

PSYCHOLOGICAL BIAS IN INVESTING

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ABSTRACT

Investment decision is a key decision, in creating financial stability. All decision makers always try to have a rational outlook, as far as decision making is considered. We sometimes forget the fact that, we are human beings and we do have emotions and personal preferences. These personal preferences, emotions, beliefs, past experience etc. create psychological bias. Psychological biases indirectly affect the investment decision making process without the knowledge of the investor. Hence, the decision an investor is taking is prompted by rational thinking as well as psychological bias. This article tries to throw some light on a few of the psychological biases which can affect the decision making process. Knowing and overcoming these biases are extremely important for an investor to take rational decisions

KEYWORDS: Behavioral Finance, Investment, Psychological Biases

INTRODUCTION

“Traditional Finance assumes an investor to be Rational and Behavioral Finance assume an investor to be Normal”

Investment decision is critical to wealth creating and achieving financial independence. An investor is exposed to multiple investment avenues ranging from investment in physical assets like real estate to metals like gold and finally to financial instruments like shares, mutual funds, bonds etc. Enough material is available regarding the pros and cons of each venue of investment and the returns an investor can expect from each venue. We normally ignore the emotional and psychological aspects of human brain. For example, of the two lines given below, which looks longer?

Optical Illusion

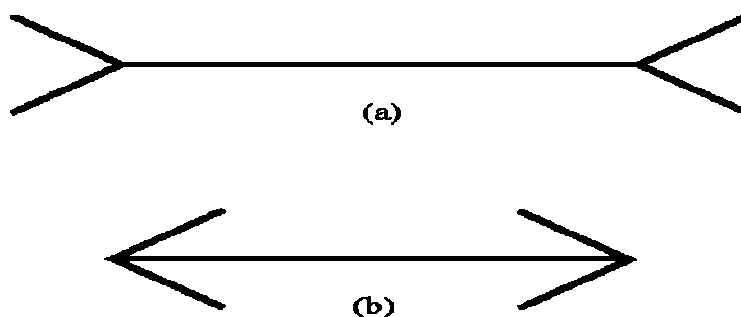


Figure 1

In fact, both lines are the same length, look again. Although you know that the horizontal lines are equal in length, the top line still looks longer. Just knowing about the illusion does not eliminate it. However, if you had to make some decision based on these lines, knowing that it is an illusion would help you avoid a mistake. The articles discuss in brief

the way in which brain works and the psychologic impulse, which gets generated because of emotional variable and past experience and, how these affects the rational thinking process of an investor.

BEHAVIORAL FINANCE

Behavioural finance is a relatively new field that seeks to combine behavioural and cognitive psychological theory with conventional economics and finance to provide explanations for why people make irrational financial decisions. Behavioural finance is a field of finance that proposes psychology-based theories to explain stock market anomalies such as severe rises or falls in stock price. Within behavioural finance, it is assumed the information structure and the characteristics of market participants systematically influence individuals' investment decisions as well as market outcomes.

The efficient market hypothesis proposes that at any given time in a liquid market, prices reflect all available information. There have been many studies, however, that document long-term historical phenomena in securities markets that contradict the efficient market hypothesis and cannot be captured plausibly in models based on perfect investor rationality. Many traditional models are based on the belief market participants always act in a rational and self-bettering, or wealth-maximizing, manner, severely limiting these models' ability to make accurate or detailed predictions.

Behavioural finance attempts to fill this void by combining scientific insights into cognitive reasoning with conventional economic and financial theory. More specifically, behavioural finance studies different psychological biases that humans possess. These biases, or mental shortcuts, while having their place and purpose in nature, lead to irrational investment decisions. This understanding, at a collective level, gives a clearer explanation of why bubbles and panics occur. Also, investors and portfolio managers have a vested interest in understanding behavioural finance, not only to capitalize on stock and bond market fluctuations but also to be more aware of their own decision-making process.

Behavioural finance highlights inefficiencies, such as under- or over-reactions to information, as causes of market trends and, in extreme cases, of bubbles and crashes. Such reactions have been attributed to limited investor attention, overconfidence, over optimism, mimicry (herding instinct) and noise trading. The central issue in behavioural finance is explaining why market participants make irrational systematic errors contrary to assumption of rational market participants. Such errors affect prices and returns, creating market inefficiencies. The study of behavioural finance also investigates how other participants take advantage (arbitrage) of such errors and market inefficiencies

PSYCHOLOGICAL BIASES AFFECTING INVESTMENT DECISION

The main psychological biases that can influence the rational thought process of an investor is listed below:

Over Confidence

People are overconfident. Psychologists have determined that overconfidence causes people to overestimate their knowledge, underestimate risk, and exaggerate their ability to control events. Does over confidence occur in investment decision making? Consider the following question:

How good a driver are you compared to the drivers you encounter on the road, are you above average, average or below average?

How would you answer this question? If overconfidence were not involved, approximately one - third of those reading this book would answer above average, one - third would answer average, and one - third would answer below average. However, people are over confident in their abilities. Most people feel that they are above average. Being over confident in driving may not be a problem that affects your life. Sometimes over confidence can affect your financial future. Consider this financially oriented example. Starting a business is very risky venture; In fact, most new businesses fail. But very few owners who start a new business thought that like majority businesses they are likely to fail also. Wall Street warns you "Don't confuse brains with a bull market". Over - confidence increases trading and trading frequency because it causes you to be too certain about your opinions. Your investment opinions derive from your beliefs regarding both the accuracy of the information you have obtained and your ability to interpret. An over confident investor believe more strongly in his own valuation and have less belief on others. He / she may over trade and chance of making loss from over trading also increase. An over confident investor will perceive his actions to be less risky than generally proves to be the case.

Illusion of Knowledge

We have the tendency to believe that the accuracy of our forecasts increases with more information. This is illusion of knowledge. This illusion of knowledge – that more information increases your knowledge about something and improves your decisions. However, this may not be right always.

For example, I roll a fair 6 sided die. What number do you think will come up and how sure are you that you are right? Clearly, you can pick any number between 1 and 6 and have a one – sixth chance of being right. What if I told you that, the last 3 rolls of the die have each produced the number 4? If I roll the die again, what number do you think will come up, and what chance do you have of being right? If the die is truly fair, then you could still pick any number between 1 and 6 and have the same probability of being correct, regardless of what previous rolls have produced. The added information will not increase your ability to forecast the roll of the die. However, many people will believe that the number 4 has a greater (than one – sixth) chance to be rolled again? Others will believe that the number 4 has a lower chance to be rolled again. Both groups of people will think that their chance of being right is higher than reality. That is the new information may make people more confident in their predictions even though their chances for being correct do not change.

Illusion of knowledge is a dangerous in investing environment. This will give a false impression to investors that they can predict the share price or have enough knowledge regarding price movement of a particular stock or sector or the market as a whole. Market price of any share is affected by n number of factors of which some may be known to the investor and some may be unknown to the investor

Illusion of Control

People become even more confident when they feel like they have control of the outcome – even when this is clearly not the case. For example, if you ask people to bet on whether a coin toss will end in heads or tails, most will be larger amounts if you ask for the best before the coin has been tossed. If the coin has already been tossed and the outcome concealed, people will offer lower amounts when asked for the bets. People act as if their involvement will somehow affect the outcome of the toss. In this case, the idea of control over the outcome is clearly an illusion.

The greater the amount of information obtained, the greater the illusion of control. When learning new information, people place too much emphasis on how extreme or important it is. Too little emphasis is placed on validity or accuracy. Much of the information received is really noise and is not important – a lot of what we call information is inaccurate or outdated. In fact some information used by investors these days is really are misleading and causes damage to return.

Status Quo Bias

The physical sciences would say that an object at rest tends to remain at rest till further disturbance. In decision making, we may often choose the option that allows us to remain at rest. In other words, we prefer the status quo to prevail. For example, assume that I started investing in share market by buying shares of Reliance Industries Ltd and that share gave me reasonable good return in the earlier years. If the same stock is not getting sufficient return now and there may be better other investment options available in the market. Again, I continue investing in Reliance Industries Ltd or not disposing off my investment in Reliance Industries Ltd and buying new more profitable stocks then I can be called having “Status Quo Bias”.

Status quo bias will reduce profitability and increases the risk of portfolio. Secondly, if shifting from one decision (or one investment philosophy or one company) to another involves complicated analytical process then the chance of maintaining the status quo increases. Majority of investors will be happy in continuing the current investment philosophy than adopting a new investment process which demands a complicated analytical process. Finally, the choice of alternative options of investment may sometimes also increase the status quo bias. It's not so easy for many investors to select an investment option from a basket of investment options. It's not always easy to select a best alternative for too many potential options. Now most of the investment and broking firms offer a dozen of investment avenues of investment, which will indirectly make the selection process tough for the investor. He may normally continue the status quo or may select a plan which the broker or financial expert advice.

Seeking Pride & Avoiding Regret

People avoid actions that create regret and seek actions that cause pride. Regret is the emotional pain that comes with realizing that a previous decision has turned out badly. Pride is the emotional joy of realizing that a decision has turned out to be a good decision.

For example, assume that you are continuously buying a lottery ticket having the same number and you never won any lottery. Then your friend (who won lottery earlier) suggested a different number. Clearly, the likelihood of the old set of numbers winning is the same as the likelihood of the new set of numbers winning. There are two possible sources of regrets in this example. Regret may be felt if you stick with the old number and the new number win, called the regret of omission (for not taking an action). Alternatively, regret would also be felt if you switch to the new number and the old number wins. This is called regret of commission. In which case would the pain of regret be stronger? The stronger regret is most likely from switching from your favorite number to the new number that your friend suggested because you have a lot of emotional attachment with the old number. A regret of commission is more painful than a regret of omission.

Risk Aversion Bias

After experiencing a financial loss, people become less willing to take risk. This is snake – bite or risk – aversion

effect. When faced with a gamble after already losing money, people generally choose to decline the gamble. The risk aversion effect can also affect your investing. New or conservative investors may decide to give the stock market a try. Adding some stocks to a portfolio gives the long term investor better diversification and higher expected returns. However, if those stocks quickly fall in price, the first stock investor may feel the snake bite. In the long term, it is harmful to your wealth if being snake bite causes you to avoid the stock market entirely. Having been unlikely enough to lose money, people often feel that they will continue to be unlucky. This bias will prompt him to avoid risk which is finally harmful for his future investment planning.

Disposition Bias

Fearing regret and seeking pride causes investors to be predisposed to selling winners too early and riding losers too long. It is common sense that because of this you may sell your winners more frequently than those losers. Selling a winner stock causes the realization of a capital gain and thus the payment of taxes. Those taxes reduce your profit. Selling the losers gives you a chance to reduce your taxes, thus decreasing the amount of the loss. But because of regret, you may not sell the loss making stock. This may not be advisable in investment. This is a psychological bias that affects you over a fairly long period of time.

Selling winners too soon and holding losers too long may not be a practice with many investors. Selling a winner too soon suggests that it would have continued to perform well for you if you had not sold it. Holding losers too long suggests that your stocks with price declines will continue to perform poorly and will not rebound with the speed you hope for. Active investors follow the economic and financial news very closely. Given your disposition to sell winners and hold losers, how do you react to a news story? Positive news of a company may induce a push in price and negative news and the result is more interesting. Good news about a company resulting in an increase in the stock price induces investors to sell (selling winners). Bad news about a company does not induce investors to sell (holding losers). This is consistent with avoiding regret and seeking pride. The cost of avoiding emotional pain is financial pain. Another strategy is to make a point of selling enough losers to offset any gains that you might have incurred during the year. It's advisable to keep a reminder to avoid regret problem. Disposition effect hurts your wealth in two ways. First, you pay more capital gains taxes because you sell winners. Second, you earn a lower return because the winners you sell no longer continue to perform well while the losers you still hold continue to perform poorly.

Break Even Effect

Losers don't always avoid risk. People often jump at a chance to make up their losses. After having lost some money; majority of investors may take some impulse decision to cover the loss. In other words they may make an investment without carefully analyzing the pros and cons of the investment proposal. The need for break-even will normally be stronger than snake – bite effect. Losers like the opportunity to break even without risking too much more money. People without significant gains or losses prefer not to take the risk of long shots.

Endowment Effect

People often demand much more to sell an object than they would be willing to pay to buy it. Do we overestimate the value of the objects we own, or do parting with them causes too much pain? Research proved that way. For example, if we use the car for a few years and if we really like the car, then we may expect a very high price from the buyer to sell the

car. In the same time we may not be willing to buy a care of the same type for such a high value. This avoids profit recognition in required intervals. This may be really dangerous in long run because markets can come down and which will significantly reduce the price of your favorite stocks. The liquidity of your stock will be under question.

Attachment Bias

The attachment bias is similar to the endowment and status quo biases. When you hold and follow a stock for a longer period of time, you get attached to it. This attachment causes you to see the stock through rose – colored glasses. Stocks are simply a way to increase your wealth. Getting emotionally attached to any particular stock will make the investment riskier. This attachment will create two dangers:

- The investor may over allocate his savings to the stock he is attached. The rule “not to put all eggs in the same basket” will not get fulfilled.
- The investor may not book profit or loss in frequent intervals

Any advisor would suggest that first the investor switch to a preservation goal instead of a growth goal, and then he should diversify. It’s advisable to allocate only a portion of the portfolio in to safer investments. Attachment bias can be sometimes strong enough to kill the entire investment strategy.

BATTING THE PSYCHOLOGICAL MISTAKES

Any investor, being a social animal exposed to emotional feelings, is bound to have psychological bias. Most of the decision that we make as part of our investment is partly rational and partly irrational. The mistake which we may face is we may think that our decisions are always rational. Markets are normally motivated by two emotions – fear and greed. Acting out of fear or greed is rarely a wise move. The decision that will benefit an investor in long run is usually made in the absence of strong emotions (i.e. based on strong rational thought process). An investor will face a lifelong struggle choosing between decisions that make the present more enjoyable and those that will make the future more enjoyable. Many decisions require balancing this trade off.

The self – control problem can be thought of as the interaction or conflict between two selves – the planner and the doer. The doer (emotional side) wishes to consume now instead of later and to procrastinate on unpleasant tasks, acting on desire. The planner (rational side) wishes to save for later consumption, show will power, and complete unpleasant tasks now. Most people want to maintain self – control and implement decisions that provide benefits over the long term. However, oftentimes desire is stronger than will power, promoting people to employ many techniques to help them have will power. The following guidelines can help an investor in decision making process:

- Control the spending
- Borrow only if required
- Don’t borrow money for investing in financial market
- Retired people – never touch the principal. Spend only the return from the investment
- Employees and earning population must diversify. A portion of savings need to be investment in risk free investment venues and a portion in risky ventures. The composition of the same can be decided based on the

risk taking capacity of the investor

- Buy once the price is low and sell once the price is high. The rule looks very simple. But research data proves that many investors keep on buying shares once it is at the peak and burn their fingers
- Bear market can be an opportunity in long run
- Bull market always won't remain to be bull.

Some of the strategies that an investor can employ to avoid getting affected by psychological bias are stated below:

- First and foremost, accept the fact that psychological biases exist in real and it can affect the decisions. So the investor can be more cautious while taking and investment decision.
- The investor has to be clear regarding his / her investment objective. If the objective is clear then the chance of taking a psychological decision will be less.
- The more diversified the portfolio is, the less will be the risk that the investor face. If the portfolio is highly diversified then the impact of psychological bias will get neutralized.
- An investor need to have a analytical outlook. Numbers hardly deceive reality. A careful analysis of the data can save the investor from taking illogical irrational decisions.
- An investor is expected to be vigilant always. Financial market is not an area where you invest some money, forget about it and expect capital appreciation in future. The investor need to be update always regarding the portfolio he is maintaining.

CONCLUSIONS

Successful investment is more than simply knowing all about stocks. It's a mix of financial knowledge, strategies and knowing the psychological biases. Investors who think they are knowledgeable frequently fail because they allow their psychological bias to overtake their rational thinking process. I expect that the reader will get fairly good knowledge of the psychological bias that can affect a decision making process and help him to apply the strategies to overcome these biases.

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