Role of Behavior Finance in Equity Markets

24 January 2020

Behavioral Finance

- Behavioral Finance is the study of psychology and finance. This theory guide us how emotions and cognitive errors can cause disasters in our financial affairs.
- The goal of behavioral finance is to provide us a framework to try and outperform the market by being aware of our emotions as well as of others and using the information to our advantage.
- The research on this subject clearly shows that *"human flaws are consistent, predictable, and can be exploited for profit"*.

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Why study behavioral finance?

This study help Investors to

- Recognizing their own mistakes and those of others
- Understand the reasons for mistakes
- Avoid mistakes (maybe!)
- Understanding that one investor's mistakes can become another's profits or another's risk!

Investors need to understand that stock prices in the short run are more a function of people's emotions than the fundamentals of the underlying companies.

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Case Study :

Raj Mehta, 36, was a risk-averse investor till September 2007. Then, the stock market lightning hit him. Historical highs every week left him completely flustered.

While, his friends were boasting of increase in wealth every day, he was only locked-into fixed instruments and returns of a measly 6 per cent a year. Even his wife started complaining that he was being too conservative.

Then, Mehta decided enough was enough. He approached a broker recommended by his colleagues, went through the entire process of filling up a form and even managed to open a demat account in record three days. In less than a week, Mehta was all ready to enter the stock market.

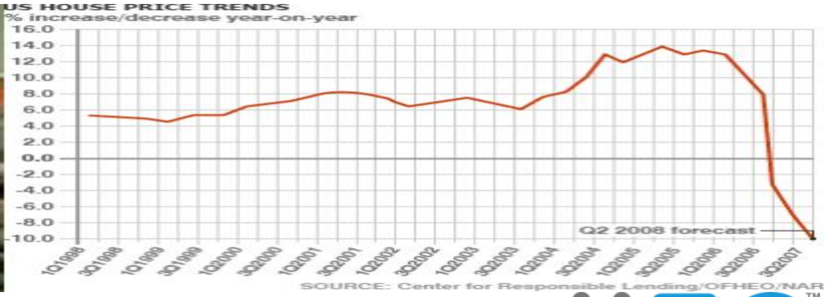
His broker also gave him a lot of attention and tips. Within the next one month, Mehta invested over Rs. 5 lakh and his money grew by over 20 per cent in a single month. Now, Mehta was more glued on to the stock market than he was in his own job.

The year, 2008, in the initial weeks, was volatile. And he, like many others, was lecturing people that this was the period of consolidation. “Oh, by March, the Sensex would be at a minimum of 25,000 points,” he told his friends.

But, scenario changed suddenly, since January 21, 2008, the markets had followed only one trend: downwards. Mehta's stocks today were down by a good 70 per cent. His gains had been completely wiped out. His capital loss: a hefty 40 per cent.

He stood undeterred though. “This stock will certainly go up and I will buy more of this stock at these levels. You know, my average costing has gone down substantially,” was his response….

This is a common investor-behavior in the stock markets.
Ego should not rule your investment decisions. Admitting that you were wrong is the first step towards success.



INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Ten Mistake’s which generally an investor commits

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

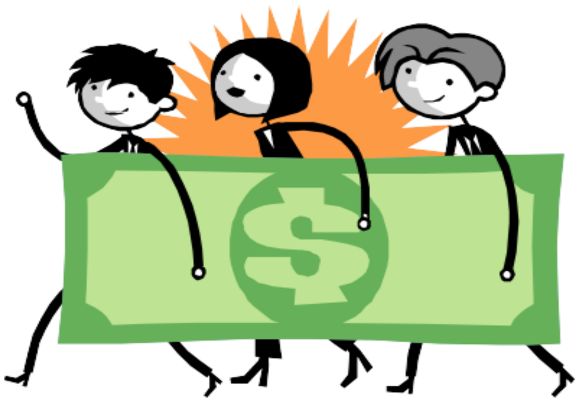
Mistake #1 : **By holding loss making stocks**

It has been observed that an investor always have a tendency to hold loss making stocks for its recovery and sell off all profit making stocks

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Mistake # 2 : Booking profits on formula basis

#It has been observed that generally an investor books profit based on some formula but the same has to be done only if the reason to buy the stock has ceased to exist.



Mistake # 3 :Buying More and more shares to do averaging

An investor usually buys more and more stocks as the price of a stock falls to do averaging which in turn increases losses only.

Mistake # 4 :Getting attached to a stock

#Many an investors get themselves emotionally attached to a particular scrip which results in either loss or reduction In profits

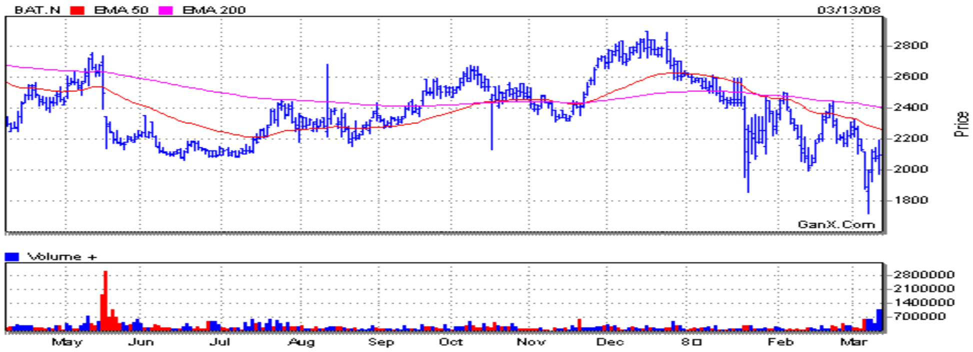
INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Mistake # 5 :Waiting for a better price

#Investors in general wait for a better price or opportune time but--- in reality, every time is a right time for investments.

Mistake # 6 : Selling a stock because its keeping quiet.

#We usually sell a stock which is keeping quiet as we get frustrated and we feel that it will not go up any further.

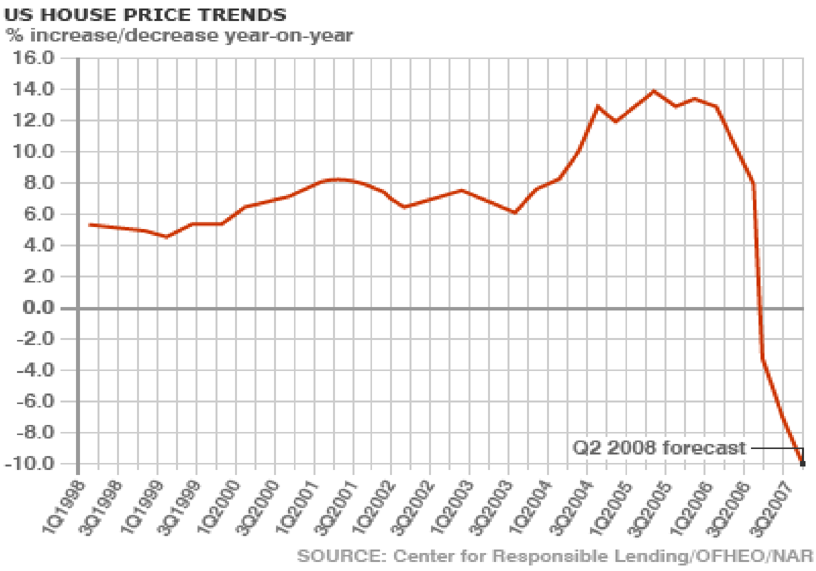


Mistake # 7 : ***Holding on a bit more so that I pay less tax***

Many a times we use to hold scrip for a bit more just to save taxes (long term capital gain) but while saving tax we forget that the result of this holding might reduce the profits more.

Mistake # 8 : *Its such a low price what can I loose*

No price can be said as the low price, a scrip may fall further too.



Mistake # 9 : *My best friend is also the best stock picker*

Your friend might me a gainer and you become a loser on the same scrip as the important issue is when to enter and when to exit.

Mistake # 10 : *Acting based on price movements*

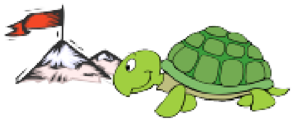
#We usually buy scrip's by just looking into the price movement but there are many other matters which should be taken care of while making investments.

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Investor Behavior

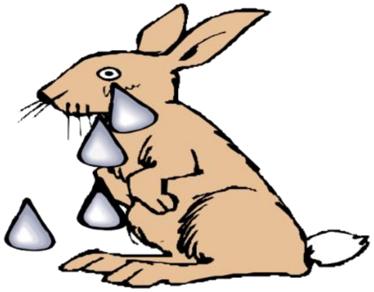
As per behavior finance theory Investors are not risk averse but they are loss averse

Investors get highly optimistic When the market goes up



And More

Pessimistic when the market goes down



Its human nature to choose a certain income fast coming despite a valuable one but in a long period of time.

Investor Behavior

People are overconfident in their own abilities, and investors and analysts are particularly overconfident in areas where they have some knowledge. However, increasing levels of confidence frequently shows no correlation with greater success because the greater success doesn't come from overconfidence.

There is no luck! It is financial analysis of the markets, the statements, the stocks, funds and behavioral analysis of the investors in their rush, greed, loss aversion for fast profit..

Ego have no place while taking investment decisions. For instance, if you have made a lousy investment, recognize and rectify it.

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Psychological biases

Emotions such as fear and greed often play a pivotal role in investor decisions

Prospect theory - Financial Decisions

Losers (Fear)

1. Loss Aversion
2. Sunk Cost theory

Gainers(Greed)

1. Decision paralysis
2. Endowment effect

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

As far as our feeling toward losses are concerned, we suffer from first behavioral anomaly

1. Loss aversion : that is our fear of losing

Scenario 1

Imagine that you have just been given Rs. 1000 and have been asked to choose between two options.

- Option A: Guaranteed additional Rs. 500.
- Option B: heads you get additional Rs. 1000, tails gain nothing?

Scenario 2

- Now imagine that you have been given Rs. 2000 and have to choose between two options.
- Option A: Guaranteed losing Rs. 500.
- Option B: heads you lose Rs. 1000, tails lose nothing?

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Impact of Loss aversion

- Investors tend to prefer fixed Income investments to stocks
- Individuals are more likely to sell stocks that have risen in price rather than those that have fallen in price
- Investors take more risks when threatened with a loss
- Investors tend to hold on losers and sell winners
- Tax Aversion : delay the decisions to save taxes on capital gains

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

2.Sunk cost fallacy: that is our inability to forget money already spent

Scenario 1

- Imagine that you've been given tickets to a performance of a celebrity singer. Before you leave your house, you learn that severe rainstorm and traffic is disrupted due to floods. You have to travel from Vashi to Nariman point in Mumbai. Would you go?

Scenario 2

- Imagine that you've bought tickets to a performance of a celebrity singer for Rs. 2000 . Before you leave your house, you learn that severe rainstorm and traffic is disrupted due to floods. You have to travel from Vashi to Nariman point in Mumbai. Would you go? Yes or No

Impact of Sunk cost fallacy

- Averaging cost of purchase
- Spending on Repairs
- Government spending on unviable projects

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

As far as our feeling toward gains are concerned, we suffer from first behavioral anomaly

Decision paralysis: that is our fear of losing

Decision paralysis explain human behavior to resist change.

When we take a decision we give ourselves a chance to move from the present comfort zone. Once we do that we have a 50- 50 chances of going right or wrong. If we choose not to take a decision we miss the chance of going right.

The reason we don't take decisions are :

- Fear of going wrong
- The possibility of losing
- To avoid looking foolish
- Unwillingness to take risks

As per research on human psychology, When there are multiple options one is more likely to delay an action other take no action at all. *The greater the choice, the harder the decision.*

iiFC™ INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

2.Endowment effect: that is the tendency to fall love with what we own and thus resist change

Would you do in the following situations?

Scenario 1

You have been gifted a souvenir Jug worth Rs.1000 (in the market place). Someone offers to buy it from you. What is the very least you would expect to be paid for the Jug?

a) Rs. 1000 b) Rs. 800 c) Rs. 700 d) Rs. 500

Scenario 2

Your neighbor has received a souvenir jug worth Rs. 1000 (in the market place) as a gift. He offers you the Jug for sale. What is the most you are willing to pay for the Jug?

a) Rs. 1000 b) Rs. 800 c) Rs. 700 d) Rs. 500

Endowment effect

Because people place an inordinately high value on what they have, a decision to change become difficult. Few suggestions you have to bear in mind when you have to take a decision

- Deciding not to decide is also a decision(In stagnant market conditions)
- Consider the opportunity costs
- Put yourself on autopilot mode
- Change your frame of Reference (suppose you hold 1000 share of DLF, Imagine you have cash & then which stock you will invest)
- Don’t get married to your stocks
- Understand that there is no free lunch
- Learn to apply Dale Carnegie principal on worry

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Tips to Applying Behavioral Finance

- Be humble

–Avoid leverage, diversify, minimize trading

- Be patient

– Don't try to get rich quick
– A watched stock never rises
– Tune out the noise
– Make sure time is on your side (stocks instead of options; no leverage)

- Get a partner –someone you really trust –even if not at your firm

- Have written checklists; e.g., my four questions:

–Is this within my circle of competence?
–Is it a good business?
–Do I like management? (Operators, capital allocators, integrity)
–Is the stock incredibly cheap? Am I trembling with greed?

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Tips to Applying Behavioral Finance

Don’t anchor on historical information/perceptions/stock prices

– Keep an **open mind**
– Erase historical prices from your mind; don’t fall into the “I missed it” trap
– Think in terms of enterprise value not stock price
– Set buy and sell targets

Admit and learn from mistakes –but learn the right lessons and don’t obsess

– Put the initial investment thesis in writing so you can refer back to it
– Sell your mistakes and move on; you don’t have to make it back the same way you lost it
– But be careful of panicking and selling at the bottom

INDIAN INSTITUTE FOR FINANCIAL CERTIFICATIONS

Thank you

INDIAN INSTITUTE FOR
FINANCIAL CERTIFICATIONS