Mirae Asset Knowledge Academy

Profit from Knowledge

Not just numbers, analyse your behaviour too for fruitful investing

Investing is not only a science, involving numeric analysis, but also an art, involving one's behaviour, emotions and attitude. Benjamin Graham, the father of value investing, rightly said: "the investor's chief problem - even his worst enemy - is likely to be himself." Investor's decision-making process always starts with logic and reason, but often deviates from it due to behavioural bias, which could lead to mistakes. This article elaborates on the influence of behaviour on investing.

What is Investment Behaviour?

Different emotions follow the investment cycle as mapped in chart 1. In any given situation, investors think and act in a certain way based on their personality traits, emotional state and psychological make-up. These factors complicate the investment decision-making process and defy logical reasoning.

Chart 1: Typical emotional cycle in stock market

For illustration purpose only

Common Investment Behavioural Biases

Anchoring Bias
Tendency to take decisions from an initial reference point

Availability Bias
Tendency to give more importance to the most recent events

Confirmation Bias
Tendency to favour only that which confirms one's belief

Disposition Effect
Tendency to sell winners early & holding losers for long

Herd Mentality
Tendency of an investor to mimic the actions of a larger group

Disposition Effect

It highlights the investors' tendency to sell winners (outperformers) early and holding losers (underperformers) for long. Investors typically have an aversion to recognising losses and, hence, refrain from selling under-performing investments. They also have a tendency to prefer registering gains rather losses; hence, they book profit early.

An investor invested Rs 1 lakh each in funds A and B in May 2014. One year later (May 2015), the investor decided to book profit in fund A (which returned 60%). For fund B, despite losing 17%, he decided to hold on, expecting that the fund's NAV will rise in future and considered it as only a paper loss. After one more year (May 2016), fund B maintained the downtrend and investor lost 27% of his capital. On the other hand, fund A's NAV rose further. Had he stayed invested in fund A, he would have made an absolute gain of 120%. He would also have reduced his losses if he had not continued holding the underperforming fund. This mistake is a classic example of the disposition effect.

Table 1: Case study

	May-14	May-15	May-16
Mutual fund NAV			
Fund A	100	160	220
Fund B	150	125	110
Portfolio Value			
Fund A	100000	100000	220000
Fund B	100000	83333	73333
Profit / Loss			
Fund A	100	60%	120%
Fund B	150	-17%	-20%

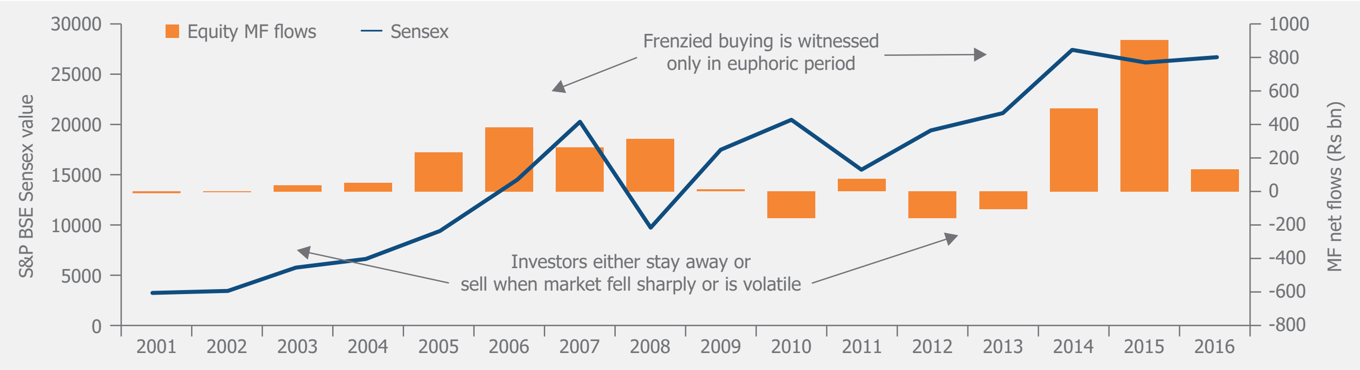
How to overcome it: Investors can avoid the disposition effect by weeding out non-performers early and staying invested in outperformers for a longer period. However, this is easier said than done. Investors should be emotionally ready for admitting the mistake of bad investment. Then they should look for more concreate analysis at regular intervals to confirm whether initial investment thesis still holds true.

In the above case, the investor could have avoided the disposition effect had he regularly analysed the risk-return parameters and portfolio exposure of the fund. By doing so, he would have developed more rational and logical stance on whether to hold or sell the fund.

Herd Mentality

Bubbles and crashes in the stock market are the perfect outcome of herd mentality. It is a tendency of an investor to mimic the actions of a larger group irrespective of whether it is rational or not. Tulip-mania, Tech-bubble and the most recent Subprime crisis are all examples of herd mentality. It is a common human tendency to feel secure when we are in a group and, hence, we are hard-wired to go with the flow.

Chart 2: Herd mentality



Source: Bloomberg and AMFI, till May 2016

As seen in chart 2, bulk of the inflows in equity mutual funds were only in the euphoric stage of the market cycle and panic selling was witnessed only when the market fell sharply or was volatile. This highlights the influence of herd mentality on investor's behaviour.

How to overcome it: There is no harm in accepting the wisdom of herd, but only if it is rational. Taking investment decisions based on actions of a larger group does not ensure success in investing. It may turn out be a mistake. Investors should rationally buy when there is pessimism and fear in the market as it is actually a fertile ground to grow wealth.

More prudent would be to adopt a holistic financial planning approach which involves investing based on one's financial goals and the risk profile. Regular investments via Systematic Investment Plans (SIP), proper asset allocation between various asset classes and portfolio rebalancing at regular intervals will help investors have a focused investment strategy.

Anchoring Bias

From an investing perspective, the anchoring effect takes place when an investor selects one initial reference point and takes decisions based on that even though it may not have logical relevance at that time.

Case study: An investor is very bullish on the engineering sector and identifies stock A as a potential opportunity given its strong presence in the sector. The stock was trading at Rs 300 and has risen 50% in the last one year. After a few weeks, the company announced its foray into the finance sector. The company's stock plunged 30% to Rs 210 as the market reacted negatively to the company's latest move. The investor decided to buy the stock, considering it a bargain.

The investor's decision to buy the stock at a discounted price was irrational. He had anchored Rs 300 as a fair valuation for the company and was positively biased toward it. When the stock fell 30%, he could not resist the temptation of buying the stock at a discount - at Rs 210. However, he failed to factor in that a fall in the stock price could be because of the negative impact of diversification to an unrelated sector on the current business model, and ultimately it may turn out to be value destructive for shareholders.

How to overcome it: Investors can overcome the anchoring bias by avoiding sticking to the initial reference point and looking for more rational points before taking decisions.

In the case study, if the investor enquires about the sudden fall in stock price and rationally analyses the impact of new development on the company's future progress, he might not buy.

Availability Bias

In the availability bias, investors give more attention to recent events or what is readily evident rather than on thorough analysis or research. Because of this bias, investors' perceptions are based on events that are forefront in their mind, which may be irrelevant or form only a part of a whole picture.

Case study: An investor lost most of his savings in the financial carnage of 2008. He decides not to invest in equity going ahead and parks money only in safe bank deposits. Is his decision to avoid equity prudent? No. He is influenced by the availability bias. His decision to quit equity asset class was influenced by fear rather than logic. Because of availability bias at work, a recent bad memory created a perception in his mind that equity is always a loss-making proposition. However, in reality, he failed to understand that market downtrend and uptrend are part of the equity cycle, and in the long term equity asset class has emerged as one of the best wealth creators among asset classes.

How to overcome it: Investors can confront the availability bias by thinking objectively rather than focusing on recent events or readily available information. Look for information to put recent events into proper perspective and then take decisions.

In the case study, instead of getting perturbed by the financial loss, the investor should have reasoned that volatility is an integral part of equity investing and it has fared well in the long term. Instead of completely refraining from equity, investors can go for proper asset allocation between various asset classes based on their risk profile.

Confirmation Bias

It is a tendency of investors to favour or try to seek information that confirms their belief and go ahead with the decision by disregarding odds that may unfavourably impact their decisions. In the confirmation bias, investors have preconceived notions about particular investments and they look for information that confirm their view and often ignore information that challenges their view.

Case study: An investor is impressed by the performance of a particular equity mutual fund and puts the fund in her tracking list. In a social gathering, she understands that her financial expert friend has also purchased the same mutual fund. Later she searches on the internet for articles recommending the mutual fund and is convinced about the fund's good performance. Without digging deeper about the fund, she believes investing in that mutual fund scheme is a sound investment decision. Is this a wise investment decision? No. She became a victim of the confirmation bias.

How to overcome it: Investors can avoid the confirmation bias by challenging their view about the investment. Seek a balanced view with an open mind on the investment rather than selectively seeking information.

In the above case, the investor had already developed a positive bias toward a particular fund and her conviction grew stronger on learning that a friend (financial expert) had also purchased the same fund. Searching for information recommending the fund also shows that she was selective and partial in her approach. She could have avoided the confirmation bias by finding reasons as to why the fund had given good performance – is it because of excessive risk taken by the fund manager or because of prudent fund management? She could have also taken help from an independent financial advisor to get an impartial view.

Summing Up

Human emotions play a very important role in investing decision making. Understanding behavior bias will definitely help investor make more rational decisions in his/ her investment journey.

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