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Islamic and Conventional Behavioral Finance: A Critical Review of Literature

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Abstract. The purpose of this study is to critically analyze existing literature on behavioral finance and to draw conclusions and recommendations for future studies in this area. The study is based on a critical review of the literature of Islamic and conventional behavioral finance. The findings reveal that investors are affected by psychological and social factors toward their financial decision-making process with respect to investment and choosing a particular financial product. The paper concludes that Islamic behavioral finance is a relatively new and efforts are needed to advance work in this area compared with the more advanced conventional behavioral finance. Behavioral issues are, however, gaining considerable attention from a broad spectrum of investors, especially those in the Muslim world.

Keywords: Finance, Psychology, Behavioral Finance, Islamic Finance.

KAUJIE Classification: G 5

1. Introduction

Traditional finance theories have been dominant in explaining financial market trends since the mid-1950s. Two main theories are worth mentioning: Modern Portfolio Theory (MPT) and the Efficient Market Hypothesis (EMH). MPT suggests strategies and techniques for selecting an efficient portfolio for investment for maximizing profit and minimizing risk. On the other hand, EMH assumes that financial markets are efficient and investors act rationally in making their financial decisions and act based on full or relevant information about market prices to maximize their profit and other objectives (Misal, 2013).

However, market bubbles, stock crashes and financial crises have shown that market information is not always perfect and that traditional finance has a poor track record in explaining financial market trends and stock price movements. In addition, there is also evidence that fund managers are subject to heuristics and biases and their investment patterns tend to follow market price trends (MacCowan & Orr, 2008). Efficient market theory has been a major point of disagreement between traditional and behavioral finance advocates in their search for a better understanding of finance and its theoretical underpinnings (Godoi, Marcon, & da Silva, 2005).

Scholars have attempted to identify alternative finance approaches which take into account the influence of psychology and other social sciences in order to be able to provide better interpretation of investors' behavior while making portfolio selection decisions. As a result of this search, behavioral finance emerged as an alternative to conventional finance in the late 1970s, highlighted by the key work of Kahneman and Tversky (1979).

Behavioral finance still remains an emerging field of study. It investigates the role of psychology and other social factors in investors' decision-making process (Kourtidis, Sevic, & Chatzoglou, 2011). Over the last three decades, however, it has become an important finance theory especially with regard to interpreting investors' behavior in financial decision-making processes. It has received great attention from academicians, professionals and practitioners alike. However, while the theory is gaining popularity, it is still considered young. Much effort is needed to develop a framework for the study of behavioral issues in finance especially due to the incompatibility of assumptions made compared to traditional finance theory and lack of sufficient research to find substitute theories (Godoi, Marcon, & da Silva, 2005).

The main aim of the paper is to critically review the existing studies in the field of both Islamic and conventional behavioral finance and to analyze their main features. The remainder of the paper is organized as follows: Section two critically reviews the selected literature in both Islamic and conventional behavioral finance, while the third section discusses some issues arising from that review. The last section reports the limitations of the study and makes some recommendations for future studies in this area of research.

2. Literature Review

2.1 Conventional Behavioral Finance

There is an enormous literature in the field of behavioral finance that explores the influence of psychology and other social factors on investors' behavior toward their financial choices. This section highlights some interesting recent findings from this literature. For instance, Bailey, Kumar and Ng (2011) examine the effect of behavioral partialities for mutual fund choices. They test: attention to news, tax awareness, fund-level familiarity, behavioral and demographic characteristics using factor analysis, correlations and descriptive analysis. The factor analysis suggests that investors often conform to a stereotype that can be characterized as a gambler, overconfident, narrow framer or immature.

To highlight the role of overconfidence and risk perception in investors' decision-making process, Broihanne, Merli and Roger (2014) study risk perception, overconfidence, risk-taking and expectations employing descriptive statistics and the GLW (Glaser Langer and Weber measure. They find that respondents appear to be overconfident in their attitude towards both financial market and stock price trends. They are also overconfident in forecasting future stock prices. The risk that they are willing to assume is positively influenced by this overconfidence and optimism and negatively influenced by perceptions of risk. However, the stock return volatility anticipated is, in most cases, an insignificant determinant of the risk that investors are ready to assume.

In an in-depth analysis of the influence of behavioral factors on investors' decision-making process, Kourtidis, Sevic and Chatzoglou (2011) group investors into three main categories: high profile investors, moderate profile investors and low profile investors based on their psychological preferences and personality traits in order to examine whether, and how, these preferences and traits drive their behavior. They examine overconfidence, risk-tolerance, self-monitoring and social influence by using descriptive analysis, ANOVA and independent sample t-test. The results show that the higher the investors' profile in risk-taking, the higher will be the performance of these investors on stock trading.

In the context of the Nigerian Stock Market, Babajide and Adetiloye (2012) examine behavioral preferences among stock market investors and their effects on stock market performance. They study the following variables: overconfidence, loss aversion, confirmation bias, framing, anchoring, status quo bias and myopic loss aversion. Their results indicate that there is strong evidence for behavioral partialities, but it is not so dominant in the case of the Nigerian market. This is due to the existence of a negative relationship between behavioral preferences and stock market performance as indicated using correlation techniques and Pearson product moment coefficient as the main tools of analysis.

To investigate the performance of day-traders in the Taiwanese futures market, Kuo and Lin (2013) examine overconfident individual day-traders using descriptive statistics. Their results indicate that day-traders are not only overconfident about the accuracy of their information, but are also mistaken in their interpretations of information. This is one of the few studies in behavioral finance that used secondary data in order to investigate psychology and other social factors on investors' decision-making process and their results are in line with the findings of other studies based on primary data.

To study whether investors' personality and perceptual biases influence their decision-making process in the Tehran Stock Market, Sadi, Asl, Rostami, and Gholipour (2011) investigate the above relationship examining overconfidence bias, availability bias, escalation of commitment, randomness bias and hindsight bias and their influence on investors' personality in relation with respect to their financial decision-making employing parametric analysis and correlation. Their findings indicate that there is a significant correlation between perceptual partialities and investors' personality traits.

Onsomu (2014) aimed to identify behavioral biases in the case of investors on the Nairobi Securities Exchange. They investigate the relationship between gender and other behavioral biases, such as availability bias, representativeness bias, confirmation bias, disposition effect and overconfidence bias using descriptive statistics and Pearson chi-square technique as an instrument of analysis. They conclude that investors were affected by availability bias, representativeness bias, confirmation bias and disposition effect. However, there is no significant effect between the overconfidence bias and availability bias, representativeness bias, confirmation bias, disposition effect and overconfidence bias and gender effects.

For the purpose of comparison some studies compare the differences between psychological , social and microeconomic factors to analyze which best explains investors' behavior. Islam (2012) studied the most influential factors from the above three categories in investors' decision-making process by testing the following variables: over-confidence, availability bias, representative bias, anchoring bias, loss aversion, regret aversion, mental accounting bias, Using the Dhaka Stock Exchange as a case study. Descriptive statistics and factor analysis were used for the analysis. The author conclude that psychological factors were the most influential factors among the three categories in investor's decision-making process.

From the above evidence it can be concluded that psychological factors are the most influential factors in investors' decision-making process compared to social and microeconomic factors. However, to rank the most influential psychological factors toward investors' decision-making process, Dharmaja, Ganesh and Santhi (2012) study the influence of the following variables: self-image/firm-image, co-incidence, accounting information, neutral information, advocate recommendations, personal financial needs, investor's financial tolerance, emotional risk tolerance and financial literacy to figure out the level of influence of various psychological factors on individual investor's behavior using the case of Geojit BNP Paribas Financial Service Ltd, Coimbatore, India. Their results, using descriptive and chi-square tests, indicate that accounting information is the most influential factor on individual investor's behavior.

To measure the relationship between the color of credit cards and their shape and psychological and other social factors, Kiyilar and Acar (2009) study overconfidence, anchoring and sticking, protection against uncertainty, protection against loss, preventing loss, regret, monetary illusion, gender, marital status, age, education level, and financial information. They also try to find out whether or not such behavior differed on the basis of demographical parameters in a number of banks in Istanbul. They employ the chi-square test for their analysis. The results indicate that women mostly preferred red credit cards while men preferred blue cards. No dependency relation was observed between any other demographical parameter and the color of credit card or their shape.

Table (1). Selected conventional studies on behavioral finance.

Author(s)/Year	Variables Studied	Type of Data/ Sample	Methodology
Dharmaja, Ganesh & Santhi (2012)	Self-image firm-image co-incidence, accounting information, neutral information, advocate recommendations and personal financial needs.	Questionnaire 200 Investors of Geojit BNP Paribas Financial Service Ltd, India	Descriptive and Chi-Square Test.
Islam (2012)	Over-confidence, availability bias, representative bias, anchoring bias, loss aversion, regret aversion, mental accounting bias	Questionnaire 312 of Dhaka stock market individual investors	Descriptive Statistics and Factor Analysis
Kıyılar & Acar (2009)	Over-confidence, anchoring and sticking, protection against uncertainty, protection against loss, preventing loss, regret, monetary illusion, gender, marital status, age, education level, and financial information.	Questionnaire 130 of credit card users in Istanbul city banks	Chi-Square Test For Independence
Sadi, Asl & Rostami (2011)	Overconfidence bias, availability bias, escalation, randomness bias and hindsight bias.	Questionnaire 200 of the investors in Tehran's stock market	Parametric Analysis and Correlation
Babajide&Adetilo (2012)	Overconfidence, loss aversion, confirmation bias, framing, anchoring, status quo bias and myopic loss-aversion	Questionnaire 300 of investors in Nigeria security market	Correlation and Pearson Product Moment Coefficient.
Onsomu (2014)	Availability bias, representativeness bias, confirmation bias, disposition effect and overconfidence bias	Questionnaire 58 of Nairobi Securities Exchange	Descriptive Statistics, Pearson Chi-Square test.

Author(s)/Year	Variables Studied	Type of Data/ Sample	Methodology
Bailey, Kumar & Ng (2011)	Attention to news, tax awareness, and fund-level familiarity bias, behavioral and demographic characteristics.	Monthly portfolio positions data Thousands of brokerage accounts of US individual investors.	Factor Analysis and Cross–Correlations
Broihanne, Merli & Roger (2014)	Risk perception, overconfidence, risk attitude, risk-taking and expectations.	Interview and Questionnaires Interviewed 64 high-level professionals and 61 questionnaires from CCR [??] Asset Management, Paris.	Descriptive Statistics and the GLW Measure.
Kourtidi, Sevic & Chatzoglou (2011)	Overconfidence, risk tolerance, self-monitoring and social influence	Questionnaire 345 investors (Individuals and professional) in Greece.	Descriptive analysis, ANOVA Test and Independent Sample T-Test.
Kuo and Lin (2013)	Overconfidence	Day Traders data in Taiwan Futures Market Sample: 3470 individual day traders in Taiwan futures market.	Descriptive Statistics.

2.2 Islamic Behavioral Finance

Islamic behavioral finance is seen to be an important field that can play a vital role in explaining investors' behavior toward their decision-making process. In this regard, some studies have been undertaken to measure the influence of psychology and other social factors on investors' behavior toward financial decision-making process and their intention to invest. Ali Zani and Kasim (2014) investigate the influence of attitude, social influence and perceived behavioral control on investors' intention to invest in the Malaysian Islamic unit trust industry employing Structural Equation Modeling (SEM) as the analysis instrument. Their results highlight that attitude and perceived behavioral control have significant and positive influence on investors' intention to invest in Islamic unit trusts.

For the same purpose, Structural Equation Modeling (SEM) was employed to examine the role of attitude, subjective norms, perceived behavioral control and moral norms on investors' intention to invest in socially responsible investments (SRI) in Malaysia by Adam and Shauki (2014). They found that attitude, subjective norms and moral norms were positively correlated to the intention to invest in SRI.

In the same market, but in a different sector, namely, Islamic credit card products, Amin (2014) explored factors that influence Malaysian bank customers toward their choice of Islamic credit cards applying the Theory of Reasoned Action (TRA) using Partial Least Squares (PLS) and factor analysis. He investigated the following variables: attitude, subjective norm and perceived financial cost in relation with intention to choose Islamic credit cards. He concluded that attitude, subjective norm and perceived financial cost significantly influenced the intention to choose Islamic credit cards in Malaysia.

Also within the Malaysian environment, but in the context of Islamic home financing products, Amin, Abdul-Rahman and Abdul-Razak (2013) investigate the effects of subjective norm, relative advantage, simplicity, compatibility and perceived behavioral control on Islamic home financing in Kota Kinabalu City, East-Malaysia using an integrated theory: TPB (Theory of Planned Behavior) and the IDT (Innovations Diffusion Theory) and PLS as a tool for analysis to examine the hypothesized relationships among different constructs. They use an integrative approach and find that it is valid in the case of Islamic home financing in Malaysia. However, their results do not support the effect of compatibility on attitude toward Islamic home financing. They also report that attitude does not govern the relationship between compatibility and Islamic home financing in the case of Malaysia.

From a regional perspective, Sun, Goh, Fam and Xue (2012) study the effects of religious commitment on Southeast Asian young adults' intention to adopt Islamic mobile phone banking using a Technology Acceptance Model (TAM). They examine the following variables: religious belief and commitment, perceived self-expressiveness, subjective norm, perceived financial cost, perceived credibility and perceived usefulness toward intentions to adopt Islamic mobile banking services. They conclude that religious belief and commitment are positively correlated with the intention to adopt Islamic mobile banking services.

In the Islamic insurance industry (*takāful*), an emerging sector in Islamic finance, Echchabi, Olarogun and Azouzi (2014) examine uncertainty, relative advantage, compatibility, social and awareness influence on Tunisian customers to adopt Islamic insurance using SEM and one-sample t-tests in order to determine factors that influence their decision-making process. Their results indicate that Tunisian customers are willing to adopt Islamic insurance services.

To examine the importance of religious influence on stock investors' behavior, Bialkowski, Etebeari and Wisniewski (2012) study the stock returns for 14 Muslim-majority countries: Bahrain, Jordan, Indonesia, Egypt, Kuwait, Malaysia, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Tunisia, Turkey and United Arab Emirates over 1989–2007, during the holy month of Ramadan, using daily equity return data and ten different testing techniques including pooled OLS and panel estimations. Their conclusion is that stock returns during Ramadan are significantly higher and less volatile compared to stock returns in the rest of the year. Furthermore, they highlight that Ramadan positively affected investors' psychology and promotes feelings of solidarity and social identity among Muslims worldwide leading to optimistic beliefs that extend to investment decisions due to changes in investors' psychology.

For the same purpose, but in a single country study, Canepa and Ibnrubbian (2014) investigate the effect of religious beliefs on stock price movements in the Saudi Arabian Stock Market using descriptive analysis and stochastic dominance analysis. Their findings indicate that religious tenets influence investors' behavior toward their selecting investment portfolio. Therefore, they reach the conclusion that the traditional finance is not that good at explaining stock price trends. Behavioral finance theories are more helpful to understand stock volatilities in the Saudi Arabian market.

Wahyuni (2012) studies factors that influence the Muslim community's behavior toward acceptance of Islamic banking services in Surakarta, Indonesia. Using factor analysis and hierarchical regression methods they test: attitude, social influence, and knowledge with regard to the acceptance of Islamic mobile money services. The results indicate that attitude and knowledge significantly influence the Muslim community's behavior towards Islamic banking services, while social influence is also found to be a significant factor in the early stages of testing.

In order to measure the level of acceptance of E-Syariah[1] Portal services in Malaysia, Yahya, Nadzar and Abdul Rahman (2012) study the factors that influence the intention to use the E-Syariah Portal They investigate the following variables: performance expectancy, effort expectancy, social influence, self-efficacy, anxiety, attitude, behavioral and facilitating conditions in addition to gender, age, experience, and voluntariness variables. They apply the unified theory of acceptance and use of technology (UTAUT). They conclude that performance expectance, effort expectancy, social influence, information and system quality, religion and belief are strongly correlated with intentions to use E-Syariah Portal Service in Malaysia.

Table (2). Selected Islamic studies on behavioral finance.

Author(s)/ Year	Variables Studied	Type of Data/ Sample Size	Methodology
Adam & Shauki (2014)	Intention, attitude, subjective norms, perceived behavioral control and moral norms.	Questionnaire 713 of Malaysian Investors	Structural Equation Model
Ali, Zani and Kasim (2014)	intention ,attitude, social influence and perceived behavioral control	Questionnaire 172 of Universiti Teknologi Mara(UiTM) academic staff in Malaysia	Structural Equation Model
Amin (2013)	Attitude, subjective norm and perceived financial cost in relation with intention to choose Islamic credit cards	Questionnaire 257 of bank customers in Labuan, Eastern-Malaysia.	Theory of Reasoned Action
Sun, Goh, Fam, &Xue (2012)	Religious affiliation and commitment, Perceived self-expressiveness, Subjective norm, perceived financial cost, perceived credibility, perceived usefulness and Intention to us	Questionnaire 30 of Southeast Asian young adults.	Technology Acceptance Model
Echchabi, Olorogun, &Azouzi (2014)	Uncertainty, relative advantage, compatibility, social influence, and awareness toward adoption of Islamic Insurance Service	Questionnaire 66 of Tunisian customers	Structural Equations Model

(1) The term Sharīʿah is sometimes spelled Syariah in Malaysia.

Author(s)/ Year	Variables Studied	Type of Data/ Sample Size	Methodology
Białkowski, Etebari, & Wisniewski (2012)	Ramadan as religious belief factor in relation with stock returns.	Daily Equity Return Data (1989-2007) Fourteen predominantly Muslim countries	Pooled OLS and Panel Estimations.
Wahyuni (2012)	Attitude, social influence, behavior intention, knowledge.	Questionnaire 198 Muslims from Surakarta, Indonesia	Factor analysis and hierarchical regression methods
Yahya, Nadzar, & Abdul Rahman (2012)	Performance expectancy, effort expectancy, social influence, self-efficacy, anxiety, attitude, behavioral intention, facilitating conditions, gender, age, experience and voluntariness toward E-Syariah Portal Service.	Questionnaire 35 of users of e-Syariah Portal.	Unified Theory of Acceptance and Use of Technology.
Canepa & Ibnrubbian (2014)	Religious beliefs in relation to stock prices	Daily Closing Prices Data Saudi Stock Market	Descriptive Analysis and Stochastic Dominance Analysis
Amin, Abdul-Rahman, & Abdul-Razak (2013)	Subjective norm, relative advantage, simplicity, compatibility and perceived behavioral control toward Islamic home financing adoption.	Questionnaire 237 of non-house owners of Islamic banks and bank customers in Kota Kinabalu, East-Malaysia	Integrated Method: TPB and the IDT models

Source: Compiled by authors

3. Discussion of Some Issues

Based on the above literature, a number of observations can be made. First of all, the studies focusing on behavioral finance investigate partialities of *actual* investors while the studies on Islamic behavioral finance mainly focus on *intentions* to invest or *perceptions* about Islamic investment. This might be mainly due to the longer history of traditional behavioral finance and the considerable number of empirical studies addressing these preferences. It might also be due to the nature of conventional finance which does not have an agreed single underpinning theory. In contrast, behavioral Islamic finance is a relatively new area of study since the industry itself is new. Hence, the corresponding data may not have been sufficient to conduct comparable studies andthis has also probably restricted the use of advanced statistical tools in Islamic finance studies.

Islamic behavioral finance studies mainly focus on the theory of planned behavior dimensions such as perceived behavioral control, subjective norms, etc., while traditional behavioral finance studies focus on ‘specific’ behavioral patterns and preferences. This is due to the same reasons as mentioned above. At this stage it is of prime importance to highlight that a comprehensive framework of behavioral finance is required rather than merely applying psychological theories of social behavior that are rooted in classic human behavior and not verified against the Islamic paradigm.

As a result of the above observations, most of the studies on behavioral finance are currently conducted in a conventional context. Hence, there is an urgent need for the development of Islamic behavioral finance theory and to establish a comprehensive framework for such studies based on Islamic principles. More importantly, future studies on Islamic behavioral finance should adopt Islamic theories applied to financial behavior.

4. Conclusion

The main purpose of the study is to critically analyze the existing literature on behavioral finance (Islamic and conventional). The literature reveals that investors’ behavior is affected by psychology and other social factors in their financial decision-making process or toward their intention to invest. The study also highlights that Islamic behavioral finance has so far investigated non-users of Islamic products at the time of study to check whether they are willing to invest or use Islamic products, while conventional studies investigate the behavior of investors already engaged in stock market or fund investments.

In general, the literature indicates that behavioral finance is an important development in financial theory. It plays a crucial role in understanding investors’ behavior towards financial decision-making or intentions to use a particular product for investing or usage. Even though the theory is gaining popularity, much work needs to be done to integrate behavioral with mainstream finance theories. Behavioral finance theories are not compatible with the assumptions of traditional finance theories but they have not (as yet) supplanted the traditional approaches. The reviewed literature highlights that Islamic behavioral finance is still in its early stage of development. It needs to cover a lot of distance to reach a stage comparable to its conventional counterpart. Moreover, it does not yet test the behavior of investors already involved in Islamic investments.

It is noteworthy that conventional behavioral finance heavily focuses on understanding financial market anomalies and the reasons investors behave contrary to rational assumptions. A comprehensive framework of behavioral finance is currently missing due to these anomalies. In contrast, Islamic behavioral finance resaerchers are in a strong position to establish such a framework based on Islamic principles that are universally agreed upon. This would subsequently contribute to the understanding of the behavior of Muslim investors and depositors. This in turn will assist in the further development of Islamic banking and finance across the globe.

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