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Understanding Human Behaviour in Financial Markets

Indian currency
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We often have a tendency to look into any field of study with certain presets that are considered norms in the subject. The study of finance, for instance, is often viewed as a number-crunching and graph-plotting game. We tend to ignore the involvement of human psychology in it at different levels and doing so leaves certain gaps in our assessment and understanding of the subject. This is because of a very simple reason that finance, howsoever technical, is conducted and managed by humans and importantly for their benefit. As such studying finance without an understanding of human behaviour or psychology will make our understanding of finance incomplete.

The goal of behavioural finance is to understand why people make certain financial decisions and how those decisions affect markets or financial systems. In behavioural finance, participants are assumed to be influenced by numerous personal and environmental components, rather than perfectly being rational and self-controlled.

If one were to trace the growth of any financial tycoon, one would find themselves studying a series of decisions they made over time. A closer look may show us that it is often these (seemingly small) decisions that end up defining that tycoon's journey, and distinguishing them from the common crowd.

What made those decisions good or bad, ingenious or unthinkable, can be understood by what motivated them, what hurdles obstructed them, and how efficiently they were tackled.

As deep as we may dig into the financial nitty-gritties and implications of the said decisions, it will all still boil down to certain uniquely human factors that dictated them. This is to say that the study of finance may possibly be incomplete without the study of decision-making, and broadly, without the study of human behaviour itself.

An important reference point for understanding this is Daniel Kahneman's and Amos Tversky's 'Prospect Theory: A Study of Decision Making Under Risk'. Investors assess outcomes against a subjective reference point, such as the purchase price of a stock, rather than computing the universe of possible outcomes and selecting the best one, as the paper points out. Furthermore, investors are loss averse, which means they are willing to take on greater risk in the face of losses but are fearful of risk when it comes to protecting their winnings. This was an important aspect that was not looked at before that time. The elements of human considerations and apprehension were taken into account.

So what remains important in behavioural finance is taking into account all the aspects of human behaviour that will eventually affect the

end result in the financial happenings. This may include our biases, ideology, mindset, environment, upbringing, rather anything that may end up affecting our choices.

Our choices, while often well-intentioned, are not necessarily reasonable. We may make a decision based simply on our feelings. Such a step could lead to a slew of bad investments and resource allocations, as well as erroneous risk estimates, and so on.

There are times in our financial lives when we make decisions 'unknowingly,' that is, without being conscious of the biases that may be propelling us in that direction. However, simply labelling or acknowledging these prejudices is unlikely to help us in the long run. Instead, we should invest in our financial future with something that is certain to yield higher returns: a deeper understanding of ourselves.

The point here, according to Seton Hall University Professor Jennifer Itzkowitz, is not that individuals are irrational, but that their irrationality is predictable.

This predictability can be seen in behaviours like allocating money into mental compartments and committing them to memory (only to have them betray us later), being lured into investment schemes by softer factors like the demographic qualities of company frontliners, anxious investing to "avoid loss" rather than investing to "seek gains," and more.

This is why academic courses, which aim to uncover the origins of our unconscious biases while also distributing knowledge on investment, trading, portfolio management, and other topics, deserve our support. To avoid falling victim to our old habits of skewed market interaction, we must first understand what those patterns are, how they came to be, and what motivates us to keep them.

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