Impact of Behavioural biases in Portfolio Investment Decision Making Process.

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ABSTRACT

This article presents a new approach in the analysis of portfolio investment decisions, namely behavioral finance. Behavioral finance is the study of the influence of the psychological factors on financial markets evolution. Psychology, including aspirations, cognition, emotions, and culture, is at the center of behavioral finance. Behavioral finance paradigm suggests that investment decision is influenced in a large proportion by psychological and emotional factors. It has been identified that the Investors do not always act rationally or consider all of the available information in their decision-making process. As a result, they regularly make errors. It turns out too that the errors they make repeat in the same way, and are, therefore, termed systematic errors. Luckily, because of this systematic character, these errors are often predictable and avoidable. The common errors that they make are also termed as behavioral biases some of them are overconfidence, anchoring, herding, regret aversion, misunderstanding, randomness, mental accounting, representativeness etc. This paper examines the role of behavioral biases on investment decision making process.

Key words: *behavioral finance, capital market, cognition, herding, anchoring, regret aversion, emotional factors.*

Introduction :

Investing has a major role in financial planning. Investment decision making is a complex process .According to Classical investment theories, they are based on the assumption that investors always act in a manner that maximizes their return. Yet a number of research show that investors are not always so rational.Designing an appropriate portfolio of investment is a very complex task for an investor .There are various investment avenues available in the financial market with varying degree of risk and returns.An investor who designs his portfolio considering various general factors will be able to earn better returns and diversify risk.However along with the general factors affecting the investment decisions,there are various behavioural factors affecting investment decisions. Although cognitive and emotional weaknesses affect all people, traditional or standrd finance ignores these biases because it assumes that people always behave rationally .One of the central propositions of financial theory for the past three decades is that markets are efficient.Efficiency means that the price of each security coincides with the fundamental value, even if some investors commit errors due to behavioural biases

An investor has to take into consideration these behavioural factors as well, which are known as behavioural biases in investing.Through proper understanding of behavioural biases an investor can avoid the mistakes in making investment decisions, maximise returns, minimise risk and have a better financial planning for the future.

Traditional finance vs behavioral finance:

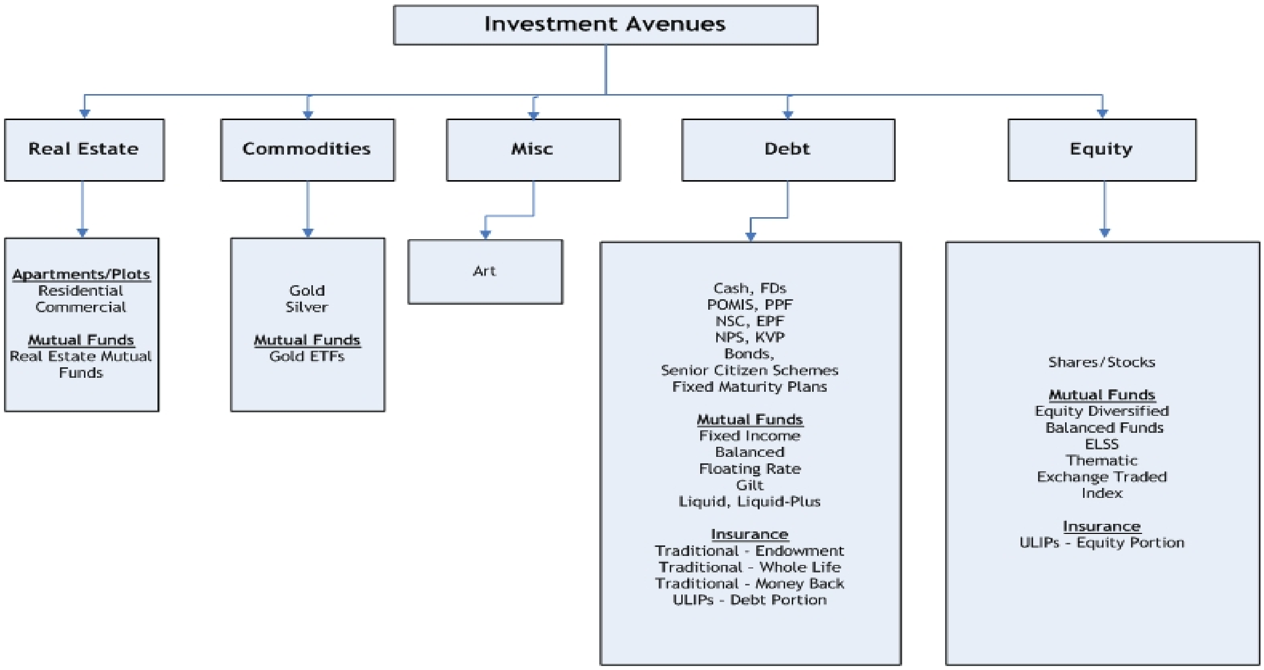
Based on efficient market hypotheses, traditional financial theories assume that investors are rational and risk averse, and hold diversified, optimal portfolios. This assumes how investors should act based on mathematical models and theories. However, this does not always play out in practice.

In contrast, behavioural finance is based on understanding how people actually make financial decisions in practice. Behavioural finance suggests cognitive errors and emotional biases can impact financial decisions, often in a detrimental way. Cognitive errors are based on faulty reasoning (belief perseverance), or due to memory errors (information processing errors). Emotional biases stem from reasoning that is influenced by feelings or emotions, not fundamental facts.

Behavioural finance challenges the assumptions of the traditional finance theory, recognizing that many investors do not make decisions in a rational manner. Investors are generally loss averse, and because their fears can get in the way, they do not necessarily hold optimal portfolios

In traditional theories of finance, investment decisions are based on the assumption that investors act in a rational manner. This means that they behave rationally so they earn returns for the money they put in various investments.Behavioral finance can be studied from both the micro and macro levels of the economy and capital markets. Behavioral finance micro (BMFI) focuses on the behaviors of individual investors, whereas behavioral finance macro (BMFA) focuses on the behavior of the markets, questioning ideas of market efficiency. Behavioral finance challenges the idea that investors are rational at both the micro and macro levels. Modern theory of investors' decision-making suggests that investors do not act rationally at every time while making an investment decision. They deal with several cognitive and psychological errors. These errors are called behavioral biases and are exists in many ways. Behavioral finance has been growing specifically over the last two decades as we find difference between the assumptions made in traditional finance theory and actual behavior of investors.

The decision-making by individual investors is usually based on their age, education, income, investment portfolio, and other demographic factors. The impact of behavioral aspect of investing is, however, often ignored. Investors fall prey to their own and sometimes others mistakes due to the use of emotions in financial decision-making. Investors are people with a very varied number of deviations from rational behavior, which is the reason why there is a variety of effects, which explain market anomalies.



Source: *Investment Avenues for Indian Investors by Radhey Sharma in Financial Planning*

General factors affecting the investment decisions:

1. Return

Investments are made to earn returns. The return expectation can be the amount received as interest, dividend received on stocks, capital appreciation on assets and many more. Different investments have different returns. Returns from an investment depend on its rating, liquidity and time horizon of the investment.

2. Risk

Savings becomes investment because of the risk factor. Risk is an inherent part of any investment activity. Some of the risk associated with an investment can be –

- Loss of capital
- Delay in repayment of capital
- Nonpayment of Interest
- Variability of returns

3. Safety

An investment is considered to be safe, if there is a certainty of return of capital without any loss of the same. The safety on probable return is generally illustrated by the ratings of the investment vehicles. A (AAA) bond signifies highest possibility of return of capital with accrued benefits to the bond holder. This is a prime characteristic of investments, as every investor invests to get back his/her capital together with profit.

4. Liquidity

It is an important feature of any investment. The yield on any investment is to an extent a function of liquidity. It can be defined as the property of an investment, wherein it can be converted in cash on demand, without loss in value. Liquidity in marketable assets are provided by the market, while non marketable assets like fixed deposits cannot be liquidated in market but can be offered for premature repayment to bank.

5. Tax efficiency

Some investments offer tax benefits, while others don't. An ideal investment is that which offers tax efficient return commensurate to risk with safety and liquidity.

Behavioral biases affecting investment decisions:

1. Excessive Optimism Bias: Excessive Optimism is one of the behavioral factors affecting the investment decision making process. People believe that good times are permanent and refuse to see the darker side. Investors tend to become so optimistic that they tend to invest in any investment avenue in the hope that they will make money.

2. Overconfidence Bias: Excessive optimism leads to overconfidence. Investors are consistently overconfident in their ability to outperform the market; however, most fail to do so. At the height of optimism, greed moves the stocks beyond their intrinsic value, creating an overpriced market. At other times, fear moves prices below intrinsic value, creating an undervalued market

3. Anchoring Bias: Anchoring describes how individuals tend to focus on recent behavior and give less weight to longer time trends. People tend to give too much weight to recent experience, extrapolating recent trends that are often at odds with long run average and probabilities. In the absence of any better information, past prices are likely to be important determinants of prices today. People have in their mind some reference points (anchors), for example of previous stock prices. When they get new information they adjust this past reference insufficiently (under reaction) to the new information acquired. Anchoring describes how individuals tend to focus on recent behavior and give less weight to longer time trends.

4. Confirmation Bias: The investors would be more likely to look for information that supports his or her original idea about an investment rather than seeking out information that contradicts it. As a result, this bias can often result in faulty decision making.

5. Hindsight Bias: The belief that they can easily predict the future based on the past events may result in incorrect oversimplifications and disastrous investment decision.

6. Gambler's Fallacy Bias: Often, Investors erroneously believe that the onset of a certain random event is less likely to happen following an event or a series of events. Investors can easily fall prey to this gambler's fallacy.

7. Media Bias: A theory that relates to how stories published in the media influence or amplify current trends. Borrowers or investors will read an article and will be influenced to act quickly on the news.

8. Herd Bias: Herd behavior is the tendency of individual to follow the actions (rational or irrational) of a larger group. This herd mentality is the result of two reasons. Firstly, there may be a social pressure of the media effect is often seen in the stock market. Most people do not want to be outcast from the group they belong. Secondly, there is a common rational that a large group is unlikely to be wrong. Purchasing stocks based on price momentum while ignoring basic economic principles of supply and demand is known in the behavioral finance arena as herd behavior and that leads to faulty decision. In the late 1990s, Venture capitalist and private investors were frantically investing huge amount of money into internet related companies, even though most of them did not have financially sound business models

9. Over and Under-Reaction Bias: Disproportionate reaction to news, both good and bad has been often seen in the financial market. They tend to become more optimistic when the market goes up and more pessimistic when the market goes down. Irrational optimism and unjustified pessimism are shown in over and under-reaction of investors

10. Gambler's Fallacy: Gamblers fallacy bias occurs when investors inappropriately predicts that a trend will reverse, for example,a gambler playing a fair roulette table who has seen seven black outcomes in a row may think that the next spin may produce a red outcome.This illusion may encourage the purchase or sale of a share on the grounds that the recent bad/good luck of the firm must be about to change

11. Mental Accounting Bias: Mental accounting is a term given to the propensity of individuals to organize their world into separate mental accounts.This can lead to inefficient decision making.The use of mental accounts could be partly explained as a self control device.As investors have imperfect self control,investors may separate their financial resources into capital and available for expenditure pools,in an effort to control their urge to overconsume.Investors treat each element of their investment portfolio separately,possibly forgoing the benefits of portfolio diversification.

Objectives of the Study

- To identify the differences between the classical and modern theories of investment decision making
- To identify the behavioural biases affecting portfolio investment decisions
- To identify the mistakes commited by investors in making systematic investment decisions
- To suggest remedial measures to overcome the mistakes in making systematic investment decisions.

Research Methodology

The study is purely descriptive research.

Review of literature:

Kahneman, et.al., (1971) describes the heart of gambler's fallacy as a misconception of the fairness of the laws of chance. One major impact on the financial market is that investors suffering from this bias are likely to be biased towards predicting reversals in stock prices. Gambler's Fallacy arises when investors inappropriately predict that trend will reverse and are drawn into contrarian thinking. Gambler's Fallacy is said to occur when an investor operates under the perception that errors in random events are self-correcting.

Gupta L.C. (1991) argues that designing portfolio for a client is much more than merely picking up securities for investment. The portfolio manager needs to understand the psyche of his client while designing his portfolio. According to Gupta, investors in India regard equity, debentures and company deposits as being in more or less the same risk category and consider including all mutual funds, including all equity funds, almost as safe as bank deposits.

Shiller (1999) investors do not think and behave rationally. To the contrary, driven by greed and fear, investors speculate stocks between unrealistic highs and lows. In other words, investors mislead by extremes of emotion, subjective thinking and the whims of the crowd, consistently form irrational expectation for the futures performance of companies and the overall economy such that stock prices swing above and below fundamental values and follows a somewhat predictable, wave-like path.

K.S.Chalapati Rao et.al.,(2000), in his research article "Some aspects of the Indian Stock Market in the post liberalization period" evaluates that as a part of the process of economic liberalization, the stock market has been assigned an important place in financing the Indian corporate sector. Besides enabling mobilizing resources for investment, directly from the investors, providing liquidity for the investors and monitoring and disciplining company management are the principal functions of the stock market. This paper examines the development in the Indian stock markets during the nineties in terms of these three roles.

Kent et al.,(2001) noted that the stocks that investors choose to sell subsequently outperform the stocks that investors retain. According to them, home sellers also appear to be loss-averse in the way that they set prices. They are reluctant to sell at a loss relative to past purchase price. This helps to explain the strong positive correlation of volume with price movement.

Kent et al(2002) in the study of investors psychology also found that it is particularly important to note that the fast movement of prices of the stocks and shares in the stock market is largely due to investors' perceptions such as (1) investors perception of the stochastic process of stock prices.(2)investors perception of value(3)investors perception on the management of stock and return (4)investors trading practices.

Pompians (2006), there are two identified aspects of Cognitive Dissonance that is related to decision making (1) Selective perception: where investors only register information, which affirms their beliefs thus creating an incomplete view of the real picture (2) Selective decision-making: Investors are likely to reinforce commitments previously made even through it might be visible that it is the wrong thing to do. This occurs because of commitment to the original decision forcing the investor to rationalize actions, which would allow him to stick to it, even though these actions are sub-optimal.

Chandra (2008) explored the impact of behavioral factors and investor's psychology on their decision –making, and to examine the relationship between investor's attitude towards risk and behavioral decision-making. Through the research, the researcher finds that unlike the classical finance theory suggests, individual investors do not always make rational investment decisions. The investment decision-making is influenced, largely by behavioral factors like greed and fear, Cognitive Dissonance, heuristics, Mental accounting, anchoring. These behavioral factors must be taken into account as risk factors while making investment decisions.

Maheran, et.al. (2008) intended to investigate the relationship between investment decision making of an investor and their rationality in investing in the Malaysian capital market. The findings of the study indicate that the economic condition and frame of references influence investor decision-making behavior. The study concluded that Malaysian investors are partially rational in their decision making

Hoffmann, et.al.,(2010) analyze how systematic differences in investor's investment objectives and strategies affect the portfolios they select and the returns they earn. The analyses in this study draw on transaction records of a sample of clients, from the largest online broker in the Netherland.The study revealed that investors who rely on fundamental analysis have higher aspirations and turnover, take more risks, are more overconfident, and outperform investors who rely on technical analysis.

Some of the common mistakes made by investors in designing their investment portfolio are identified as follows:

1. Investors fail to design their portfolio of investment avenues systematically.
2. Investors fail to diversify their portfolio.
3. Investors generally overestimate their skills, attributing success to ability they don’t possess and seeing order in information or data where it doesn’t exist i.e., Investors are overconfident while making investment decisions
4. Investors blindly follow the crowd (herd mentality) while making investment decisions which leads to wrong investment decisions
5. Investors anchor on historical information.
6. Investors think that good times are permanent .They feel that ones they earn a good profit from their investment avenue ,the investment would give them good returns permanently
7. Investors are greed and they want to earn money quickly (Instant gratification) which also leads to wrong investment decisions.
8. Investor’s generally making short term investment decisions rather than long term investment decision.

Suggestions:

1. Investors should carefully identify and analyse the general and behavioural factors affecting investment decisions and should design an appropriate portfolio of investments.
2. Portfolio diversification among various asset classes ,such as stocks ,bonds,money market fund and real estate ith different patterns of returns over time,helps to increase the stability of returns and thus to reduce risk.Proper diversification of portfolio can help an investor to avoid tragic losses and to overcome the behavioural biases and thus lead to successful financial planning.

3. Investors should not be overconfident while making investment decisions .They should not think that good times will be permanent.
4. Investors should not follow the crowd blindly rather they should think accurately and make rational investment decisions.
5. Investors should look out for accurate information and sufficient information before they make investment decisions .Lack of sufficient information also leads to making mistakes in taking investment decisions
6. Investors should be patient before and after taking investment decisions. They should not aim at instant gratification(Earning quick profits)
7. Investors should always realize that past continuous events are all independent and are not co-related and the probability of the same event is still possible
8. Investor's should always aim at long term investment decisions
9. To reduce the influence of psychological biases, investors can establish a realistic investment objectives in terms of returns and risk tolerance.The investor has to recognise the constraints such as liquidity,time horizon and taxes to achieve their objectives.
10. Investors should periodically revie and keep track of their investment portfolio at least once a year.If the weights for each asset class diverge too much from the desired weights,the investor can consider reallocating the assets within the portfolio.

Conclusion.

Designing a systematic portfolio of investment is a very complex task for an investor, however while framing the portfolio of investments, an investor should not only consider the general factors but he should clearly understand the behavioural factors affecting investment decisions.Behavioural biases could be overcome if the investors look out for accurate information and sufficient information before they make investment decisions. The investors will be in a position to maximise the returns, diversify the risk and ensure a better financial planning process only by overcome biases.

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