demographic data as well as the target's self-perception of risk taking; and there is a sizeable false consensus effect.[32] emphasize on the experimental method's tools—the capacity to directly observe, regulate, and manipulate variables—are suitable for behavioural finance research because many variables are not observable and are challenging to measure or regulate for researchers looking at data from actual financial markets.[33]discovered that even in a situation without reputational incentives, a sizeable portion of investors will stick with a well-established trend.

When there are reputational issues, they don't seem to significantly influence herd behaviour.[34] addressed the association between behavioral finance and decision-making with cognitive biases such as overconfidence, anchoring effect, and anchoring bias; however, it gave no relevance to the experimental method.[35] Examine how extraversion and neuroticism affect people's decision-making in an experimental asset market. The authors employ a novel method that combines a questionnaire to gauge an individual's level of extraversion and neuroticism with an experimental asset market to gauge their ability to make financial decisions in order to establish this connection between research on experimental asset markets and social psychology.[36] The purpose of this paper is to examine the impact and contribution of the Journal of Behavioral Finance.[37][38]The results support the expected effects of beta herding, but not those of unfavourable herding. Additionally, this beta-based portfolios do not support the low-beta phenomenon. However, we do support the risk-return relationship. Lastly, we show how the herding level may function as a systematic return driver, improving the performance of traditional "anomaly" based strategies in the portfolio.

Conventional Finance Theories

Researcher Name	Year	Theory / Concept / Model
John Stuart Mill	1844	Introduced the concept of *Economic Man* (*Homo Economicus*)
VonNeumann & Morgenstern	1944	*Theory of Games and Economic Behaviour*
Harry Markowitz	1952	*Modern Portfolio Theory* (*Markowitz Portfolio Theory*)
Daniel Bernoulli	1954 (revisited)	*Expected Utility Theory*
Jack Treynor, William Sharpe&John Lintner	1962, 1964, 1965	Early development of *Capital Asset Pricing Model (CAPM)*
Jan Mossin	1966	*Capital Asset Pricing Model (CAPM)* – Extended and formalized
Eugene Fama	1970	Efficient market hypothesis

Modern Finance Theories

Researcher(s)	Year	Theory / Concept / Model
Herbert Simon	1955	*Models of Bounded Rationality* – challenged perfect rationality assumptions
Festinger, Riecken & Schachter	1956	*Theory of Cognitive Dissonance*
Tversky & Kahneman	1973, 1974	Introduced *Heuristic Biases*: availability, representativeness, anchoring & adjustment
Kahneman & Tversky	1979	*Prospect Theory* – introduced *Loss Aversion Bias*
Tversky & Kahneman	1981	Introduced *Framing Bias*
Richard Thaler	1985	Introduced *Mental Accounting Bias*
De Bondt & Thaler	1985	*Overreaction Hypothesis* in stock markets
Barberis, Shleifer & Vishny	1998	*Investor Sentiment Model* – underreaction and overreaction in stock prices
Meir Statman	1999	*Behavioural Asset Pricing Theory* and *Behavioural Portfolio Theory*
Andrei Shleifer	2000	Linked *Behavioural Finance* with *Efficient Market Hypothesis* – showed stock markets are inefficient
Barberis, Huang & Santos	2001	Incorporated *Prospect Theory* into asset pricing models
Grinblatt & Keloharju	2001	Explored the role of *Behavioural Factors* in determining trading behaviour
Hubert Fromlet	2001	Emphasized *Behavioural Finance* as a shift from *Homo Economicus* to a more realistic decision-making model
Barberis & Thaler	2003	*Survey of Behavioural Finance* – overview of theories, biases, and empirical findings
Meir Statman	2005	Refined **Behavioural Portfolio Theory**, explaining how investors form layered portfolios reflecting multiple goals.
Werner De Bondt	2005	Demonstrated **market overreaction and underreaction** in global contexts, extending behavioural patterns beyond the U.S. market.
Coval & Shumway	2006	Showed how **biased investors** influence price movements; found **price reversals** driven by psychological factors.
Barberis & Thaler	2003/2007	Published **"A Survey of Behavioural Finance"**, synthesizing key biases and empirical anomalies in financial markets.
Thaler & Sunstein	2008	Introduced the concept of **"Nudging"** in decision-making, influencing public policy and financial behaviour (via *Nudge*).
Daniel Kahneman	2011	Published *Thinking, Fast and Slow*, which deeply impacted finance by distinguishing **System 1 vs. System 2** decision-making.
Richard Thaler (Nobel Laureate)	2017	Awarded the **Nobel Prize in Economics** for contributions to behavioural economics and integration of psychological assumptions.
Andreas Oehler	2018	Empirical studies on how **personality traits** (e.g., extraversion, neuroticism) affect **investment decisions**.
Angelito Calma	2019	Provided behavioural insights in emerging markets through articles in the *Journal of Behavioural Finance*.
Barberis, Huang, & Santos	2001/2020	Refined **Prospect Theory Applications** in asset pricing and investor behaviour over two decades.
Petros Messis	2021	Investigated how **herding bias** affects **stock betas and idiosyncratic risk** in volatile markets.
Rehman & Raheem	2022	Studied how **investor sentiment, uncertainty, and risk** predict U.S. stock market behavior.
Misra & Verma	2022	Analysed **behavioural biases** among Indian retail investors using **heuristic-based models**.
Varma & Sethi	2023	Proposed **behaviourally informed robo-advisory tools** to counter overconfidence and anchoring bias.
Costa et al.	2017–2023	Conducted **bibliometric analysis** linking **overconfidence, confirmation bias**, and decision-making patterns.
OECD & World Bank	2020–2024	Released reports on **financial decision-making under cognitive bias**, leading to policy reforms and behavioural nudges globally.

CONCLUSION

This concept is becoming more and more popular, as we all know, and investors stand to earn a lot if they can recognize and eliminate any behavioral biases that prevent them from making an unbiased choice. A new paradigm in

which investor behavior directly influences investment decisions is introduced by behavioral finance, which contradicts all prior theories.These prejudices can influence their decisions and behaviors, leading them to make incorrect choices.Because of their capacity to produce significant market disruptions, these decisions are known as market oddities. Because these anomalies negatively affect a person's financial well-being as well as the state of the economy as a whole, they must be avoided.Such prevention will only be successful if practitioners are more conscious of their own behavioral and psychological boundaries. Thus, in the present day, a more comprehensive study of this field is essential.

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