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# A COMPARATIVE STUDY OF TRADITIONAL MODE OF FINANCE AND CURRENT BEHAVIORAL MODE OF FINANCE

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## ABSTRACT

*Traditional finance, often called conventional finance, and recently formed behavioural finance are two categories of the financial sector. Earlier in the Financial Market, the emphasis was on the previous theories of finance, such as the Harry Markowitz Model and the Efficient Market Hypothesis, which are based on the reasoning of traders. Due to its unjustifiable assumptions, traditional financial theories were called into doubt in the 1990s. Globalization of the capital markets has been influenced by a wide range of variables, including institutional and governmental limitations, diffusion of information, domestic economic activities, and, most importantly, general sentiment as well as response. This research work aims to examine the fundamental change that occurred from conventional financial theories to behavioural finance and to emphasise the significance of behavioural finance.*

**Keywords:** Traditional finance, rationality, Behavioural Finance.

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## INTRODUCTION

Investors act and think "rationally" when purchasing and selling stocks, as per classical economists. Investors are specifically expected to make "rational expectations" about the future in assessing the worth of companies and the state of the economy in general. As a result, stock prices should fairly reflect underlying values and only fluctuate up or down in response to unanticipated positive or negative news. Therefore, analysts have come to the conclusion that stock prices follow a "random walk," financial markets are efficient and stable, and the entire state of the economy moves toward "general equilibrium".

However, Shiller (1999) asserts that in practise, investors do not act and think logically. Investors, on the other hand, speculate on equities between irrational highs and lows because they are motivated by greed and fear. In other words, shareholders continuously form irrational expectations for the future growth of companies and the wider economy, leading to stock prices that swing above and below fundamental values and follow a somewhat predictable, wave-like path. This is because shareholders are misinformed by extreme levels of emotion, open to interpretation thinking, and the caprices of the crowd.

The academic field of "behavioural finance," which explores how emotions and cognitive biases affect investors and the decision-making process, includes investor behaviour. Academics and portfolio managers have long been interested in how individual investors behave, but not the investors themselves because the herd mentality might occasionally take precedence over logic. Human herding behaviour is the result of individuals acting impulsively in response to cues from the conduct of others (Prechter, 1999).

This article's goal is to provide a succinct overview of previous research and theory on behavioural finance while also examining investor behaviour, psychology, and investment style. Do they make decisions based on logic or are they sentimental and irrational? The remaining portion of the essay is structured as follows. While next area will cover implications, suggestions, and conclusions, next part covers surveys the literature.

## **LITERATURE REVIEW**

### **TRADITIONAL FINANCE**

The efficient market theory has dominated finance for more than 30 years (EMH). The EMH is founded on three fundamental theoretical justifications. The first and foremost important is that because buyers are intelligent, assets are implicitly valued sensibly. The second is predicated on the notion that everyone carefully considers all of the data known before taking investing decisions. Internal reliability is relevant. No of the subject, each choice must be made in a methodical manner to ensure that it is in line with the others.

The third tenet is that the judgement always acts in his or her own best interest. The anticipated gadget of selection over risk, put forth by Von Neumann and Morgenstern (1947) in DeBondt, is the one that is most frequently used in finance (1998). The axioms that support anticipated utility maximisation as the best rule provide the foundation of its rationality. Efficient data gathering, processing, and expectation formation result in potential outcomes (of total wealth) and associated opportunities. The probability distribution is modified in accordance with Bayes' rule when there is new information.

### **BEHAVIORAL FINANCE**

A market research called "behavioural finance" makes use of psychology to shed more light on the motivations behind stock purchases, sales, and even stock abstention. The multiple "market abnormalities" that defy accepted theory are explained by the investor behaviour study. This is due to the persistent nature of the issue. Thus, this behaviour does exist.

Research that rejects the conventional premises of expected utility maximisation with logical investors in an efficient market is referred to as behavioural finance. Cognitive psychology and arbitrage constraints serve as the two cornerstones of behavioural finance (Ritter, 2003). When a market is inefficient, arbitrage is limited due to cognitive concepts such as how individuals think.

People consistently make decisions that are easier to make (heuristics), are overconfident, place too much weight on recent experience (representativeness), separate decisions that should be combined (mental accounting), present individual issues incorrectly (framing), are slow to notice changes (conservatism), and their preferences may also cause distortion when they avoid recognising reality gains (disposition effect). Models used in behavioural finance include some agents who are not entirely rational due to preferences or false beliefs. A preference assumption might be that people are loss averse. People are poor Bayesians, which leads to incorrect beliefs.

The term "bounded rationality," which is connected with Herbert Simon, refers to a number of novel concepts that are central to many of the fundamental theories of behavioural finance (1947, 1983). It has to do with the cognitive constraints on judgement. Human behaviour is therefore created through streamlined processes or heuristics (Tversky and Kahneman, 1974). This is in line with Slovic's (1972) investigation of investing risk-taking behaviour. He discovered that man has cognitive limitations and exhibits biases that cause people to overestimate the importance of knowledge. Additionally, people frequently overreact to information (De Bondt and Thaler, 1985, 1987).

Some of the basic concepts in behavioural finance are surveyed by Shiller (1999), including the Prospect theory, Regret theory, Anchoring, and Overand under-reaction. According to the prospect hypothesis, which Khaneman and Tversky first proposed in 1979, 1981, and 1986, people react differently to similar circumstances depending on whether they are given in the context of a gain or a loss. Even when faced with a certain gain, most investors are risk-averse, but when faced with a certain loss, they start taking more risks. Investors often become concerned at the idea of losses and are delighted by potential winnings. Khaneman claims that this is why investors exhibit "loss aversion".

Individuals who have "loss aversion" are more risk-averse and prefer avoiding losses over benefits. Although most investors have an optimistic bias toward their predictions (e.g., "this stock is going to go up"), cognitive bias is the core idea that they are less inclined to lose money than to earn it.

Another hypothesis that addresses people's emotional response to having made a judgmental error is the "regret theory" (Larrick, Boles, 1995). For instance, investors might refrain from selling stocks whose value has dropped in order to spare themselves the disgrace or regret of making a poor investment. The tendency to hold onto failed investments may also be a result of embarrassment. According to some academics, investors tend to follow the herd and common wisdom in order to avoid the potential of experiencing regret if their choices turn out to be inaccurate.

Many investors find it simpler to purchase a well-liked company and justify its decline by pointing out that everyone else already has it and highly regards it. It is more difficult to justify purchasing a stock with a poor reputation if it declines. Investors may anchor when they believe present prices are approximately right in the absence of better knowledge (Yates, 1990). For instance, in a bull market, more recent history gradually loses relevance as each new high is "anchored" by its proximity to the previous high. People frequently extrapolate recent patterns that are at conflict with long-term averages and probability by placing too much weight on recent experience.

Investors who place too much emphasis on current news at the cost of other data risk causing the market to overreact or underreact (DeBondt and Thaler, 1985). People exude arrogance. When the market is rising, they tend to be more optimistic, and when it is falling, they tend to be more pessimistic. As a result, prices drop too much in a weak economy. Despite the overwhelming evidence that they cannot, the majority of investors believe they can outperform the market.

In their 1999 study on the behaviour of purchasing and selling stocks, Kahneman and Odeon discovered that when an investor sells one stock and buys another right away, the stock that was sold often performs better the next year by 3.4%. They also noted that "cognitive illusions" such as becoming wealthy and well-known or being able to exit the market before a bubble burst are common among people. People overstate the importance of competence and downplay the influence of luck when making decisions. People frequently do not realise the risk they are taking. It is understandable why the typical investor panics during a market downturn—perhaps a time to buy rather than sell—especially when loss aversion is included in.

## **THE BEHAVIOR OF INVESTORS**

Long known as a cause of bias in judgement and decision-making, human information processing capability is limited by time, memory, and attention. Heuristics, or flawed decision-making processes, are therefore necessary (Simon, 1955, Tversky and Kahneman, 1974). According to Hirshleifer (2001), many or the majority of common psychological biases can be seen as the results of heuristic simplification, self-deception, and judgments based on emotions. Researchers Kent, Hirshleifer, and Subrahmanyam (2001) revealed evidence of investors' systematic cognitive biases, which have an impact on pricing.

(1) Investors frequently do not participate in all asset and security categories, (2) Individual investors exhibit loss-averse behaviour, (3) Investors use past performance as an indicator of future performance in stock purchase decisions, (4) Investors trade too aggressively, (5) Investors behave on status quo, and (6) Investors do not always form efficient portfolios, according to Kent, et al. (2001).

### **Frequently, investors do not engage in all asset and security categories.**

Investors frequently concentrate primarily on stocks that are "on their radar screens," according to Kent et al. (2001). That has to do with familiarity or "mere exposure" effects, such the idea that something that is known is more alluring and less dangerous. According to Kent et al., their findings were in line with those of Blume and Friend (1975), who observed that many investors completely disregard major asset classes (such as commodities, stocks, bonds, and real estate), as well as many specific instruments within each class. The same thing happened to "Kelantanese" investors, who exhibit strong prejudice when selecting securities and only opt for the most well-liked ones. (Nik Maheran et. al., 2003).

### **Individual investors behave in a risk-averse manner.**

The equities that investors decide to sell go on to perform better than the stocks that investors choose to hold, according to Kent et al. (2001). They claim that the manner price is established by home sellers also suggests that they are loss-averse. They are averse to selling at a loss in comparison to the previous purchasing price. This contributes to the explanation of the volume's high positive association with price change. This result supported Odean's (1998) theory, which demonstrated that individual investors are more likely to sell their successes than their losers. The disposition effect, which states that investors are more likely to experience gains than losses, is explained by these psychological effects, according to Tversky and Kahneman (1991). This effect has been supported by several investigations of behaviour in field and experimental markets.

When making stock purchase selections, investors look at historical performance as a predictor of future performance.

Investors regularly used so-called "technical analysis" to base their conclusions on the past behaviour of stock prices.

This has to do with a propensity to assess likelihood by making naive comparisons between the traits of the event being anticipated and the traits of the observed sample (Representativeness). This shows that occasionally, investors would extrapolate past price trends in an erroneous manner.

### **Investors trade with too much vigour**

Investors are overconfident in their decision-making, according to Kent et al. (2001). Traders in experimental markets tend to overreact to inaccurate information more often than to reliable information, which is consistent with overconfidence. They also give less weight to other people's information and actions. Evidence that more active investors obtain lower returns due to paying higher transaction costs lends stronger credence to overconfidence (e.g., DeBondt and Thaler, 1995). Male traders engage in more aggressive trading than female traders, incur higher transaction costs, and as a result, generate poorer (post-transaction) returns, according to Odean (1999).

Barber and Odean (1999) found that investors who have had the highest trading success in the past will trade the most in the future, according to Kent et al. (2001). This evidence is in line with the theory of self-attribution bias, which states that the investors are more likely to have attributed their prior success to talent than to chance.

### **Investors act in a status quo manner.**

Investors only devoted their decision-making a small amount of attention and cognitive resources, according to Kent et al. This is a result of their status quo, since they believed the option to maintain the status quo to be implicitly recommended. As a result, Kent et al. claimed that their findings were in line with those of Madrian and Shea (2000), who discovered that investors are susceptible to status quo bias and tend to stick with their previous decisions when making investments.

### **Investors don't always build profitable portfolios.**

In a broader sense, Kent et al. (2001) discovered data showing that investors occasionally fail to create optimal portfolios. When two hazardous assets and one risk-free asset are in a portfolio and returns are distributed regularly, portfolio allocation was explored in several experimental investigations. People frequently make investments in ineffective portfolios that are not two-fund segregated.

### **Investors behave similarly to one another.**

Herding is a phenomenon that is consistent with logical reactions to new information, agency issues, or bias against conformity. Herding behaviour has been observed in institutional investors' trading decisions, stock analysts' recommendation decisions, and investing newsletters (Welch, 2000). (Graham, 1999). No matter how intelligent their choices are, people often behave similarly to one another, claim Kent et al. in 2002.

### **Historical high or low trading stock prices have an impact on investors.**

Investors were significantly impacted by the stock price's historical performance, according to Kent et al. (2001). These results are in line with Daniel, Hirshleifer, and Teoh's (2002) theory that investors may develop theories about how the market functions based on irrelevant historical values, which is somewhat comparable to making decisions based on mental accounting with respect to arbitrary reference points. This has a connection to the anchoring theory put forth by Tversky and Karneman in 1974, which holds that investors set an initial value for future prices.

## THE PSYCHOLOGY OF INVESTORS

Since a generation ago, observers of the stock market have realised that psychological variables can be increasingly important in influencing the direction of share prices. The share price cannot be sent to the "moon" and subsequently pushed to the "precipice" by psychological reasons alone, according to studies. Political and economic issues are both very important in deciding the share price.

People are prone to "cognitive illusions," like being wealthy and famous or being able to exit the market before a bubble breaks, according to Kahneman (1974). People overstate the importance of competence and downplay the influence of luck when making decisions. People frequently do not realise the risk they are taking. It is understandable why the typical investor panics during a market downturn—perhaps a time to buy rather than sell—especially when loss aversion is included in. He believed that people are naturally optimistic. The casino is constantly filled during the day and night with people looking for luck, and this is the reason why. Investors are tempted to purchase stocks and shares when their market prices have reached historic highs because people are naturally hopeful. Investors ought to be offloading their stock and shares at current euphoric market state.

The association between stock returns and variables on aspects including the weather (Hirshleifer and Shumway, 2001), biorhythms (Samstra, Kramer, and Levi, 2001), and social happiness was examined in Kent, Hirshleifer, and Siew's study (Kent, Hirshleifer, and Siew, 2002). (Boyle and Walter, 2001). Emerging ideas in psychology economics on visceral elements and the "risk-as-feeling" approach serve as the foundation for these many analyses.

The various emotions, moods, and driving states that people encounter when making decisions are known as visceral factors. According to the "risk-as-feeling" perspective, these visceral aspects could influence and even take precedence over intellectual considerations when making decisions that involve risk and uncertainty. Because people in good moods tend to be more optimistic in their estimates and judgments than persons in bad moods, this leads to predictable patterns in stock returns (Wright and Bower, 1992, in Kent et al, 2002). Stock prices should be predicted to be higher at times when the majority of investors are in good moods than at times when they are in neutral or bad moods because there is a widespread tendency for investors to make optimistic or pessimistic judgments about the future prospects from the business direction.

It was discovered that meteorological factors have an impact on a person's mental state or mood, which makes them more likely to engage in specific behaviours. Additionally, it has been discovered that seasonal differences in the number of daylight hours per day affect people's mood, leading to the so-called Seasonal Affective Disorder (SAD) (Rosenthal, 1991 in Kamstra, Kramer, and Levi, 2001).

In their investigation into the psychology of investors, Kent et al. (2002) discovered that it is crucial to remember that investor perceptions, including those of the stochastic process of asset prices, value, risk management, and trading behaviour, play a significant role in the stock market's rapid price movement of stocks and shares.

### Opinions about price changes

Investors have looked for trends and stock price turning points in the equity markets. It is the "art of technical analysis," a technique used to spot trend alterations early on and to keep an investment stance up until the preponderance of the data shows that the trend has changed. It has been discovered that investor attitude is influenced by market performance over the past 100 trading days, and possibly much longer.

The overwhelming weight of the data indicates that, especially for challenging tasks like predicting stock prices, people's subjective probability distributions are too tight. According to Tversky and Kahneman (1974), forecasters' over reliance on their most plausible prediction is what causes overconfidence. In addition, De Bondt (1993) asserts that their anchor is the previous price level.

### **Value Perceptions**

Value perceptions are influenced by socially shared mental frameworks that are communicated through news, media, conversation, and advice from friends or financial experts (Shiller, 1990). Many people are unable to distinguish between good stocks and good businesses. As a result, businesses that are featured on the covers of prestigious business publications are thought to be wonderful investments, whereas businesses that post losses appear to be by nature undesirable. Highly regarded businesses typically appear to be pricey. De Bondt (1998) asserts that the fundamental issue is that too many individuals "judge a book by its cover" and are short-term oriented. Their valuation invariably results in mispricing as a result.

### **Managing return and risk**

Studies have shown that even if equity shares give a more attractive long-term return, small individual investors minimise the threat of risk by retaining a sizable amount of their financial resources in risk-free assets. This is frequently connected to risk-averse people. However, it is generally accepted that "aggressive investors" should hold a larger stock holding percentage.

### **Trading methods**

Many investors have a psychological tendency to take advantage of gains on prior winners early and to avoid taking advantage of losses. To manage their emotions, traders employ a range of rules and commitment strategies. Many people trade stocks haphazardly or based only on unplanned suggestions from friends. One factor is that people have unwarranted optimism over practically everything related to their own lives (Weinstein, 1990 in Kent et al., 2002). The fact that trader sentiment lags the market is a further issue that was previously mentioned. Investors tend to buy shares during bull markets and sell shares during bear markets as a result. Finally, the use of reference points affects trading behaviour significantly. They serve as performance standards. The cost of the original purchase may serve as a useful benchmark.

## **INVESTING STYLE**

Nik Maheran et al 2003.'s study of Kelantanese investors indicated that the majority of them frequently base their first purchase on the advice of a friend or relative. Typically, this initial trade only involves a limited number of shares. In the event that it is a success, the person usually follows the friend's or relative's subsequent advice and purchases more shares than they did the first time. This cycle eventually comes to an abrupt end when the investor loses the majority of their investment, if not all of it. This result is in line with earlier studies that have demonstrated how the drive for fast gains frequently undermines a logical, long-term investing plan. In fact, speculating on shares is typically more thrilling than investing in them. A long-term perspective will typically cause the average investor less stress and less need to monitor the investment on a daily basis.

Peterson (1999) noted that investors tend to "Buy on the rumour and Sell on the News" when making financial decisions (BRSN). The EMH theory states that investors react swiftly to news pertaining to securities. News regarding the favourable future event must have a delayed impact on investing behaviour in order for the BRSN pattern to show price inefficiencies.

As the events near, news about them is frequently spread and highly promoted more quickly. Based on data from the Malaysian stock market, Hameed and Ting (2000) discovered that the returns from a "contrarian portfolio" strategy—which involves buying and selling stocks when they are comparatively undervalued and overvalued—are positively correlated with the volume of trading in Malaysian securities.

## FACTS RELATED TO INDIA INVESTORS

Based on the descriptive analysis of investment decision-making behaviour, it can be seen that economic factors, followed by financial and frame of reference, have the greatest influence on individuals' investment buying behaviour. However, the majority of respondents indicated that they are unlikely to rely on emotions (i.e., gut instinct, overreaction) in making decisions.

Table2: Behavioral profile  
N=147

<b>Variables</b>	<b>Mean</b>	<b>Std. Deviation</b>
<b><i>Rational Behavior</i></b>		
Environment	3.00	.847
Financial	3.69	.942
Economy	3.80	.628
<b><i>Irrational Behavior</i></b>		
Emotion	2.95	1.057
Frame of references	3.1850	.76143

## IMPLICATION

Why does it matter if small individual investors behave differently than we would like them to? According to De Bondt, there are two factors (1998). The first is that sound financial management has a direct impact on people's well-being, and the second is that it's likely that investor conduct will have an impact on market activity. Costly arbitrage brings psychological elements into play, and it would be unwise to construct market behaviour models on the presumption that people are rational. The (stock) market is not a weighing machine, on which the value of each issue is recorded by a large-scale impersonal mechanism, rather the market is a voting machine, where countless individuals register choices that are the result partly of reason and partly of emotion, according to Graham and Dodd in De Bondt (1998).

## RECOMMENDATION

Here are some investment advice and resources that might help investors avoid some of the major behavioural errors that investors make. Keep in mind these financial theories. Many investors don't start by establishing goals and don't place enough attention on their particular time horizon. Instead of researching how a stock or fund might perform in the future, many consumers purchase them because they performed well in the past. Diversifying their portfolios is something that investors frequently neglect to do. There are four guidelines to follow before making a stock market investment, according to Charles Heath, President of Roller Coaster Stocks. Avoid investing with the crowd, put your emotions aside, practise patience, and grab your profits rather than giving them back.



Numerous investors exhibit excessive confidence, according to studies. Despite historical evidence to the contrary, the majority of investors think they can outperform the market. The ease of information access offered by the Internet and the sense of empowerment it instils in users are two factors that may contribute to investors' overconfidence. But information alone won't help us make wise decisions unless we know how to understand it. Investor credulity and widespread systematic mispricing infer a potential role for legislation to safeguard uninformed investors and enhance risk sharing. Investor decision-making and price efficiency can both be improved by the possible advantages of government policy and regulations.

## CONCLUSION

According to previous studies, there is strong evidence that investors commit serious systematic errors and that psychological biases have a significant impact on market pricing. Additionally, there are some signs that there is a significant misallocation of resources in the economy as a result of mispricing. As a result, there are some recommendations for economists to research how regulatory and legal systems can prevent the harm brought on by flawed reasoning. The political process and public discourse appear to be significantly impacted by emotions and psychological biases in judgement and decision-making, which results in widespread dilutions and an exaggerated emphasis on problems that are momentarily popular. Government might therefore step in to address informational externalities in capital markets if people made entirely rational market and political decisions. The argument against such intervention stems from the propensity of groups to deceive themselves in the political realm and the ability of pressure groups to take advantage of political participants' fallible reasoning. It is a proposal, nevertheless, to aid investors in making wiser decisions and improving the effectiveness of the market. These include laws, financial literacy initiatives, and maybe mutual fund advertising standards. Laws on market manipulation by rumours spreading and restrictions on how securities are marketed can both protect naive investors and limit the freedom of action of those who might prey on them.

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