Behavioural Finance: The Literature Review of Myopic Loss Aversion

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Abstract: Behavioral finance is a theory that tries to analyze the psychological bias that is less noticeable in the standard financial theory. In this theory, there are a lot of behavioral biases that occur in investors that can cause them to make costly mistake when making decisions. This article focuses on the most common, and the most costly, of all the biases that cause perfectly rational people to make irrational investment decisions that is Myopic Loss Aversion (MLA). The purpose of writing this article is to explain the MLA as a whole, their consequences, and how to avoid it. Myopic loss aversion (MLA) is a combination of the two theories, namely behavioral loss aversion and mental accounting. Loss aversion refers to the fact that a person will tend to be more sensitive to losses than profits. While mental accounting refers to a series of cognitive actions undertaken by economic agents in managing, evaluating, and maintaining financial activities.

Keywords: Behavioral finance, myopic loss aversion

Behavioral finance provides an important role in decision making by investors as the development of investment activity in the capital market. Investment decision will be influenced by a variety of information obtained and the knowledge and experience of investors in handling such investments. Investment decisions an investor has been seen from two sides, namely, (1) the extent to which such decisions can maximize wealth (economic factors), and (2) behavioral motivation, i.e. investment decisions based on the psychology of investors (Christanti and Mahastanti, 2011).

Financial theories have been developed previously as portfolio theory of Markowitz (1952) and the Efficient Market theory of Fama (1970) became one of the guidelines for investors to optimize their investment funds. Standard financial theories generally assume rationally thinking investor in making an investment decision. A rational investor would normally be inclined to think to maximize the wealth of the investments made. In this case, investors will be looking for as much information as possible, such as information on the company's financial statements, the company's performance, risk, economic conditions, inflation, interest rates, and so forth. However, along with the development of financial management sciences, particularly related to investment in capital market theory, many researchers are seeing a shift in the tendency of investors in determining investment decisions. Example is the psychological aspects that can affect the behavior of investors more familiar with the concept of behavioral finance.

Indeed, in reality, investors are not always rational thinking. The investors in the capital market often display irrational behavior and take action based on the judgment that is far away from the assumption of rationality (Suryawijaya, 2003). Therefore the concept of behavioral finance ranging widely was studied by researchers in seeing the behavior of investors in the capital market. Behavioral finance relating to individual and methods for collecting and using information. Behavioral finance try to understand and predict the implications of the financial market's systematic psychological decision processes. In addition, behavioral finance focuses

on the application of the principles of economics and psychology to an increase in financial decision making (Olsen, 1998).

Behavioral finance or behavioral finance is a theory that tries to analyze the psychological bias that is less noticeable in the standard financial theory. In theory, there are many behavioral biases that occur in investor that can cause them to make mistakes when making investment decisions. In the concept of behavioral finance say that the investment decisions made by investors consider aspects of the economy, especially non-psychological aspects that may affect the behavior of investor. This is because investors are in fact often perform actions based on the judgment and contrary to the theory that had been raised in the capital market on the assumption of rationality. The market may react quickly to information (as required by the Efficient Market Hypothesis), but the influence of the reaction it may be more influenced by the element of subjectivity, emotion, and various other psychological factors (Suryawijaya, 2003).

The concept of behavioral finance into account various types of investors in view of the risks associated with any investment decision. According Bailard, Biehl & Kaiser (an investment institution in California, USA) as quoted by Suryawijaya (2003), there are five types of investors in the capital market. The first group is a group of adventurers (adventurers), which generally is a group that ignored the risks or even liking (risk takers). They assume that where there is a risk it will be even greater the returns are, so they often ignore the advice of its financial advisors. The second group is a group of celebrities that consist of people who always want to look, stand, and into the limelight. They often do not care about cost-benefit calculation of the investment, provided that their decision to buy or sell securities seen and heard by many people. The third group is a group of individualists who tend to work alone and do not care about other people's investment decisions. This group tends to avoid high risk and do not mind the risk of being moderate and more rational. The fourth group is a group of investors that guardians are more "mature", more experienced and knowledgeable. This group tends to be cautious in making investment decisions and is more risk averse. The latter is a group that is not explicitly included in the above group is better known as a group of straight arrows. These groups sometimes are risk averse and sometimes risk takers. On the other occasion can also be individualists, and at other times more revealing nature follow the crowd.

Based on the various types of investors, hence a lot of research was trying to investigate the behavior of investors in making investment decisions. It is then expressed in the concept of behavioral finance that many investors who tend to stray from the assumption of rationality and the more expensive aspects of non-economic (psychological aspect) in making investment decisions.

In 1979, Kahneman and Tversky conducted a study by introducing the theory that emphasizes the psychological aspects of investors that prospect theory (the prospect theory) which explains that a person prefers the realization of profits than loss or person experiences a sense of fear of loss (loss aversion) resulting in avoidance of big risk. This research inspired the emergence of subsequent research that emphasizes the aspects of psychology or behavioral finance,

Basically the topics raised in this research also led to the theory of behavioral finance. The analysis in this study focused on the behavior of investors in risky investment decision-making process is based on the theory of myopic loss aversion (MLA) of Benartzi and Thaler (1995). Myopic loss aversion (Benartzi and Thaler, 1995) describes the combination of the two theories of behavior, which is loss aversion and mental accounting. Loss aversion refers to the fact that a person will tend to be more sensitive to losses than profits. Someone said to suffer from loss aversion when awareness in focus on losses (losses) on the profits (gains) (Haigh and

List, 2005). This is reflected in prospect theory (the prospect theory) that the empirical claim that the sensitivity of investors against losses is two times greater than the sensitivity to profit

Mental accounting refers to a series of cognitive actions undertaken by economic agents in managing, evaluating, and maintaining financial activities (Thaler, 1999). Furthermore, Pompian (2006) states that mental accounting refers to the activity of coding, categorizations, and evaluating financial decisions. In certain cases, mental accounting discussed on how a transaction evaluated over the time (for example concerning how often a portfolio evaluated) and cross-sectional (e.g., whether the transactions are evaluated based on their portfolios or evaluated individually) (Thaler et al. 1997; Haigh and List, 2005). Broadly speaking MLA can be described as a situation where an investor is constantly evaluating its investments as if afraid to be at a disadvantage, because the emotional impact generated when the loss is greater than in times of profit.

LITERATURE REVIEW

Behavioral Finance

Barberis and Thaler (2003) in Bodie, Kane and Marcus (2008) describes the behavioral finance as a financial market model that emphasizes the potential implications of the psychological factors that influence the behavior of investors. Sewell (2008) define Behavioral Finance is a "study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on the market". It can be concluded that Behavioral Finance is an assessment of the psychological factors that influence investors in making investment decisions. After receiving the information and facts, investors make decisions based on factors cognitive and emotional factors. The problem is these two factors are very susceptible to bias or irregularities.

1. Cognitive Bias: Cognition is the process of understanding, processing, and conclusion on the information or facts. Cognitive biases describe irregularities or errors in the process.
2. Bias emotional: Emotional feelings and spontaneity is more focused than the facts. Describe emotional bias error of judgment because it ignores the fact.

Behavioral finance explicitly can be defined as the application of psychology in the disciplines of finance (Pompian, 2006). This theory began to develop in the 1950s, where Burrell (1951) and Bauman (1967) when it has started to incorporate elements of psychology in their research. Meanwhile, Slovic (1969, 1972) has been writing articles about the investment decision-making process in terms of a behavioral perspective.

In understanding the behavioral finance theory (behavioral finance) need to be understood in advance who the investors are. According to some financial experts who are members of Bailard, Biehl & Kaiser (an investment institutions in California, United States) said that basically investors in the capital market can be categorized into five models (the five-ways model) that is adventurous (adventures), celebrities, individualists, guardians, and straight arrows (Pompian, 2006; Asri, 2003).

The adventurers usually do not care about the risk even liked it (risk takers) that makes them tend to ignore the advice of financial advisors. Celebrities are a group of investors who seem to want to stand out and be the center of attention in the capital market. This tendency makes them want to look not too take into account the costs and benefits of an investment as long as their trading activity known to many people. When the two kinds of investors dominate the market, then the market will be far from rational.

Individualists a group of investors who prefer to work alone and do not care about the investment decisions of others. Guardians consist of investors-investors who are more

experienced, which is relatively wider knowledge. Because of the experience and knowledge of this, they tend to be more cautious in making investment decisions. In general, two kinds of investors to meet the assumption of rationality in standard finance theory. The last category is the straight arrows, where the group is sometimes to be risk averse, but at other times can be risk-takers, so that these groups cannot be categorized into four groups advance.

In addition to understanding some groups of investors, it should be understood also characteristics that often occur on the investor as heuristic dealing to information, overconfidence, and the psychology of sending messages (Fromlet, 2001; Shiller, 2000; Nitsch, 1999, and Goldberg, 1999 cited in Asri, 2003; as well as Kahneman and Tversky, 1979). Heuristic dealing to information is an action to interpret the information quickly and (expected) appropriate, by relying on a number of thoughts (cognitive) and intuition (affective) owned by investors. Overconfidence is excessive self-confidence, in which an investor was already highly skilled in stock trading when only a few times to get a capital gain from the results of his trading. Meanwhile, the psychology of sending messages can be defined as the difference between the response of investors to the translation of a story.

Thus, in addition to using the "ratio", investors often use "emotion" in making investment decisions. Both "cooperate" in forming a short term response and long-term behavior of man, in which at certain moments that ratio will dominate investors in making investment decisions, whereas in other circumstances the possibility of emotions that will dominate (Wendy, 2010). To explain the emotion, Elster (1998) showed several factors that can trigger human emotions such as confidence factor (beliefs), intentional objects, physiological expressions, a tendency to act (reaction), and physiological symptoms.

Beliefs are a belief in "something", for example, investors decide to buy shares. WNY because he felt confident the issue would be beneficial to him. Intentional objects explain the relevance of emotions with specific objects (people, goods, or state). Emotions one can "rise" when they see the success of people (investors) otherwise they will try to compete with the success of the person. Physiological expression can be expressed through a person's behavior when responding to "something" for example, jump, laugh, or even cry (Frijda, 1986 in Elster, 1998). Emotions are also often associated with a person's inclination (investor) to action (reaction). Some elements of emotion that often influence a person to do "something" like anger, regret, fear, joy, even love, all of which would result in a person's mood changes Wendy (2010).

These explanations indicate that the behavioral finance developed to complement the standard financial theory that investors tend to ignore psychological factors. Behavioral finance is actually a theory that tries to explain the psychological investor’s bias or emotional condition that cannot be explained by standard financial theory. Wendy (2010) revealed that with the inclusion of psychology in financial studies, the expected results of future research is no longer simply answering the question "what", but also able to answer the question "why".

Myopic Loss Aversion

Investment portfolio theory states that the expected rate of return (expected return) and risk (risk) are the two conditions are directly proportional. This shows that the higher the rate of return expected by an investor, the higher the likelihood that it will face the risk level. Because of the risk factors inherent in each unit expected return is expected, and then an investor needs to do a comprehensive analysis before making an investment decision. Thus, investment decisions will ultimately depends on the ability to analyze and courage of the financiers themselves.

The choice to invest in safer assets irrespective of the level of higher returns in the capital market is a phenomenon that is very difficult to explain the economic model and become a puzzle for researchers to date. Therefore, in financial theory, the equity risk premium is often also referred to as the equity premium puzzle (Siegel and Thaler, 1997). Mehra and Prescott (1985) attempted to analyze the phenomenon of the equity premium puzzle by using stock returns and bond. Their empirical findings only explained that the high level of risk aversion that can be used to explain why most investors choose to save the bond. Furthermore, Benartzi and Thaler (1995) combines the two concepts of behavior that is loss aversion (Kahneman and Tversky, 1979) and mental accounting (Thaler, 1985) which was later called myopic loss aversion (MLA) to build the theoretical foundation in observing the equity premium puzzle.

Their degree of risk aversion that differ from one individual to another individual's behavior is one of the factors put forward by Kahneman and Tversky (1979) in prospect theory, which was later referred to them as loss aversion. Someone said loss averse (Kahneman and Tversky 1979: 279) when he does not like betting symmetric (50:50), as well as their evasion rate against the bets will increase according to the increase in the absolute size of the stakes. Furthermore Kahneman and Tversky (1979), and Starmer (2000) explains that, the notion of loss aversion is equivalent to a utility function, in which a person is more concerned with the loss of the profits. Thaler (1999) explains that in general people will feel more 'sick' when losing a hundred dollars compared to the excitement at the time a hundred dollars. Furthermore Thaler (1999) suggested to relieve the 'pain' is a way to combine them with a greater level of profits. Studies of some of these studies indicate that the loss aversion basically refers to the difference in utility between losses and gains on a wager that has the absolute size of the same.

Mental accounting developed by professor Richard Thaler of the University of Chicago (Pompian, 2006; Haigh and List, 2005). Mental accounting itself can be interpreted as a series of cognitive actions of economic actors in managing, evaluating, and maintaining financial activities (Thaler, 1999). On the other hand, mental accounting can also be interpreted as a system for recording and summarizing business transactions and financial transactions in the book, then analyze, verify, and report the results (Thaler, 1999). Furthermore, Pompian (2006) states that mental accounting refers to the activity of coding, categorizations, and evaluating financial decisions.

According to Thaler (1999), mental accounting includes three main components. The first component relates to how an outcome is perceived and used as an experience, as well as how to make decisions, and then evaluate the decision. The second component involves the activity for elaborating a detailed account, for example, to group the sources and use of funds to be labeled properly. The last component includes the frequency of an account is evaluated. The more frequently an account evaluated then someone will be more careful in making further decisions. Account has then to be evaluated periodically rebalanced. Furthermore, Barberis and Huang (2001) stated that mental accounting would happen if a person think and evaluate their financial transactions regularly.

CONCLUSION

Behaviorists have noted a tendency for investors to check the performance of their portfolios too frequently. If an investor checks his holdings on a daily basis, he will experience many days of losses. Conversely, the longer the time frame between checks, the less likely it is that the portfolio will experience losses. Given that investors feel the pain of losses far greater than they feel the pleasure of gains, they are likely to not only experience disappointment if they check their portfolios with great frequency, but they are more likely to panic and sell as the pain of losses becomes intolerable.

How can myopic loss aversion impact investment results? Investors that check on the values of their portfolio with great frequency are more likely to be subject to this particular bias. And with the advent of the Internet age, most investors now have the capability to check on their portfolio's valuation in real time, with great ease – subjecting themselves to the pain of losses with great frequency. This pain, caused by myopic loss aversion, can easily cause them to stray from a well-thought-out investment plan. This is especially true in bear markets when the frequency and intensity of the pain are high. Thus investors become susceptible to buying high and selling low.

To avoid myopic loss aversion, one of the first things to do is to write out your investment plan and always take it with you wherever you're going. So when there is an unexpected situation happens, you can put yourself in a better position to put dramatic market action into its proper perspectives and avoid falling into this behavior trap.

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