HUMAN SOCIETY AND FINANCIAL BEHAVIOR

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Abstract. *The basic expression of today's decision base in any banking institution or asset management company is risk management. Nothing new would say, its risk and profound implications have been the subject of study since the beginning of the last century when Knight, von Neumann, Morgenstern, or Arrow prefetted this field. And yet, why today, more than ever, does everything go from interpreting it in a way that becomes almost obsessive? Often invoked risk management motivation leads us into a banking system that fails to credit the economy, companies have increasingly difficult access to finance, whole sectors suffer, large companies collapse. The question that is naturally born is what has changed in the interpretation of risk in recent years? Can we talk about a subjective element that defines the risk? Referring to modern times, we notice that the barrier that delimits this change of paradigm is 2008, a time that has fundamentally transformed the approach of risk, not necessarily its quantification. This is why we need to address the risk through human behavior with its subjective valences and its implications for decision-makers.*

Keywords: *risk management; human nature; behavioral finance; sentiment; rationality; behavioral biases.*

Introduction

In the fever of finding "logical" explanations on how decisions are made and the financial markets are functioning, the countless evidence of irrational investor behavior has gradually led to the abandonment of some of the dominant concepts of neoclassical finances. Moreover, the idea that the 21st century would be "behaviorist" or not (Thaler, 2000) was accredited. For now, one thing is certain: Behavioral finances are "under construction" and set up as solid support for the vast financial sector. Studies conducted over the past decades have made behavioral finance incorporate standard finances, re-introduce them into new concepts and establish connections between theory, demonstration and practice. Statman (2014) notes an essential aspect: Behavioral Finance puts normal people in place of rational people in standard finances.

In the mirror, the two disciplines are based on four symmetrical pillars, the behavioral finances representing the alternative for each of them (Statman, 2014, p.65):
Standard finance assumes that:
1. People are rational;
2. Markets are effective;

3. People should design portfolios based on the average variance rules within the portfolio theory;
4. The expected return on investment is described by the standard pricing theory of the standard assets, where the expected return on profit is determined only by the differences in risk.

Behavioral finances assume that:
1. People are normal;
2. Markets are not effective, even if they are difficult to defeat;
3. People design portfolios based on the behavioral theory;
4. The expected return on investment is described by the behavioral theory of asset pricing, in which case the expected return on profit is determined by many more elements than the risk differences.

De Bondt states that behavioral finances, in turn, rely on three main pillars: feelings, behavioral preferences and arbitrage limits (De Bondt et al., 2008). The authors point out that sentiment is understood as investors' mistakes, but similarly, these errors are also found in the market. In other words, behavioral finance models classified individually generate results at the macro level, which is why, in the literature, studying distortions (biases) has been revealed in Behavioral Finance Micro and Behavioral Finance Macro. Micro Behavior Finance analyzes the cognitive biases or biases of individual investors that differentiate them from rational investors targeted by classical economic theory. Macro behavioral finance detects and describes anomalies in efficient market theory as behavioral patterns that may be explained (Pompian, 2006). In the case of macro-behavioral macroeconomics, the discussion of specialists goes around the question: "Are efficient markets or are they the subject of behavioral effects?" As far as micro-behavioral finances are concerned, the subjects turn around the dilemma if individual investors are perfectly rational or cognitive and emotional errors affect their financial decisions. Psychologists explain that these errors are due to the fact that people's beliefs are often subjected to cognitive illusions.

The human society is based on moral and ethical standards. To understand the relationships among people we need to explore the human nature and inevitable we'll find the importance of the sentiment. The risk is seldom triggered by human sentiment and to understand it we need to understand the way people approach it.

"Economics is a social science studying the behavior of people when they are involved in production and exchanges. Predictive models about prices or about market tendencies are run with high errors and uncertainty." (Păun, 2016, p.1) Due to the free will of the human nature, we can state economics doesn't have a great level of predictability, which translates into a risk environment. On top of that, there is always the state intervention who significantly alters the normal course of the economy.

A new approach from the perspective of ... difficult to assess situations

The recent literature on behavioral finance suggests that investor sentiment may greatly affect the value of earnings in the case of financial securities. The effect is felt to a greater extent in the case of financial titles that are difficult to assess and/or difficult to arbitrate, such as small, "young", unprofitable or high-yielding securities. When investor sentiment is high, the return on these types of titles tends to be relatively low, and vice

versa, in the case of low emotional states. The causes of fluctuations in investor sentiment vary and in some cases may be quite banal. Hirshleifer and Shumway (2003) have collected evidence of the daily returns of 26 capital markets in the world that show that they are affected by the cloudy weather in the city that runs the stock market in the country. Kamstra, Kramer, and Levi (2003) provide similar evidence, showing that investor sentiment, risk tolerance and asset returns in different countries are influenced by the low hours of light in winter, probably resulting from seasonal affective disorders.

Implications for investors' decisions

Theoretically, it is appreciated that investors are able to gather relevant information and evaluate them objectively. In reality, there are a number of mental and emotional factors that are difficult to separate into an analysis system. Sometimes these factors can lead to good results in the decision-making process, but it is also possible to reverse the situation. Following countless observations and tests, researchers have been able to demonstrate that, most of the time, people's beliefs are predictable on deformation of decisions. In most cases, the source of the problem is cognitive. The decision-making process by which investors discover things by themselves, usually by trial and error, leads to the development of general rules of assessment or rules of good sense ("rule of thumb").

According to Ritter (2003), behavioral finance is based on psychology, which suggests that human decision-making processes are subject to more cognitive illusions. These illusions are divided into two groups: illusions caused by heuristic decision-making (representativeness, trust, anchoring, player error, availability), and illusions generated by the adoption of mental frames grouped in prospective theory (aversion to loss, aversion to regret, mental computation, self-control).

The authors of the article Role of Behavioral Finance in Investment Decisions (De Bondt et al., 2008) characterize behavioral biases in three main categories: a) feelings: anchoring, representativeness, availability, excess trust; b) preferences: aversion to loss, mental calculus, myopia of aversion to loss, self-control, aversion to regret; c) limits of arbitration.

Backer (2010) performs another type of classification, listing four major thematic categories in which the factors affecting investment decisions fall. The first category focuses on heuristics, where the author lists the distortions that may affect the decision-making process: affection, representativeness, availability, anchoring and adjustment, familiarity, exaggerated trust, status quo, aversion to loss and regret, aversion to ambiguity, conservatism, and mental computation. Framing is the second category by which Backer believes that people's perceptions of the choices they have to make are heavily influenced by the way these options are framed, even if the objective situations remain constant. Emotions, the third category, include unconscious/unknown needs, fantasies, and fears, which also play an important role in making financial decisions. The book analyzes the relationships between the investor's condition and investment decisions under the influence of weather, sun, sports events. The impact on the market is the last category to analyze the effects of cognitive errors and individual distortions or groups of people that may affect capital market prices.

Pompian (2012) analyzes behavioral biases and their implications for making financial decisions from the perspective of cognitive errors and emotional deviations. In the first category, the author classifies: a,) distortions of persistent beliefs: conservative distortions, confirmation, representativeness, the illusion of control, retrospective, cognitive dissonance; and b) distortions of the information process: anchoring, mental computation, framing, availability, self-attribution, outcome, recent experience.

Dealing with distortions of investor behavior in decision-making

According to the author (Pompian, 2012), persistent beliefs in the context of behavioral biases are the tendency of people to cling to a situation that has previously occurred or that has recently created irrational or illogical beliefs. Investors seek to justify their beliefs because of distrustful confidence in themselves or in their own ideals or abilities. The distortions of the information process show how people process the information, logically or irrationally, into the decision-making process.

Emotional distortions are the second category defined by Pompian. These can cause investors to make ineffective decisions. Emotional distortions are more difficult to correct than cognitive errors because they stem from impulse or intuition, rather than from conscious computations. Because emotions are rarely identified and recorded in the decision-making process - they have to do with how people feel, rather than what they think and how - the researchers have found fewer distortions. The seven emotional distortions discussed in the above-mentioned paper (Pompian, 2012) are an aversion to loss, exaggerated confidence, self-control, status quo, endowment, aversion to regret and affinity.

Nair and Antony (2015) appreciate that four of the major themes in behavioral finance are: a) heuristics; b) framing; c) emotions and d) market impact. In the first category, the authors say that more than 50 biases were identified, among the most often represented representativeness, availability, anchoring and adjustment, familiarity, over-confidence, status quo, aversion to regret, aversion to ambiguity, conservatism and mental computation. Framing deals with how people encode events. Framing separates the background shape and therefore deals with perceptions. The framing was defined by the authors as a point of view of the decision maker on possible problems and outcomes. In the category of emotions are listed: fear, hope, anger, regret, pride, care, guilt, and mood. All these emotions determine the level of risk tolerance of investors. The higher the level of complexity or uncertainty, the greater the emotional impact. The impact on the market refers to the process of choosing alternatives to investment, a process that can be influenced by new information. Under these circumstances, investors' decision may suffer an incorrect valuation due to arbitrage limits. This will affect the market price, generating deviations from the fundamental values. These are the main anomalies that lead to the discussion of the efficient market hypothesis.

The list of titles can continue with various classification ranges, from author to author. However, the methodological aspect is less important for understanding the distortions of investor behavior in the decision-making process. Relevant are remarks and recommendations on how all these behavioral distortions can be identified and managed to limit the impact on investment decisions and the stock market.

Among the most known cognitive biases, representativeness, over-confidence, anchoring, betting error, availability of deformations are models that, in the heuristic decision-making process, have gathered around them countless examples of investor practice.

The level of risk tolerance of the investor

Aversion to loss is an argument for understanding and explaining the tendency of investors to keep their losses and to sell their gains too early. Shefrin (2000) called this distortion (bias) "mood effect". The hypothesis was supported empirically by data collected by Odean (1998), which analyzed the transactions for 10,000 accounts from a brokerage house. The results showed that the investors kept the shares on the loss for 124 days on average, while the shares on the win were kept on average only 104 days. With the help of an experimental term market, Heilmann et al. (2000) were able to demonstrate that the number of assets offered and sold was higher during periods of increase in trading prices than in periods of declining trading prices. This risk aversion to gains, which leads to a hurried sale of shares, directly leads to a fall in prices relative to the core values. On the other hand, the fall in share prices will cause investors to resist too much time in making a trading decision, which will cause stock prices that have had a negative momentum momentarily to exaggerate their core values. Studies show that the level of risk tolerance of the investor fluctuates with changes in the stock market. As a rule, investors use the open market price to build their attitude of risk tolerance.

Although the importance of assessing financial risk tolerance is well documented, in practice the evaluation process tends to be very difficult due to the complexity of the concept and the subjective nature of risk taking. Carducci and Wong (1998) conducted research to identify personality factors that can influence the assumption of financial risk. They suggested that investigating the factors that determine financial risk and risk tolerance can be extended beyond testing purely psychological factors. Demographic, socio-economic and attitudinal characteristics are essential factors to consider in determining how a person's behavior influences the financial risk assumption.

Specialist literature supports this idea with countless results related to factors of influence such as gender, age, education, marital status, occupation, income, race, ethnicity, etc. Slovic (1966, p.169) says that "a predominant belief in our culture is that men should, and even do, take higher risks than women." Countless studies show that the level of tolerance to risk is inversely proportional to age but directly proportional to the increase in the level of studies and incomes. Wang and Hanna (1997) examined the relationship between age and risk tolerance based on data collected from the consumer credit survey between 1983-89. The authors developed a life-cycle hypothesis by measuring the risk tolerance by the ratio between the asset's risk and the total wealth/wealth. This was defined by combining human capital and net wealth. By analyzing the descriptive tools, the authors suggest that risk tolerance increases with increasing age.

Individuals, compared to married ones, have a higher level of risk tolerance, as are people with a high occupational status or a higher level of knowledge in the field of investment.

Conclusions and implications

As can be seen from the various studies mentioned above, the risk concept has multiple dimensions depending on the approach of the approach. Assuming risk is dependent on context and context. Gooding's studies (1975) on investor perception of risk and return on ordinary financial securities reveal significant differences between professional and non-professional investors. That's why people's willingness to take risks must be analyzed and evaluated in context. There is no best or only way in which attitude to risk can be assessed or predicted, anticipated.

The investor has to establish from the very beginning what kind of risks he can assume, what are the objectives he is pursuing and what are the constraints to which he is exposed. Investor needs and financial market expectations are the focus of investment strategy building. Depending on economic dynamics, political, social, environmental or demographic changes, portfolios management will constantly require careful monitoring and continuous adaptation to the requirements or expectations of the financial market. Investment policy will allow for accurate analysis and assessment of the performance achieved in this management, based on the benchmarks adopted: the benchmark portfolio or the standard performance objectives. The reference portfolio reflects the investor's risk preferences and corresponding returns. In turn, standard investment performance should be compared to this benchmark portfolio. For example, an investor seeking low-risk and high-risk investments should compare the standard investment performance set with that of low-risk and high-risk portfolios.

The most appropriate allocation of assets within a portfolio (i.e. which asset classes and in what amounts) depends on the investor's objectives and on the constraints inherent in such a way as to ensure the necessary congruence with the characteristics of the allocation (strategic and tactical) and, of course, its behavior.

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