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JOURNEY TOWARDS FINANCIAL BLISS

Behavioural Biases in Investment Decision Making

What is Bias

Bias is the human tendency to make systematic errors in judgement or when making decision based upon certain thinking, thoughts or preconceived notions

Creating and managing an investment portfolio requires decisions to be made on – how to invest, in which asset classes, timing of entry/exit and reviewing/rebalancing the portfolio. Decisions ought to be based on the analysis of available information so as to optimise expected performance and risks associated with such investment. Very often the decisions are influenced by behavioural biases in the decision maker. Sometime even experienced Fund Manager may also fall prey to it, which leads to less than optimal choices being made.

An investor faces several hurdles, minor and major both. These include personal ones like lack of knowledge and ability to invest at the optimum levels. Some of the well documented biases that are observed in investment decision making are:

Disposition Bias: An important hurdle that often comes in the way of realizing an investor's financial dream is the emotions of the person that mislead him to divert from what he should ideally do. It's always better to be informed about such emotional hurdles in investing before it is too late. For example, people often keep on holding stocks bought years ago and are still in the red, but prefers to sell off those stocks in which they have made profit and has further potential to make more profit. In this case termed as disposition bias in financial economics literature, investors tend to hold on to their losing bets in the hope of recouping their losses sometime in the future but feel good to make some small profit by disposing off their winners.

Optimism or Confidence Bias: Investors cultivate a belief that they have the ability to Out-perform the market based on some investing successes. Such winners are more often than not short-term in nature and may be the outcome of chance rather than skill. If investors do not recognize the bias, they will continue to make their decisions based on what they feel is right than on objective information.

Familiarity Bias: This bias leads investors to choose what they are comfortable with. This may be asset class they are familiar with or stocks/sectors about which they have greater

information and so on. Investors holding an only real estate portfolio or a stock portfolio concentrated in shares of a particular company or sector are demonstrating this bias. It leads to concentrated portfolios that may be unsuitable for the investor's requirements and feature higher risk of exposure to the preferred investment. Since other opportunities are avoided, the portfolio is likely to be underperforming.

Anchoring: Investors hold on to some information that may no longer be relevant, and make their decisions based on that. New information is labelled as incorrect or irrelevant and ignored in the decision making process. Investors who wait for the 'right price' to sell even when new information indicate that the expected price is no longer appropriate, exhibit this bias. For example, they may be holding on to losing stocks in expectation of the price regaining levels that are no longer viable given current information, and this impacts the overall portfolio returns.

Loss Aversion: The fear of losses leads to inaction. Studies show that the pain of loss is twice as strong as the pleasure they felt at a gain of a similar magnitude. Investors prefer to do nothing despite information and analysis favouring a particular action that in the mind of the investor may lead to a loss. Holding on to losing stocks, avoiding riskier asset classes like Equity, when there is a lot of information available on market volatility are manifestations of this bias. In such situations investors tend to frequently evaluate their portfolio's performance, and any short-term loss seen in the portfolio makes inaction the preferred strategy.

Herd Mentality: This bias is an outcome of uncertainty and belief that others may have better information, which leads investors to follow the choices that others make. Such choices may seem right and even be justified by short-term performance, but often lead to bubbles and crashes. Small investors keep watching other participants for confirmation and then end up entering when the markets are over heated and poised for correction.

Demonstrative Effect: Investors, especially new to investing, often get carried away by what their friends or relatives say. There are people who boast how they have made multiple times in some stock, which has a demonstrative effect on the new comer, who without understanding even the basics of investing, just dive into putting his money into something which could be an extremely risky bet or may not even be suitable for him. In such situations, it is also seen that the person claiming his multiple winning stock to people known to him, may also have hidden stocks and investments in which he has lost money. So it's very important for investors to keep away from such demonstrative effects which could, in the long run, prove to be a loss making proposition.

Recency Bias: One of very strong emotional bias is "recency bias", the phenomenon of a person most easily remembering something that has happened recently, compared to something that may have occurred a while back. The impact of recent events on decision making can be very strong. This applies equally to positive and negative experiences. Investors tend to extrapolate the event into the future and a repeat. A bear market or financial crisis lead people to prefer safe assets. Similarly a bull market make people allocate more than what is advised to risky assets. The recent experience overrides analysis in

decision making. So everybody expect the recent performance to continue over a future period which is not true.

Choice Paralysis: The availability of too many options for investment as also too much of information can lead to a situation of not wanting to evaluate and make the decision.

Greed: At times there are people who claim that they could give very high returns, compared to the accepted market linked returns of financial products, and that too within a short period of time. Investors should be careful about such tall claims before investing

Individual investors can also reduce the effect of such biases by adopting few techniques. As far as possible the focus should be on data and interpreting & understanding it. Setting in place automated and process-oriented investing and reviewing methods can help biases such as inertia and inaction. Facility such as systematic investing helps here. Over evaluation can be avoided by doing periodic reviews. A rational investor would probably look at the portfolio of all the stock as a whole and decide which ones to sell off and in which ones they should remain invested, irrespective of the losers and gainers status.

It is always good to have a financial adviser the investor can trust who will take a more objective view of the investor's finances in making decisions and will also help prevent biases from creeping in.

Best way to invest, for new as well as experienced investors, is to have a disciplined approach, patience and diversify.