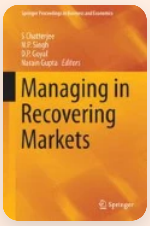
Behavioral Finance: A Study of Correlation Between Personality Traits with the Investment Patterns in the Stock Market

| Conference paper | First Online: 01 January 2014

| pp 143–155 | Cite this conference paper



Managing in Recovering Markets

Saima Rizvi & Amreen Fatima

Part of the book series: Springer Proceedings in Business and Economics ((SPBE))

Abstract

Conventional theories are based on the assumption that investors are rational beings. All their decisions are logical and judgments fair and rational. Based on this assumption, they have derived all their financial models. The capital asset pricing model assumes that investors are rational beings and they have the same expectations. This assumption contradicts behavioral theories, which assume that investors under uncertainty behave in a not-so-rational or irrational manner. The phenomenon of behavioral finance was noticed post-2000, when IT bubble was

built up and finally busted. During this time period, investors showed herd mentality, and they preferably invested in companies having “.com” attached to them. The market prices of IT companies rose much above their intrinsic value or fair value. It also happened in the subprime crisis when real estate prices in the USA started rising much above their fair value. After a certain time period, the bubble collapsed leading to the fall of stock prices, wiping off the hard-earned money of investors. The history of irrational behavior can be traced to the sixteenth century in Holland. The tulip bulbs were imported to Holland from Constantinople. These bulbs became very popular with Dutch elite class. Trading of these bulbs started on major stock exchanges in Europe. The prices rose to great heights and people started trading in bulbs in a big way. After a certain time period, people started selling these bulbs and the prices began falling. People started defaulting on their tulip contracts. This bubble finally collapsed leading to huge losses. Therefore, it was realized that there was something which these conventional models were unable to explain. These softer issues were never addressed and recognized by traditional theorist before. It was Kahnman and Smith who for the first time brought insights from behavioral sciences into the field of finance and economics. They stated that under uncertainty investors do not behave ideally but rather behave normally. The present paper describes the relationship between personality traits and investment pattern of investors. A survey of about 100 investors, who have invested in the stock market, has been conducted. The investors have been classified into various demographic profiles such as gender, age group, income level, number of dependents, profession, and marital status. The data for the study has been collected from both primary and secondary sources. Convenience sampling method is used to select the sample of 100 investors. The Big Five personality test has been incorporated to assess the personality of investors, and its correlation with their investment behavior is being evaluated in the study using various statistical tools. The paper attempts to rate the personality of investors on parameters such as extraversion, agreeableness, conscientiousness, neuroticism, and openness. The study relates the personality of investors with stock market investment, type, objective, factors influencing the investments, and so on. The findings can be useful for portfolio managers, fund managers, and wealth managers to understand the mindset and behavior of their clients. This will facilitate them to construct a portfolio which may be less than optimal and which can be adhered to by the advisor and the client amicably. This is especially significant in the context of managing portfolios in these recovering markets post-recession which the global economies have witnessed in recent times. The concept of behavioral finance is one such emerging area which if incorporated well in the hard-core finance, based on fundamentals, can yield dividends for portfolio managers and equity analyst and also on the wealth generation of the overall economies emerging in the aftermath of the recession.

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Cite this paper

Rizvi, S., Fatima, A. (2015). Behavioral Finance: A Study of Correlation Between Personality Traits with the Investment Patterns in the Stock Market. In: Chatterjee, S., Singh, N., Goyal, D., Gupta, N. (eds) Managing in Recovering Markets. Springer Proceedings in Business and Economics. Springer, New Delhi. https://doi.org/10.1007/978-81-322-1979-8_11

.RIS .ENW .BIB

DOI
https://doi.org/10.1007/978-81-322-1979-8_11

Published
26 August 2014

Publisher Name
Springer, New Delhi

Print ISBN
978-81-322-1978-1

Online ISBN
978-81-322-1979-8

eBook Packages
Business and Economics
Business and Management (R0)