BEHAVIORAL FINANCE IN INVESTMENT DECISION-MAKING PROCESS

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Abstract— Factor analysis and estimation on the prospects of an investment instrument are a major factor for investors in making an investment decision-making process. However, over time, some researchers suggest that psychological factors of investors have an important role in the investment decision-making process. With the psychological factors that investors have different views that will affect the results to be obtained.

Index Terms— Behavioral Finance, Decision-Making.

I. INTRODUCTION

Decision making is one of the basic cognitive process of human behavior by which a preferred option or a course of actions is chosen from among set of alternatives based on certain criteria (Wang, 2007). Psychologists tend to use a descriptive approach in studying the decision-making process. Therefore, the analysis of the decision-making process to make an investment that uses the science of psychology and the science of finance known as behavioral finance. Behavior finance is the study of how the psychological phenomenon affects the behavior of financial. (Shefrin, 2000).

The hardest part in making an investment decision is in choosing a particular area and field of investment. Investors in making an investment decision will take into consideration the risk profile (risk tolerance), rate of return, market condition, and other constraints. Behavior finance illustrates how investors react to the information in the market. In general, the investor is a perfect calculator to absorb all the information contained in the market and will make rational investment decisions and optimal. But in practice, show different things, namely that each individual has a different view in receiving the information received, so that there is a bias and irrational in the investment decision-making process.

Behavior Finance aims to understand the behavior of investors in making investment decisions and act in the capital markets that will affect the market performance (Qawi, 2010; Wendy, 2010; Shahzad et.al., 2013). In addition, the science of behavioral finance provides explanations of the significance of the occurrence of some market anomalies. In addition, behavior finance also assist investors in selecting investment decisions and avoid making the same mistakes in the future.

Based on Prospect Theory of Tversky &Kahneman (1979) the decision made by decision-maker difer from the presemptions of economists, which they proved with the help of various experiments. According to Tversky &Kahneman (1979), investors have a tendency to avoid risks in favorable circumstances, and chose to take a greater risk of loss condition. Therefore, based on these arguments, this study aims to minimize the cognitive and psychological biases in the investment decision-making process.

II. LITERATURE REVIEW

Implications and Principles and Behavioral Finance
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A. Prospect Theory

The prevailing theory states that every investor will provide the same action and reaction to the information in the market. Therefore, in the process of making investment decisions, investors tend to make rational investment decisions. Along with the times, discovered a new phenomenon which stated assumption that "rationality" is often violated. One factor that mnyebabkan it is the decision of the frame. To clarify this, Tversky and Kahneman propose or Prospect Theory, a model of decision-making by considering risk factors in the decision. This theory suggests several characters from investors in facing the risk, including the risk aversion and loss aversion. This theory, illustrates if there are two investor faced with two choices, ie potential gains and potential losses, the most likely investors will tend to choose the second option.

Based on the Prospect Theory, the decision-making model based on the S curve which states that an individual decision based on the advantages and disadvantages and not based on total wealth. Moreover, the S shape of the curve implies that each individual have a different response on gains and losses faced. This means that each individual will make decisions based not only on expected outcomes, but also by the conditions faced by each individual and how the condition can affect the environment in the decision.

S curve shape is curved into (concave) describe individuals who have characteristics that avoid the risk of returns and risk for loss seekers. While the curve is curved out to explain the behavior of individuals who avoid risks, in this case a loss.

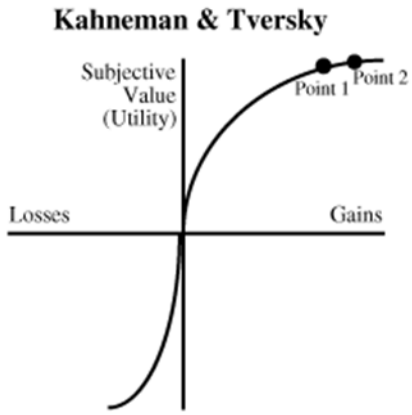


Figure 1.
Source: Romanos (2013)

Suharnan (2002) states that the function of the values between the acquisition and the loss tends to be asymmetric. This means that the same thing, a loss would be a higher perceived value to lose than gain value of an acquisition. Aspects of Prospect Theory, such as overconfidence and loss aversion is highly relevant to the investment decision. Overconfidence behavior tends to be optimistic in predicting the future, and have a high level of confidence in the ability itself respectively.

Individuals tend to have slow reaction in response to a loss, but tend to be reactive in response profits. Kahneman (2003) suggest that any individual would accept the loss in a risky game when it has been played several times rather than played once. They tend to think narrowly for a one-time investment, and broad thinking for the investment that has been done many times.

B. Intertempolar Choice and Self Control

Intertempolar Choice is a study that stated by Irving Fisher on the model of choice between the time about how rational consumers in making choices in a different time period. If more is being consumed now, we will eat a few others that can be consumed in the future.

This model sees the barriers faced by consumers and how they choose between consumption and savings. In theory, Fisher outlines some things about consumption:

1. Consumers should choose a combination under the budget line.
2. Consumers will choose the desired combination of consumption along the indifference curve.
3. Consumers will try to reach the level of indifference curve as high, reaching optimum conditions.
4. Consumers will increase their consumption levels if income increases.
5. Changes in real interest rates make changes combinations of consumption.
6. Borrow and save will affect the current consumption and future.

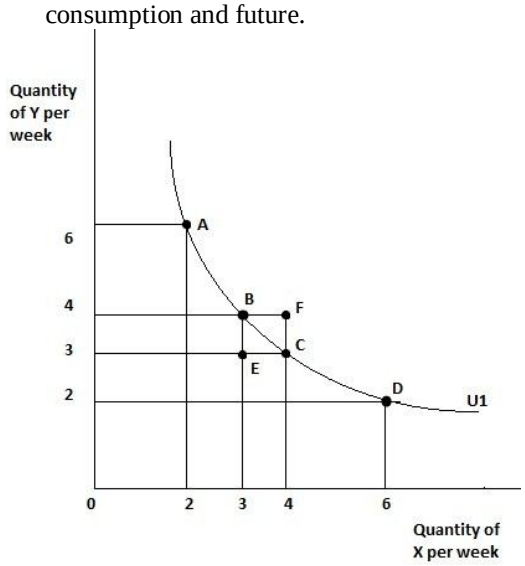


Figure 2. Indifference Curve
Source: www.wikipedia.com

The consumption function described in Intertempolar Choice theory is as follows:

$$c = aA + bY$$

Where:
A = Asset
A = MPC asset
b = MPC income

While the theory of self-control is an activity that encourages a person to make savings by reducing impulsive purchases (Otto, Davies & Chater, 2007). In addition the power of priority also affect a person's level of discipline in managing finances (Putra, Handayani and Pambudi, 2013). Success or failure of financial management is influenced by self-control (Tangney, Baumeister & Boone, 2004).

Self control relate to manage their finances better by going against the desire or urge to spend money excessively. In other words, spending money based on a desire not need (Baumeister, 2002).

Dewi (2004) found that self-control involves how strong a person holding value and confidence in order to be used as reference when making a decision. Therefore, self-control factors will greatly affect an individual's decision to invest.

CONCLUSION

Over the last few years has done research on behavioral finance. However, until now, there are no models of behavioral finance that significantly describes the behavior of investors in the money market. It takes the deepening of the financial science and psychology to be able to build this model. Although behavioral finance does not claim that every investor would experience the similar illusion, instead it scast light on to take initiatives to avoid the illusions that will influence the process of decision-making,

particulary while making investments decision.

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