Framing And Investment Decision Making

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Abstract: Framing is a cognitive heuristic, which suggests that people react differently to the choices they are asked to make depending on how these choices are presented. In the context of the stock market, framing is defined as the effect of different investment frames on investment decisions. The present paper is an attempt to make a comprehensive discussion of framing, both of routine everyday decisions and also of decisions made in the specialized context of investment choices. In addition, it discusses methods to prevent framing so that choices and decisions derive from rational processes.

Keywords: Behavioral Finance, Framing, Psychology, biases, investment

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I. Introduction

In terms of the standard finance theory, individuals, particularly investors, always actrationally in their effort to maximize expected utility and wealth. Their psychological situation, emotions and biases are not emphasized, as they are considered to have no impact on investment decisions.

The weaknesses and shortcomings of the mainstream finance theory have led to a considerable interest in an approach focusing on investment behavior, which has come to complement and contradict the traditional and outdated approach.

Behavioral Finance is a new financial investment paradigm, an increasingly developing discipline, which has emerged from the study of economy on the basis of psychology. It attempts to interpret investment irrationality by discussing the social psychological considerations underlying investment behavior.

The framing effect is among the major considerations which are likely to generate irrational investment behavior. Framing as a term is used in the theory of communication, the sociology of psychology and other disciplines, and is related to building, constructing and discussing a reality or anxiety "framed" within a particular point of view. In money and stock market contexts, it is basically a cognitive bias which causes people to react to investment choices differently depending on how these are presented.

The present paper attempts an analysis of the concept of framing both in general terms and also in the specific context of investment behavior. In addition, it explores and addresses framing issues, such as methods and means to prevent framing, with a view to ensuring rational decision making, which is a requirement for a gain-making investment choice.

Framing

Framing is defined as a cognitive heuristic, according to which people tend to draw conclusions based on the framework in which a situation is presented or formed. The term "frame" implies that "the way people behave depends on the way that their decision problems are framed" (Shefrin, 2000). The way a problem or a prospect is presented affects the decisions to be taken. The impact of framing has been repeatedly demonstrated in the decision-making process and depends on one's age, range of knowledge and psychological state. The specific effect violates the standard finance theory of rational choice, which assumes frame independence of the problem, namely, that the framing of a problem does not affect decision making.

To illustrate and understand the framing effect, viewers were asked to answer the following question: "Which of these parallel lines is the largest?"
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![Müller-Lyer, 1889](image)

Most people answered that the bottom line was longer. However, by changing arrow configurations an illusion was created, that the top arrow line was shorter than the bottom one, despite the fact that both lines were of exactly the same length. The test, called the Müller-Lyer illusion, was devised in 1889 and has been often used to demonstrate how our visual perception can be distorted by configurations.

People react differently to similar sets of events if these events are presented in a different manner. Thus, the government tend to address economy issues by emphasizing employment rates whereas the opposition is focused on unemployment rates, and although they both communicate the same information, the impact on public opinion is different (Arkell, 2012).

In 2001, Druckman distinguished the concept of framing in "framing in communication" and "framing in thought". The former involves experimental manipulation, specialized formulation (e.g. the way we ask a question), and the latter a psychological perspective of a situation, a mental representation. The audience reacts differently to different descriptions, even though they may carry the same information.

**Framing and investment choice**

According to the mainstream theory, investors make investment choices depending on the potential profit-making outcomes they may have. Extensive research in psychology has demonstrated that investors tend to treat every decision as unique and isolate each choice from others. This is defined as the effect of narrow framing, where the conjunction of complicated choices are neglected (Kahneman and Lovallo, 1993).

Overall, framing has a great impact on decision making, particularly on stock market decisions. For each investment problem, there are many investment frames (Kumar and Lim, 2008), and when investors make business-related decisions, they adopt the most easily available narrow decision frame (Kahneman 2003). Shefrin (2000) holds that framing is caused by:

- aversion loss
- concurrent decisions
- hedonic editing

Stock exchange investors, according to Shefrin, are susceptible to the concept of loss aversion, aversion to possible loss-making outcomes, aversion to prior losses, which operates like a deforming mirror of future investment choices, and in combination with guilt, causes investors to make safer and more conservative decisions and be risk-averse.

Shefrin (2000) suggests that the decisions investors are called upon to make at the same time, that is to say, concurrently, may not be correlated. The number of investment stock decisions in a short period of time is affected by the investors’ psychological situation. An unbalanced psychological situation, due to anxiety, which is caused by the fact that investors have to act on the decisions they are called upon to make, often leads to hasty, irrational behavior and a shift of preference.

Finally, hedonic editing involves the strategic decision to organize multiple events in order to hedonically maximize outcomes (Thaler, 1980). The method investors use to process events aims at greater pleasure and satisfaction rather than gains, which is a requirement.

An additional drawback is the fact that individuals commonly tend to frame investments within very narrow deadlines. Investment projects are long-term; investment choice evaluation in narrow time frames results in wrong investment behavior.

A major problem with framing is relaying information for manipulation. Information processing from each individual’s own cognitive point of view may generate varied investment choices. Presenting part of the truth, constantly perceiving and suppressing or underestimating negative outcomes tends to mislead the investing public.

**Preventing framing**

**Information resources and cooperation with market stakeholders**

Relaying information to people is mostly imperfect. Frequently, a part of the news or a part of the truth is communicated, either deliberately or due to ignorance. Thus, an event is perceived differently by various addresses depending on how it is communicated. It is worth highlighting that usually information may be...
deliberately misleading, or corrupt, with a view to distorting or misinterpreting facts, announcements, expected outcomes or outcomes which attempt to mislead addressees, namely, investors.

In addition, a major issue in investment decision making is information resources. Investors are short of time or meanstoefficienciesavailableinformation. Irrespective of confidential information, continuous corporate information flow and events which may affect a company or the stock market progress, deter profit making investment decisions. Gaps in information on issues concerning the vast global market, and particularly, the stock market, can be a significant consideration contributing to framing.

To manage the negative effects of gaps or distortions of information, it is vital that investors cooperate with stock market or investing stakeholders. In addition, full assignment of investment processes in collaboration with competent professionals (investment consultants or analysts), who are knowledgeable (fully qualified, expert and capable of perceiving deliberate information distortion) of the domestic and global investment markets, will deter framing in investment decisions.

Cognitive Reflection Test and Framing

How prospects are presented and affect investment choices may not be salient, either due to poor information or the investors’ irrational thinking and actions. When investors act mainly on impulse, there is less scope for successful data processing. Profit making investments are achieved by rational decision making processes rather than emotional and impulsive actions.

According to the Cognitive Reflection Test (C.R.T.), a cognitive work of reflection, there are two types of cognitive activity, "System 1" and "System 2". The former involves decisions made quickly and rather impulsively without conscious thought, and the latter decisions deriving from slow, thorough examination (Kahneman, Frederick, 2002).

To prevent framing and a set of emotional errors generating non-profit investing decisions, system 2 or a combination of system 1 and 2 have to be activated.

Overall, only processing, analysis, and further reflection of information, events, situations, and, in particular, investing decisions, can generate successful outcomes. Impulsive actions and intuitive judgements are completely irrelevant to profit making and successful investing processes.

Framing awareness

To prevent framing, it is essential that investors and stock market participants be aware and knowledgeable of the specific effect. Framing, similar to any other bias within the framework of behavioral finance, must be first identified and interpreted before it is controlled.

As events are multidimensional and involve various presentations with a viewpoint neglecting or underestimating specific aspects, framing awareness makes investors more cautious, and, thus, capable of better interpreting information or advice, and distinguishing between unbiased and partially or differently presented outcomes. Awareness of framing means and methods enables investors to recognize deceptive behavior and avoid investment traps.

Continuous information on framing and framing progress can contribute to preventing deception and, consequently, nonprofit investing processes.

Controlling emotions

Emotion control during investing decision making processes is one of the major considerations driving to gain outcomes. The pleasure deriving from gain-making investment choice can convince investors that current successful investment decisions can remain in the foreseeable future. In addition, due to the euphoria produced by success and gains, in combination with unjustifiably optimistic behavior, investment information evaluation and, generally, evaluation of future investing perspectives may be banned. Thus, investors themselves may tend to frame general information and underrate unpleasant or negative news about specific investment decisions, or overstate positive outcomes and future positive prospects.

Similarly, unpleasant feelings can also affect investors when investment decisions are risky. Resentment and bitter feelings of failure can produce pessimist and conservative attitudes to investors who, thus, tend to incorrectly filter investing news and information. Investors are also likely to be wrongly convinced that they are deceived and misled, and become too cautious to obtain information. Only by unbiased emotions and by avoiding making any decisions in an emotionally charged situation can framing be deterred.
II. Conclusion

Psychological situation, biases and emotions may cause irrational investment choices and increase risk. Framing is a cognitive heuristic, under which people tend to be led to conclusions based on the "frame," in which a situation has been presented or formed. This framework, the way in which a perspective is presented, has got a significant impact on people's decisions.

In the context of investment decision making, framing is defined as the tendency of investors, in the process of making investment decisions, to respond differently to a choice, based on the way it is presented (formulated). The different ways in which information about a company's performance are framed reflect different investment options.

When framing can be recognized and interpreted, it can also be controlled. When investors are cautious to the cognitive effect at issue, they are able to control and prevent it. On the other hand, when investors’ decisions are made in cooperation with certified stock market professionals or other money market stakeholders, deliberately misleading or imperfect investment information can be discouraged. Partial or no information and inability to recognize fraudulent information generate irrational decisions and make it difficult for investors to address investment problems.

In addition, to prevent framing, it is essential that emotion be controlled. The pleasure deriving from gain-making choices and the dissatisfaction caused by failure can create frames in information and investment decisions. Within this context of emotional euphoria, investors may underestimate unpleasant and negative information and, in the context of dissatisfaction caused by failure, develop too-cautious and conservative attitudes. Finally, impulsive choices can harm rationality; impulsive hasty decisions endorse fraudulent information.

To conclude, the above mentioned processes enable investors not to yield to the cognitive error of framing; on the contrary, they enable them to recognize and cope with deceitful information and, thus, make rational investment decisions, which will drive to gain outcomes.

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Papers

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