

Disposition Effect : Review of Literature

Neeraj Amarnani*

The disposition effect is the manifestation of loss regret aversion that investors are prone to. This is an application of prospect theory developed by Professors Daniel Kahneman and Amos Tversky (1979), for which Professor Kahneman was awarded the Nobel Prize in Economics in 2002.¹ This theory along with that of mental accounting developed by Richard Thaler (1985) have since formed the bedrock of studies in the area of behavioural finance.

Behavioural Finance and the Disposition Effect

The traditional finance paradigm of the efficient market hypothesis seeks to understand financial markets using models in which agents are rational. However, years of study shows that basic facts about the aggregate stock market, cross-section of average returns, and individual trading behaviour are not easily understood in this framework. Behavioural finance is a new approach that has emerged, at least partially, as a response to this difficulty, and argues that some financial phenomena can be better understood using models in which some agents are not fully rational. It emphasizes the study of investor market behaviour that derives from psychological principles of

* Faculty, Institute of Management, Nirma University, Ahmedabad

¹ Professor Kahneman has stated that, had Professor Amos Tversky not prematurely died in 1996, he would have been jointly awarded the Bank of Sweden Prize in Economic Science in memory of Alfred Nobel.

decision making to explain why people buy or sell the assets that they do, thus linking behavioural cognitive psychology, human decision making, specifically under uncertainty, and financial market economics. There are two building blocks of behavioural finance. One is the limits to arbitrage, which argues that it can be difficult for rational traders to undo the dislocations caused by less rational traders. The other is psychology which catalogues the kinds of deviations from full rationality that may be observed (Barberis and Thaler, 2003). Individuals, in their inability to compute precisely the Bayesian probabilities of situations, tend to take shortcuts in their computations and use rules of thumb that they are comfortable with. These are called heuristics. In some situations, their inability is more to do with the decisions they take that are a side effect of these heuristics, which are termed as biases (Kahneman and Tversky, 1974; Taleb, 2004).