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Understanding and Evaluating Peer Effect on Financial Decision Making Process

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Abstract

Financial decision making process is very much affected by peer effects which mean that decisions taken by the investors are widely affected by the relation with their friends, relatives, neighbours and colleagues. In this study, independent variables such as business communication, social learning, social utility etc and dependent variable, profitability was taken for the study. Primary data is collected using questionnaire from selected respondents. T-test is applied to find out whether social learning, social utility and business communication affects profitability of a business. From this study it was found that there was strong peer influence for the successful organizations.

Keywords: Peer effects, social utility, social learning and business communication.

INTRODUCTION

Peer Effects can be referred to a state where a firm takes a specific action completely in response to its peers. It is the change in individual's behaviour due to the influence of friends, relatives and colleagues. When an individual's behavior is directly influenced by the actions of each other, peer influence is very attractive. Humans have an inclination to follow the paths which are made by their friends, colleagues, relatives etc. They advance their affairs through imitating others. Empirical evidence shows that individual behavior is influenced by the behaviour of their peers. Many studies have been conducted about peer effects, focusing mainly on the American scenario. But, peer effects occur in all countries, irrespective of the culture, language and financial capacities though empirical evidence is limited. According to Social Psychology, when people are not able to make accurate action, they have a tendency to follow others. Humans having similar problems and options make similar choices consequently.

Review of Literature

Leonardo Bursztyn, Florian Ederer, Bruno Ferman and Noam Yuchtman, highlights the fact that when a person buys an asset or property, his peers will also want to buy it. This is due to social learning and social utility from the asset in their study "Understanding Peer Effects in Financial Decisions: Evidence from a Field Experiment"

Sandro Ambuehl, B. Douglas Bernheim, Fulya Ersoy, and Donna Harris throws light in their study on "Peer Advice on Financial Decisions: A case of the blind leading the blind?" on the fact that people do not just imitate others who are better than them, but also make decisions in a better way.

Cyrus Aghamolla. Richard T. Thakor on IPO Peer Effects throws light on the firm's becoming public, after following an R&D competitor.

Mark T. Leary and Michael R. Roberts shows that peer effects play a significant role in the finding out the capital structure of a firm. It is found that less successful small firms follow successful and large firms in their study “Do Peer Firms Affect Corporate Financial Policy?”

Jiawei Wang, Bachelor of Economics, Shaanxi Normal University, Master of Science, State University of New York at Buffalo shows that the economic policy is highly related with peer effects in his study.

Hojun Seo, Krannert School of Management, Purdue University made a study on Peer Effects in Corporate Disclosure Decisions, suggests that the behaviour of individual members is influenced by the behaviour of the group.

Isma Zaighum and Dr. Mohd Zaini Abd Karim, Othman Yeop Abdullah Graduate School of Business (OYAGSB), University Utara Malaysia conducted a study on Peer Effects, Financial Decisions, and Industry Concentration, which shows how much the concentration of industries are affected by peer pressure.

Muhammad Mudassar Anwar, Arshad Hassan and Filza Hameed on “Peer Effect in Firms’ Financial Decision Making: Evidence from Corporate Capital Structure” shows how much the effect of the financial decisions of peers helps to find out the capital structure of a firm.

Kwangho Park, Insun Yang and Taeyong Yang have conducted a study on the peer-firm effect on firm’s investment decisions. Investment strategies, industry competitions are studied by this group. It was found that dependency on the investment decisions are more for financially constrained firms.

Shenglan Chen, School of Economics and Management, Inner Mongolia University, China and Hui Ma, School of Accountancy, Shanghai University of Financial and Economics, China on Peer effects in decision making: Evidence from corporate investment, shows that when firms get more information and disclosures, more will be the peer effects.

Thi Anh Nhu Nguyen and Kieu Minh Nguyen have conducted a study on Role of Financial Literacy and Peer Effect in Promotion of Financial Market Participation: Empirical Evidence in Vietnam. This study shows that financial market participation is highly related with financial literacy level as well as peer effects.

Research Gap

Though peer effects are very much lively in our country, a very few studies have been conducted in Indian financial market relating to peer effects. Most of the studies are based on western scenario, mainly on American companies. In India, most of the businessmen take the financial decision depending upon the peers. Even if, they have the ability to take their own decision, they spend their time and effort to collect information from their friends, colleagues and relatives. Peer pressure is a driving force in influencing decisions and habits, especially for the business people who lack financial experience may also go after the decisions of their peers. Proper studies should be conducted about individual peer effects as well as industry peer effects in Indian financial market.

Scope of the study

Peer effects study should be conducted in Indian financial market for the benefit of business men. Most of the businessmen take the financial decision depending upon the peers. They spend their time and effort to collect information from their friends, colleagues and relatives. Proper studies about peer effects in Indian scenario will be very useful, at present as well as for future. This will help the individuals as well as the industry, when peer effects of Indian financial market are studied. Similarly the study about behavioural phenomenon like herd behaviour, prospects theory, mimicking, overconfidence, disposition effect, narrow framing etc will be very much beneficial.

Statement of the problem

The problem to be studied is about the loss incurred to many investors who relied on peer pressure. When peer effects are taken in the right sense only, the benefits out of peer effects can be obtained. If the information from peers is just imitated, without making a proper study and comparison about the features of our business and that of our peers, it may be stepping into the wrong path. Instead, the pros and cons of the business should be studied and compared with that of the peers and decision should be taken whether the information can be taken. If the scenario of our business is entirely different from the peer's business, second thought should be made whether to accept the information from peers or not.

Objects of the Study

1. To study and evaluate behavioural phenomenon related with the peer effects

2. To study the social utility and social learning related with peer effects

3. To measure the level of peer information affecting the profitability of the business

Hypothesis Testing

T test is applied to make the hypothesis whether peer effects have significance in profitability of a business.

Independent variables taken for the study are: Business communication, social learning, and social utility. Dependent variable taken for the study is the profitability of the business. Primary data is collected using questionnaire given to selected respondents who are doing different types of business.

H0 [Null Hypothesis] – there is no significance of peer effects in profitability of a business

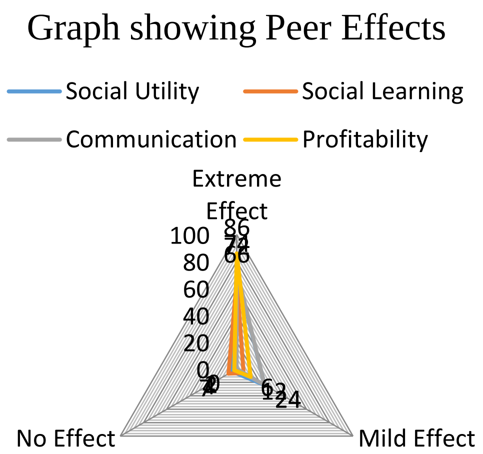
H1 [Alternate Hypothesis] - there is great significance of peer effects in profitability of a business

TABLE SHOWING p VALUES		
Variables	One Tailed Test	Two Tailed Test
Social Utility and Profitability	0.50	1.00
Social Learning and Profitability	0.217656	0.435312
Communication and Profitability	0.466213	0.932426
Social Utility and Social Learning	0.184416	0.368831
Social Learning and Communication	0.237625	0.47525
Social Utility and Communication	0.370901	0.741801

Analysis

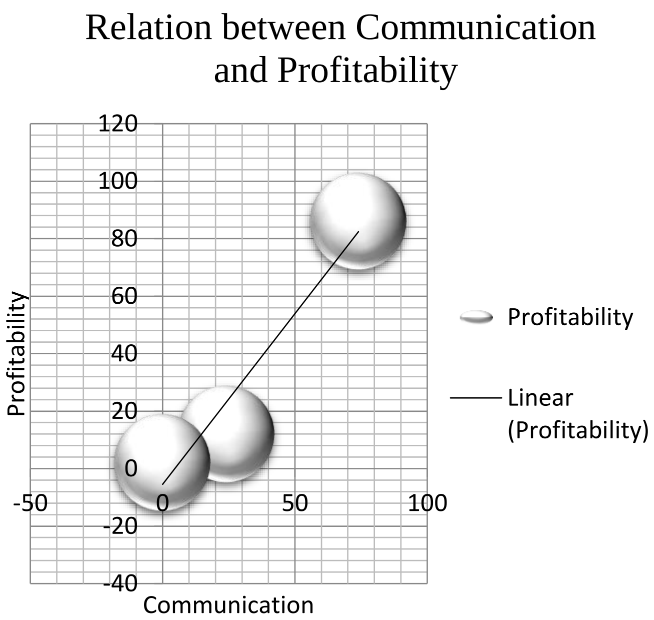
This study was made to understand the level influence of peers in financial decision making process. Data was obtained from business people in and around Ernakulam district, doing different types of business. T- Test was conducted using the data and it can be observed that p values in one tailed as well as two tailed tests are greater than 0.05. Thus the null hypothesis that there is no significance in peer effects is rejected and the significance in peer effects is accepted. The study gives evidence that most of the investment decisions are affected by peers.

The relation among social utility, social learning and decision making are studied using radar graph. From the study, data regarding the extreme effect due to social utility was 72%, social learning was 66%, communication was 74% and the profitability was 86% which shows the significance of peer effects in a business.

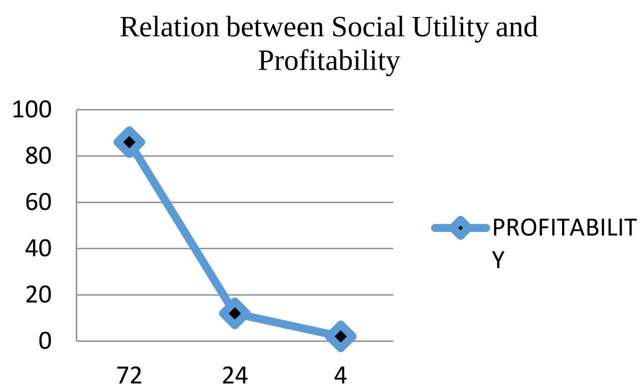


The radar graph indicates the relation among social utility, social learning, communication and profitability. Thus, it can be inferred that the magnitude of peer effects is very much in the case of financial markets, especially in times when the financial information is intricate and problematic.

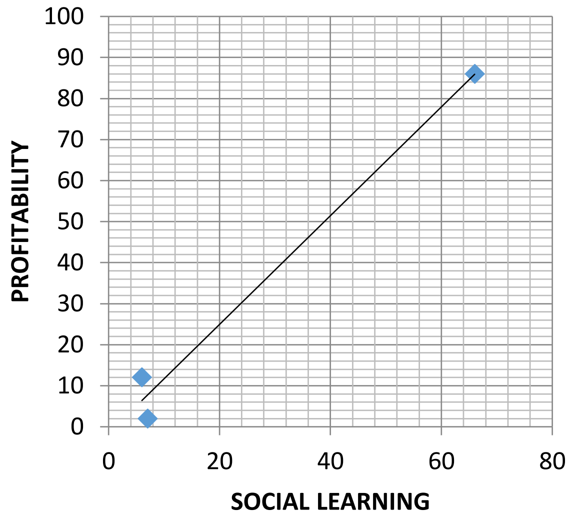
The relationship between communication and profitability is shown using the bubble diagram. Thus, it can be stated that communication with peers augments the profitability of the business. The payback of communication can be seen in the financial decision making process of many firms, who are not experts in making judgments. Relationship among people of various walks of life helps decision making process.



Considering the relation between communication and profitability, an inference is obtained that the higher the communication with the peers, the more profitability will be. The information obtained from the study makes this fact obvious. Communication with the peers is very much connected with profitability of a concern. When the communication with the peers increase, better decisions can be taken which in turn increases profitability. Social pressure plays an important part in the financial decisions taken by a person due to his immaturity and the complexity in making such decisions. Conditional randomization of people is benefited by peer groups here. When the peer group behaviour is scrutinized and a discussion on a subject which is related to our financial decision is conducted, communication becomes helpful to make a proper financial decision.



The importance of social utility and how much it supports profitability can be noted here, from the above graph. When the investors realize the importance of social utility, it increases the profitability of the concern.



Social learning has a lot to do with profitability which is made clear in the above chart. When the investors are thoughtful whereby more magnitude is given to social learning, they could get more profitability. A fact from the study is uncovered that social learning is a driving force out that cause pee effects to a greater extent. The reason for social learning is the fact that information needed for the creation of financial decisions is costly. Here people are persuaded by the information from their peers as well as their own information regarding the decisions. This can be called as an endogenous peer effect. Here, snowball effects and social multiplier effect can be also found out. Snow ball effect is a procedure that begins from the initial phase of minute importance, which builds upon itself, becoming graver and stern. Social multiplier effect is a social externality by which high levels of one trait which can be seen in a peer can spillover or pour out the effect on a person.

Conclusion

From the study made using t test, on the effect of peer influence in profitability, can be seen to a greater extend. 86 % of the respondents gave their opinion in support of the alternate hypothesis that dependent variable of profitability is based on the influence of peers. Similarly, it was found that level of social learning has influence on financial decision making. 66% of the respondents were supporting this view. The majority of the respondents, say about 72 % opined that the independent variable, social utility affects profitability of the concern. 74% of the respondents have the opinion that business communication is one of the reasons for profitability of concern. Social learning and social utility are great driving factors of peer effects.

Findings

From the study it is clear that firms make financial decisions not in isolation, but it depends on the decisions taken by the peers. This generally happens when they have to face insecurity and uncertainty while making crucial and irreversible financial decisions. Robust, significant and amazing behaviour of peer firms can be seen from the study that was conducted on peer influence. Strong peer influence can be found in the case of firms which are only on the path of success, but with less profits and sluggish growth. Firms which are in a state of flourishing nature do not copy others, while less successful firms show the tendency of mimicking behaviour. This tendency become strong when such firms are encountering economic crisis and want to sustain their economic status in the industry. Sensitivity of peer influence is very extreme for young firms also, who are followers in the industry. The findings from the experimental study puts forward that the peer impacts are noteworthy during the periods of vagueness of economic policy.

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