Assessment of Corporate Behavioural Finance

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Abstract

Behavioural finance is important at the individual as well as corporate levels. A lot of researches analysing corporate behavioural finance have been made in recent decades. However all are related to solutions of capital or debt financing problems, finding the best possible source of capital increase or the cheapest debt possibility. This article aims to evaluate corporate financial investment decisions made via experts’ survey, trying to assess the main players in financial markets between non-financial companies, taking into consideration portfolio formation, motivation of investments, risk-return relationship, etc. The results show that Lithuanian non-financial companies are not very active in the financial market; they choose less risky (less profitable) short-term investments, keep a considerable amount in cash or time deposits, and strive to accumulate funds from financial investments for implementation of various projects related to their main company activities. Generally service companies, operating for more than five years and with sales volume exceeding 1.45 million Euros per year, are the main players in the financial market among non-financial companies.

1. Introduction

The dominating role of the Efficient Market Hypothesis as a theoretical framework of investing ended with the development of the theory of Behavioural Finance. Since then these two approaches have been in constant conflict with one another. Investment rationality and efficient market ideas clearly contradict with an investor’s psychology and biased behavioural rules. Nevertheless, inefficient access to investment information and long-term market anomalies provide evidence regarding the priority of Behavioural Finance.

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Behavioural finance is important at the individual as well as corporate levels. Usually most researches of corporate behaviour are related to capital structure, budgeting or financing problems. Therefore, this paper aims to assess decision-making features of non-financial entities when they operate in financial markets. The experts’ survey is used seeking to test the following hypotheses:

- Lithuanian non-financial companies are not active in financial markets.
- Short-term investments hold a priority against long-term investments.
- Liquid financial instruments such as deposits or governmental bonds are more popular than riskier securities such as stock or derivatives.
- The motivation for investing is associated with intentions to save financial resources necessary for implementation of projects related to main company activities.
- Big service companies are much more active in financial markets than others.

The first part of the present paper attempts to provide a comprehensive discussion of both Efficient Market Hypothesis and Behavioural Finance in the context of the corporate finance theory. The second part describes expert survey methodology, which allows testing the above-mentioned hypotheses. It also provides final results regarding financial corporate behaviour in Lithuania.

2. Studies on Behavioural Corporate Finance

The term "corporate finance" describes the interaction between company managers and investors and its impact on company value, i.e. the theory of corporate finance tries to explain financial contracts and investment behaviour arising from the interaction between managers and investors (according to this theory, managers should make unbiased forecasts of future events and use them in making decisions that best suit their own interests) (Baker & Wurgler, 2011). According to modern corporate finance business executives and investors act rationally when taking financial decisions. If the assumption of rational behaviour is correct, managers can expect that capital markets are efficient, implying that stocks and bonds are priced correctly at every given moment (stock prices correctly reflect the public information about their fundamental value). According to this theory the behaviour of managers in decision-making will be based on the principle of self-interest (Shah, 2013). Based on the fact that the primary role of the capital market is redistribution of property, which is effective when price helps a fair redistribution of resources, Fama (1970) pointed out that the market was called efficient when prices fully revealed available information.

In terms of the impact of the efficient market theory on corporate financial decisions it should be added that based on this theory it has been customary to assume that information about the securities and the market as a whole spreads very quickly and is reflected in prices of the securities without delay (Malkiel, 2003). Thus, since the end of the twentieth century finished the global domination of the efficient market hypothesis; a significant part of modern economists support the idea that the stock price is at least partially predictable, emphasizing the psychological and behavioural factors of the stock price and arguing that stock prices can be at least partially predictable based on their trends in the past and fundamental analysis (Malkiel, 2003).

Recent literature research has shown that a rational assumption of the behaviour of corporate executives and investors cannot be done in reality (Shah, 2013). Empirical studies have shown that investors taking financial decisions pay attention to peripheral information or “noise” (Black, 1986). In addition it was observed that deviations from rational behaviour are not random but systematic and depend on the approach to risk assessment and uncertainty of future problems of the impact of decision-making (Kahneman & Riepe, 1998).

When the traditional approach to corporate finance is based on the company's value-based management and the three conditions - rational behaviour, the fixed asset pricing model, and efficient markets, the proponents of behavioural corporate finance argue that psychological factors influence the traditional paradigm of the three components (Shefrin, 2001). It is believed that psychological phenomena do not allow decision-makers to act
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