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Evaluation The Problem Of Decision Making Under Uncertainty And Risk From The Perspectives Of Traditional And Behavioral Finance

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Extensive Summary

Investors who have to make decisions under uncertainty and risk have to consider many factors. Traditional finance theories argue that individuals should be mindful of risk and return factors when making decisions, assuming that they are rational and that they are, in all circumstances, aimed at maximizing their profits. Behavioral Finance, an alternative approach, underlines that individuals are limited rational and that psychological factors are also influential in investment decisions. The aim of the study is to identify the risks that investors face when making decisions under uncertainty and the factors that influence investment decisions. For this purpose, we first examine the traditional finance theories of what investors need to do to maximize their benefits, and then the behavioral finance approach that reveals what investors actually do. Finally, the instruments we will need for the new financial regulator and the risk elements of our time to determine legal regulations are discussed.

Financial globalization also has considerable effects on risks and uncertainty. Financial globalization contributes to portfolio diversification and hence to risk reduction as it allows investors to invest in foreign assets. Despite this advantage, it brought with it many risks.

In the pre-globalization era, risk remained within the regional boundaries in terms of time and space. With the lifting of the borders, the risks have also become global and, contrary to expectations, uncertainty has increased. While local factors affecting stock price are a source of uncertainty before financial integration, the economic, social and political conditions of other countries should be considered when investing now. For example, the crisis of mortgage loans based on the mortgage, which started in the United States in 2007, caused financial crises in many countries. Due to the events of the Gezi Park in Turkey in 2013, tourists prefered their holiday preferences from Greece. Despite nothing to do with Greece, the profitability of companies operating in the tourism sector in Greece has increased unexpectedly.

The increasing uncertainty and risks that are almost impossible to predict, have brought the question of how confident we should be to the probability calculations, and the decision has become a more complex process. For example, in 2005, bird flu cases caused serious damage to the white meat sector and tourism. In Iceland in 2010, the volcano erupted and the airlines lost their losses to their shareholders due to canceled flights. After the September 11, 2001 terrorist attack, the American Stock Exchange closed. Calculation of the likelihoods of these events, even those that would have been unpredictable. Even if it would have been useful to make an estimate by looking at the past, as traditional finance advocates have argued, nothing in the past has been seen to indicate that these events could happen. Another conclusion that can be drawn from the events of September 11 is that not everyone has full knowledge. This attack, which was impossible to predict for the victims, was a known fact for terrorists.

As a result, financial decision making, which is an action for the future, involves uncertainty and risk factors. Traditional finance argues that the risk can be measured by certain techniques and that uncertainty can be reduced at this rate. It also assumes that financial markets are efficient and financial actors are rational. Behavioral finance recognizes that individuals are limited rationally and influenced by psychological prejudices when making decisions. Fundamental views of behavioral finance where markets are inefficient, abstract models and complex formulas can not afford to overcome the uncertainties of real life.

A new world order has been established with globalization. Technological developments, on the contrary, have increased the risks. Existing financial instruments and legal regulations are no longer sufficient for this new order. In order to establish a new financial system, it is necessary to analyze well the factors that influence investors when making their financial decisions, and what risks these factors have on the market. Otherwise, it will not be possible to develop new tools which help us to be protected from these risks.

There are a number of methods of treatment for the damaged system to function properly once the risks have arisen in the current system. If we think of these methods as some kind of medicine, we can see that there are many side effects besides their benefits. Therefore, an updated insurance system should be developed, knowing that preventions are more effective than treatment.

Uncertainty always exists, but in order to reduce the risks, some improvements should be made throughout the financial system rather than dealing with unhelpful formulas. Establishing a legal infrastructure functioning in international standards, ensuring that regulatory and supervisory agencies work in harmony, attaching importance to the training of qualified finance experts, strengthening physical and technological infrastructure and developing methods to reduce transaction costs will increase investors' confidence in the system.

Investors' beliefs and value judgments are also very influential in investment decisions. For example, an environmentally-friendly investor may want to invest in an industry company's stock that is known to the environment sensitively. A company that produces alcoholic goods for a Muslim investor may not be attractive even if the return is very high. Similarly, the majority of ultra-nationalist investors may not want to invest in a company that is in the hands of foreigners. Considering all these factors, incentives should be provided for the quotation of the companies which will be in the forefront with typical characteristics. This will help non-public companies to open up to the capital market and spread capital to the base, while the other side will help increase product diversity and attract more investors into financial markets. As a result, a system with a high liquidity level will be established besides an increase the savings level and capital accumulation of the country.