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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 paperis an attempt to make a comprehensive discussionof framing, both of routine everydaydecisions and also ofdecisions made in the specialized context of investment choices. In addition, it discusses methods to preventframing 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 thestandardfinance theory, individuals, particularly investors, always actrationallyin their effort to maximize expected utility and wealth. Their psychological situation, emotions and biasesare not emphasized, as they are considered to have no impact on investment decisions.

The weaknesses and shortcomings of the mainstreamfinance theory have led to aconsiderable interest in anapproach focusing oninvestmentbehavior,which has come to complement and contradict the traditional and outdatedapproach.

Behavioral Finance is a new financial investment paradigm, anincreasinglydevelopingdiscipline,whichhasemerged from the study of economy on the basis of psychology. It attempts to interpret investment irrationality by discussing the social psychological considerationsunderlying investment behavior.

The framing effect is among themajor considerations which are likely togenerateirrationalinvestmentbehavior. 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 presentpaperattempts an analysisofthe concept of framingbothin general termsand also in the specific context of investment behavior. In addition, itexploresandaddresses 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 demonstratedas one of the majorbiases 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 framingeffect, viewers were asked to answer the following question: "Which of these parallel lines is the largest?"

Müller-Lyer ,1889

Most people answered that the bottom line was longer. However, by changing arrow configurationsan illusion was created, that the top arrow line wasshorter than the bottom one, despite the fact thatboth lines wereofexactly 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 toaddresseconomyissuesbyemphasizing employment rates whereastheopposition is focused on unemployment rates, and although they bothcommunicate the sameinformation, the impact on public opinion is different (Arkell, 2012).

In 2001,Druckmandistinguishedthe concept of framing in " framing in communication" and " framing in thought". The formerinvolves experimental manipulation, aspecialized 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 thougheachmay carry the same information.

Framing and investment choice

According to the mainstream theory, investors make investment choices depending on thepotential profit-making outcomesthey may have. Extensive research in psychology has demonstrated that investorstend to treat every decision as unique and isolate each choice from others. This is defined as theeffect of narrow framing,whereinthe conjunctionsofcomplicated 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, aresusceptible to the concept of lossaversion,aversionto possible loss-making outcomes, aversion to prior losses,whichoperates like a deforming mirroroffutureinvestment choices,and,in combination with guilt, causes investors to make safer and moreconservativedecisions 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, irrationalbehaviorand a shift of preference.

Finally, hedonic editinginvolves the strategic decision to organize multiple events in order to hedonically maximizeoutcomes (Thaler, 1980). The method investors use to process eventsaimsatgreater pleasure and satisfaction rather thangains,which is a requirement.

Anadditionaldrawback 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 wronginvestingbehavior.

A major problem with framing is relaying information for manipulation.Informationprocessing from each individual's own cognitive point of view may generatevaried investment choices. Presenting part of the truth, constantly perceiving and suppressing or underestimating negative outcomestends to mislead the investing public.

Preventingframing

Information resourcesand cooperation with market stakeholders

Relaying information to people is mostly imperfect. Frequently, a part of the newsorapart of the truth is communicated, either deliberately or due to ignorance. Thus, an event is perceived differently by various addresseesdependingonhow it is communicated. It is worth highlightingthatusuallyinformationmay be deliberately misleading, or corrupt, with a viewtodistortingormisinterpreting facts, announcements, expected outcomes or outcomeswhich attemptto mislead addressees, namely, investors.

In addition, a major issue in investment decision making is information resources. Investorsare short of time or meanstoaccessavailableinformation. Irrespective of confidential information, continuouscorporate information flowand events which may affect a company or the stock marketprogress,deterprofit making investing decisions. Gaps in information on issues concerningthe vast global money market,andparticularly, the stock market, can be a significant consideration contributing toframing.

To manage the negative effectsofgapsor distortionofinformation,it is vital that investors cooperatewith stock market or investing stakeholders. In addition, full assignment of investment processesor collaboration with competent professionals (investment consultants or analysts), who are knowledgeable (fullyqualified, expert and capable of perceiving deliberate information distortion) of the domestic and global investingmarkets,willdeterframing in investment decisions.

Cognitive Reflection Test and Framing

Howprospectsare presented and affect investment choicesmay not be salient,either due to poor information ortheinvestors' irrational thinking and actions. When investorsactmainly on impulse, there is less scope for successful data processing. Profit making investments are achievedbyrational 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 quicklyandrather impulsively without conscious thought, and the latterdecisionsderiving from slow,thoroughexamination (Kahneman, Frederick, 2002).

To prevent framing and a set of emotional errors generatingnon-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,inparticular,investingdecisions,cangenerate 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, similarto any other bias within the framework of behavioral finance, must be first identified and interpreted before it is controlled.

As events aremultidimensionalandinvolve various presentationswith a viewtoneglecting or underestimatingspecific aspects, framing awareness makes investors more cautious, and, thus, capable ofbetterinterpreting information or advice, anddistinguishingbetweenunbiasedandpartially or differently presentedoutcomes. Awarenessofframingmeansand methodsenablesinvestors to recognizedeceptivebehaviorand avoid investment traps.

Continuous information on framing and framingprogress can contribute topreventingdeceptionand,consequently,nonprofit investing processes.

Controlling emotions

Emotion control during investing decision making processesis one of the majorconsiderations driving togain outcomes.The pleasurederivingfroma 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 bysuccess and gains, in combination withan unjustifiably optimistic behavior,investmentinformationevaluationand, generally, evaluation of future investingperspectivesmay 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 decisionsarerisky. Resentment and bitter feelings of failure can producepessimist and conservative attitudes to investors who, thus,tend to incorrectly filter investing news and information. Investors arealsolikely to be wrongly convinced that they aredeceived and misled,andbecome toocautioustoanyinformation.Only by unbiased emotions and by avoiding making any decisions inemotionally chargedsituations can framing bedeterred.

II. Conclusion

Psychological situation, biasesandemotionsmaycauseirrationalinvestment choices and increaserisk.Framingis 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 performanceare framed reflect different investment options.

When framing can be recognized and interpreted, it can also be controlled. When investors are cautiousto the cognitive effect at issue, they are able tocontrolandpreventit.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. Partialor no information and inability to recognizefraudulent information generateirrationaldecisionsand make it difficult for investorstoaddress investment problems.

In addition, to prevent framing,it is essential that emotion be controlled. The pleasure deriving fromgain-makingchoicesandalsothe 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,developtoocautious and conservativeattitudes.Finally, impulsivechoices can hamper rationality; impulsiveor hasty decisions endorse fraudulentinformation.

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

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