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Some Behavioural Biases and Irrational Investment Decisions of Investors in the Stock Market

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ABSTRACT:

Sometimes investment decisions are influenced by the behavioural biases of investors and these biases affect the investment decisions of investors as well as the stock prices. Some behavioural biases of investors are Overconfidence, Anchoring, Frame Dependence, Mental Accounting, Loss Aversion, Herd Behaviour, Culture of Greed and Fear, Over-reaction and Under-reaction, Momentum Effects, Endowment and Disposition Effects. Sometimes, the decisions of investors differ from rationality due to these biases. Behavioural finance supplements the standard theory of finance by introducing behavioural aspects to the decision-making process. So, for the improvement of financial decision-making, psychological and economic principles both should be applied together.

Keywords*: Behavioural Finance, Limits to arbitrage, Investors' Biases*

INTRODUCTION:

Human beings sometimes make mistakes in their judgments. It is also true for judging investment decisions. How these mistakes and other aspects of human behaviour affect investment decisions and stock prices falls under the behavioural finance. Behavioural finance attempts to explain how the emotional processes, reasoning errors and biases of investors influence the investment decisions and stock prices. Standard Finance always assumes that human make economic decisions rationally all the times. But always this assumption does not hold true. Behavioural Finance tries to supplement the standard theories of finance by analyzing the behavioural aspects in the financial decision-making process. Sometimes a substantial amount of investors tend to over optimistic or pessimistic market situation which cannot be corrected through arbitrage by rational investors. Some proponents of behavioural finance believe that the reasoning errors and behavioural biases will cause market inefficiencies i.e. mispricing occurs. They also argue that this mispricing cannot be corrected due to limits of arbitrage. Limits to arbitrage states that rational and well-capitalized investors may not be able to correct mispricing at least quickly. The risks and costs which limit the arbitrage are Fundamental Risk, Noise Trader Risk, Implementation Costs and Synchronization Risk and Delayed Arbitrage. Due to some behavioural biases of investors, their decisions differ from rationality. Here are some behavioural biases of investors which affect the investment decisions and make them irrational.

OVERCONFIDENCE: Many empirical findings show that human beings are generally overconfident. Two biases are responsible for overconfidence.

Self-attribution bias: People think success came due to their own ability but failure occurred due to bad external circumstances.

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Hindsight bias: People judge their ability much more than they actually have. They think they predicted that event well in advance which is happening now.

We all overestimate our abilities in many areas. Overconfidence affects the investment decisions in two ways. Firstly, overconfident investors trade too much. Odean (1999) has found that investors trade excessively due to their overconfidence. The returns from this excessive trading are not sufficient to met trading costs. Even when trading costs are ignored these investors actually lower their returns through trading. The researchers have found that investors who make relatively more trades have lower returns than investors who trade less frequently. So, the moral is "Excessive trading is hazardous to your wealth". Secondly, sometimes, there may be lack of diversification in the asset allocation due to overconfidence.

ANCHORING: Anchoring is the tendency to attach or anchor our thoughts to a reference point – even though it has no logical relevance. For example investors invest in the stocks that have considerably fallen from their recent highs and they think it is an opportunity to buy at discounted price. Sometimes investors can take the advantage of this short term volatility, but most often they face decline in value due to fundamental changes.

FRAME DEPENDENCE: The decision of a person depends on how the problem is framed or presented to him. If an investment problem is presented in two different (but both are actually equivalent) ways, investors often make inconsistent choices i.e. a person's decisions changes simply because of a change in frame.

Let us take an example –

Scenario-I: A person has been given Rs 1,00,000 and asked to choose any one of the following two options:

Option A: He will get another Rs 50,000 for sure.

Option B: He will throw a fair coin and if head comes up, he will get another Rs 1,00,000 and if tail comes up, he will get nothing.

In this case most of the people (about 85%) choose option A.

Scenario-II: A person has been given Rs 2,00,000 and asked to choose any one of the following two options:

Option A: He will lose Rs 50,000 for sure.

Option B: He will throw a fair coin and if head comes up, he will lose nothing and if tail comes up, he will lose Rs 1,00,000.

In this case most of the people (about 70%) choose option B.

If we look closely at the two scenarios, we will see that both the scenarios are identical. If we choose option A in both the cases our outcome is certain which is Rs 1,50,000. But if we choose option B, then if head comes up our outcome is Rs 2,00,000 and if tail comes up, our outcome is Rs 1,00,000 i.e. in both the scenarios our outcome is Rs 2,00,000 or Rs 1,00,000 with the equal

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probability. But the investor's decision is not consistent. This is happened due to framing of the problem. But the traditional finance theory assumes that people should have consistent choices, regardless of presentation.

MENTAL ACCOUNTING: When an investor invests in a stock, by nature, he will always consider its purchase price. Due to passes of time, when the stock price changes he/she calculates unrealized gains or losses of each stock. This behaviour is known as mental accounting. Sometimes, due to mental accounting, investor builds up a personal relationship with the each stock of his holding. In this case, it is difficult to sale a stock. Again, it is difficult to sale a stock lower than its purchase price. Thaler (1985) developed a new model of consumer behaviour involving mental accounting of gains and losses using the prospect theory value function. The essence of prospect theory is investors are risk- avoiders in case of gains but risk-takers in case of losses. Thaler (1999) states that each of the components of mental accounting violates the economic principle of fungibility. As a result, mental accounting influences choice, that is, it matters.

It is seen that people are more adventurous with the money received from sudden and unexpected source but they are conservative with their regular and hard-earned money. But mind that all moneys are yours and they have same value irrespective of the source of income.

LOSS AVERSION: Loss aversion can help to explain the tendency of investors to hold on loss making stocks while selling profit making stocks too early. So, the individual investor's behaviour goes against the investment maxim –

"Ride your winners and sell your losers".

Let us consider a situation:

A year ago, you bought shares in X co. for Rs 500 per share. Today these shares are worth Rs 300 each.

Now what will you do? Will you sell this stock? Will you hold this stock? Will you buy this stock?

The answer should be on the basis of rational analysis. If the rational analysis says that it is reasonable to purchase the share at Rs 300, then you are not suffering from loss aversion. But if you argued yourself that the share of X company were a good buy at Rs 500, so this price will must increase, then you are suffering from loss aversion. There are two important lessons from this example –

(i) The market says that price of shares of X Ltd. is Rs 300 and the market does not care that you paid Rs 500 a year ago.

(ii) You must evaluate your investment at their current price not at their purchase price.

In reality investors don't want to sale the stock by accepting the losses and ultimately they suffer huge losses.

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HERD BEHAVIOUR: It is the tendency of people to follow the others. In case of investment decisions also investors follow the big names without any hesitation. Even if the decision is irrational or incorrect, you still follow the herd, believing they know something that you don't. People simply think that other people could not be wrong though the rational investment decision should be on the basis of processing the available information.

CULTURE OF GREED AND FEAR: People invest their hard-working money; hence every investment should be after rational judgment. In the developing countries like ours, there is hype among people that stock market is the only place where an investor can be millionaire overnight. On the other hand, some people believe that investing in stock market is not an investment, it is a gamble and investor may lose entire of his investment. Due to this culture, Investors enter into the market when valuation is high and they exit when valuation is low. So, the overreaction takes place.

OVER-REACTION AND UNDER-REACTION: In the stock market sometimes investors may over react (or under react) to a particular event. According to the Efficient Market Hypothesis, new information should more or less be reflected instantly in a security's price and this price change persists until new information come. But participants in the stock market overreact to new information and create larger than appropriate effect in the security price. The study of De Bondt & Thaler (1985) shows that the loser's portfolio consistently beats the market index, while the winner's portfolio underperforms during the three year time span. The under-reaction evidence shows that in one month to twelve months time span, security price under react i.e. news is incorporated slowly into prices, not instantly.

MOMENTUM EFFECTS: One explanation of momentum effect is the trend of a security price that creates a bubble and changes significantly towards the momentum direction. Another explanation is computer generated stop loss orders which accelerate the downward trend. Jegadeesh and Titman (1993) have found trading strategies that buy past winners and sell past losers realize significant abnormal returns. Winners and losers stocks are selected on the basis of past 6 months returns and it generated excess return after a holding period of 6 months. But the returns of losers portfolio is significantly higher than the winners portfolio after 8 to 20 months of portfolio formation. Thus momentum effect is found in stock market in short to intermediate terms and reversal of overreaction in the long term. Joshipura (2009) found the existence of momentum profit in the short term period of six months and one year and contrarian returns in a longer period of three years in Indian Stock Market.

ENDOWMENT AND DISPOSITION EFFECTS: Endowment effects show that the price of an asset to a particular people depends on whether they already own it or not. Due to this effect, people sometimes demand more money to give up something than they would be willing to pay to acquire it.

Disposition effects show that people create their own reference point without having any rational argument. Odean (1998) examined the disposition effect and found that investors have a tendency to hold the losing investments whereas they sale winning investments too early. For example, if an investor buys a stock at Rs 100 each, which then drops to Rs 85 each before rising again to Rs 95 each (which is the right value at that time), he will still tend to hold the stock till it

reaches the Rs 100 again. It is similar to loss aversion. The same investor sells the stock when it reaches the original buying price of Rs 100, though there were more gains expected rationally.

CONCLUSION:

Some investors' biases are present while making investment decisions and these biases lead to the irrational investment decisions. The rational theories can explain certain idealized events but in reality market participants often behaved very unpredictably and some anomalous behaviours of investors are found that couldn't be explained by the rational theories. Behavioural finance supplements the standard theory of finance by introducing behavioural aspects to the decision-making process. So, for the improvement of financial decision-making, psychological and economic principles both should be applied together.

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