Investors' Behavior

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"Though this be madness, yet there is method in it" -Shakespeare, Hamlet.

The glooms of uncertainties, the woes of sluggish economy and era of low returns may become things of the past. The investors are on cloud nine as the Sensex crossed the magical 12000 milestone. One cannot be sure when this rally would fizzle out.· Bolstered by Political stability, strong economy, corporate performance and significant presence of foreign investors vying for the value created by Indian corporate, the market has made a phenomenal rise in the stock market. Stock market's performance is not simply the result of visible rational characteristics but also due to the invisible characteristics of the investors. Despite loads of information bombarding from all directions, it is not the cold calculations of financial wizards but crucially the investors' irrational emotions like overconfidence, fear, risk aversion etc., drive and dictate the direction of the market. In the 1930s, legendary economist John Maynard Keynes and value-investing maven Benjamin Graham emphasized the effect of investors' emotions on stock prices. Contrary to available theories that say individuals act rationally by processing the available information in the decision-making process, researchers have uncovered patterns of irrationality, inconsistency, and incompetence in the ways human beings arrive at decisions. When faced with uncertainty, how emotions over ride rationality in driving the market to dizzy heights or the rock bottom makes a fascinating study.

According to *Sewell,* behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the vulnerability of markets to human emotion. Behavioral Finance is a field that attempts to understand and explain influence of emotions and cognitive errors on investor's decision-making process.

Age

Age accounts for the major differences in risk taking decisions by investors. The older an investor, the better seemed his/her performance in comparison to the younger ones. Overconfidence in their own investment ability among the youngsters largely accounts for the excessive trading among younger investors leading to lowering of performance. Entry in to stock market is the result of realization that opportunities to earn money are open to every one who has reliance on their ability and assessment of the data. Youngsters today, with growing belief in their instincts are getting more exposed to the glamour of securities by watching T.V, accessing Internet, talking to friends or even by way of knowing about the fortunes of the company in their search for employment. Hence they, especially the IT professionals with fat salaries, no longer consider trading in shares as incredibly dangerous but as putting their money in the hands of smart managers like TATAs or Ambanis etc. who build products or offer services. Those who are around thirty years of age have enough time and higher risk taking ability thus get attracted to equities which have a long horizon. Those with a longer time horizon will be better able to deal with risk. Those who are close to 30s try to earn enough money from their investments to meet their life style goals. The companies with strong marketing strategies are strongly tempting these people to invest. The latter stage warrants fulfillment of family responsibilities resulting in lowering of risk appetite. Individuals whose retirement is imminent become very conservative about the risk one can incur and prefer safety and stability in their investments rather than expecting high returns. In their pursuit of wealth accumulation, they need to

think of unpredictable illness or enough money to take care of their expenses during non working days without losing their comforts.

Geographical Differences

Geographical differences accounts for certain changes in investor's behavior. For instance, the investors from different geographical districts may have the different degree of risk-aversion. As the location affects the lifestyle, the investing perspective varies from village to Metropolitan residents. Since, the metropolitan residents have easy access to various avenues of investment opportunities and information in comparison with the other investors. Hence, they may exhibit active trading behaviors. There seems to be a significant home bias in the stock selection process too. Investors prefer to invest in the stocks of the firms that have activities in their home country or State or district or places known for rapid economic progress.

Gender

In most places men shoulder the financial responsibilities thus investing is traditionally a masculine task. Their results suggest that men do exhibit more overconfident characteristics than that of women. This leads to excessive trading thus end up making lesser returns than women do. Several studies say that women earn higher returns than men. In countries like India, female investors tend to remain passive and the men take active investment decisions.

Experience

Psychologists feel that experience accounts for varying degree of cognitive bias among the investors. Usually we hold that accumulated experience make us rational and reduces the tendency to commit cognitive errors. However, behavioral biases, like over confidence actually get exacerbated with experience. Greater the experience, higher seems the probability to succumb to cognitive biases or irrational behavior. One's bad experience in the market may always cause anxiety at the time of next investment. Slightest hint of risk will lead the investors to run amuck to sell the stock.

For those who are novices to investment, it is not different either. The new investors enter the market with the lure of making quick buck from stock market. They neither have definite knowledge of the companies they invest in nor the confidence in their investment decisions. Once the market begins to fall on its way to natural correction, they think it would be no end to this or downslide. Then they begin to drive down the prices of the shares further causing a vicious cycle.

Emotions

"Markets invariably move to undervalued and overvalued extremes because human nature falls victim to greed and/or fear." ***William Gross***. Contrary to the popularly held belief investors are said to be less rational than they actually think they are. Penn State Great Valley finance professor Daniel Indro explains, " Anyone trading stocks isn't just driven by calculations. They're also driven by their psychology -- fear, greed, and so forth."

Fear and Greed

"I have had a long, long life full of troubles, but there is one curious fact about them - nine-tenths of them never happened." (Andrew Carnegie). Fear and greed are the explosive emotions that can determine the direction of the market. Human beings primarily indulge in things that increase their pleasure and reduce their pain. Greed multiplies the pleasure and fear accounts for all the pains.

Fear of uncertainty, fear of losing money, fear of the unpleasant or the new, fear of economic recession etc. are the indisputable emotions that haunt many investors. There always exists some uncertainty in the market generating anxiety among the investors. In case an investor makes profits he /she experiences emotional pleasure whereas a loss automatically results in emotional turmoil leading to fear. Fear of loss leads to panic to sell unbelievable number of shares which may actually fetch better returns in future. Threat of war or rumors about the dwindling fortunes of

a company or poor performance etc. cause the market crash as the investors switch panic button and go on a selling spree. When the markets are in firm grip of Bears, pessimism is glaring and the downtrend is very steep.

"Greed results from a combination of overconfidence and the desire to make fast money in the time possible." The quick grab approach is bound to lead to stress and subjectivity. The greed prompts the investor to enter the market, the fear compels investor to make early exit or flee from the market. In February 2000, when the prices of tech stocks were skyrocketing WIPRO's market cap stood at Rs. 225,000 crore and Premji became one among the richest men on earth. People who have entered the market then with a commitment between 5000-10000 levels have never seen the stock rise again after the march melt down. Greed, an inevitable part of human psyche prompted that peak is yet to come though the stock was already over valued many times. The temptation to make more often blinds people to reality and profit positions turn to losses and losses translate to disasters. Instead of being greedy, it is appropriate to accept Warren Buffet when he says. "I would rather be certain of a good return than hopeful of a great one"

Risk Aversion

People have blind faith in stock brokers, fund managers and the like as it is easy rely on their ability to avoid risk. Tversky and Kahneman (1979) originally described "Prospect Theory" proposed that people placed different weights and probabilities on gains and losses. They found that individuals are more distressed by prospective losses than they are happy by equivalent gains. Some economists have concluded that investors typically consider the loss of $1 dollar twice as painful as the pleasure received from a $1 gain. Researchers have also found that people are willing to take more risks to avoid losses than to realize gains. Presented with certain gain, most investors become risk-averse, but faced with sure loss, investors become great risk-takers. Money manager David Dreman, who published "The New Contrarian Investment Strategy", argued that investors could outperform by not following market fads. "Does the Stock Market Overreact?" by Richard Thaler and Warner De Bondt (1985) have noted that commonsense has vital say in investors risk behavior. Many investors will focus obsessively on one investment that's losing money, even if the rest of their portfolio is giving great returns.

Studies of risk perception find that people in Asian cultures (China, Japan, and Hong Kong were test groups) are less risk averse than people in Western cultures (United States, Germany, and Poland were test groups). On the other hand, people in an emerging market like that of India till recently are less familiar with how equity markets work. The familiarity bias is another heuristic simplification that predicts that investors who are familiar with an asset will view it more optimistically (higher expected return and/or lower risk). Feng and Seasholes (2002) find that Chinese investors suffer from a familiarity bias in their purchasing of local companies. People in an emerging market are not as familiar with stock price dynamics and trading as people in more developed markets. Because they are less familiar with stock investing, Chinese people may view stocks as being very risky.

Other behaviors that are much more subtle, difficult to spot and harder to correct are given below.

Overconfidence

A series of gains without any set backs usher in a feeling of invincibility or over confidence which will ultimately prove detrimental in getting higher returns. Overconfidence refers to our boundless ability as human beings to think that we're smarter or more capable than we really are. Investors and analysts are particularly overconfident in areas where they have some knowledge. Money managers, advisors, and investors are consistently overconfident in their ability to outperform the market. The state of over confidence results in indiscriminate trading leading to losses. Overconfidence in the markets is often visible in the research reports of market analysts.

When the markets reached 5000 levels in January 2000, 6000 seemed achievable. At 6000 over optimistic bulls said the market will rally beyond the 7000 and may touch 7500, but this never turned true and the Bull Run was not only halted, but also culminated with a big bear hug bringing the Sensex down to 3500.

Investors tend to look at the recent performance of a stock or market and extrapolate too far into the future. They feel invincible, so they trade more believing they have the ability to do well". Information explosion through internet also contributes the overconfidence of the investors as the investors regularly access it and react hastily to such information. "Knowledge is up by 20 percent but perceived knowledge went up 80 percent during the bull market". Thus, Internet can multiply over confidence through the credibility it enjoys among the investors. Some analysts also say the Internet is partly to blame for the nearly simultaneous downturn of all of the major and most of the minor markets worldwide. Thus, increasing levels of confidence shows no correlation with greater success.

Overtrading

A natural sequel to greed is over trading. Many traders feel they need to play the market all the time. There are many day traders on the Wall Street, so too on the Dalal Street who earn their living by trading. Some carve for excitement through trading. The advent of Internet as said above has also contributed towards this. In India trading over the net is in infancy, but in US and other countries it has become a major distraction as people trade at the fraction of a mouse click. Trading has become the biggest and easiest obsession in the net. In the metropolitan and big cities of India, fever of net trading is already a reality. H.J. Wolf (1926) in his book "Studies in stock speculation calls this phenomenon marketitis". He compares it to the same kind of impulse that makes a man board a train before he knows in which direction it is headed. The disease makes the trader believe that trader's guess indeed a certainty. It makes trader think that the trader is speculating when indeed trader is gambling.

Regret

Despite the investments made for all the right reasons, when an investor is faced with negative consequence, investors fall prey to regret. That regret can lead an investor to make a bad sell decision. Professor Stateman (Regret theory) is an expert in the behavior known as the "fear of regret." People tend to feel sorrow and grief after having made an error in judgment. Investors deciding whether to sell a security are emotionally affected by whether the security was bought for more or less than the current price. One theory is that investors avoid selling stocks that have gone down in order to avoid the pain and regret of having made a bad investment.

People typically give too much weight to recent experience and extrapolate recent trends that are at odds with long-run averages and statistical odds. They tend to become more optimistic when the market goes up and more pessimistic when the market goes down. Many believe that when high percentages of participants become overly optimistic or pessimistic about the future, it is a signal that market heads in that direction. When the opposite actually takes place, they regret their decisions.

Perception

Usually individual reality is based on perception. Most of the time they act and react based on perceptions not necessarily on the basis of objective reality itself. Psychological basis of perceptions is to understand how investors reaction varies based on the information provided by the environment. Investors frequently trade on same information they get. Some subjectively believe that they got superior and relevant data, even when it is not fully verified by the market. This results in speculative trading. A participant in speculative trade believes he or she has superior information and another participant feels that his/her information is far more superior.

People may make predictable, non-optimal, choices when faced with difficult and uncertain decisions because of subjective heuristic simplifications or the shortcuts in decision

making. Arnold S. Wood of Martingale Asset Management describes the "touchy-feely syndrome" as the tendency for people to overvalue things they've actually "touched" or selected personally. Similarly, many researchers believe that analysts who visit a company develop more confidence in their stock picking skill, although there is no evidence to support this confidence. Another, outcome of heuristic simplification, self-deception, occurs because people tend to think *that they are better than they really are.* Both the psychology and the recent finance literature characterize people with this type of behavior as being "overconfident." Investors who are overconfident believe they can obtain large returns and underestimate the associated risks. It is found that individual investors trade excessively, expose themselves to a high level of risk, and make poor investing decisions. So it is common to find that the stocks individuals sell outperform stocks that they tend to buy.

Mental accounting is yet another heuristic simplification, where the mind keeps track of gains and losses related to decisions. According to Hirshleifer (2001), mental accounting may explain the "disposition effect." People want their good decisions to be recognized immediately in their mental accounts, but they postpone acknowledging their bad decisions. Investors' tendency to realize their gains at a much higher rate than their losses is known as disposition effect. A loss hurts us more than the gains we enjoy. Hence, investors sell the stocks that have performed well so that they can feel good about themselves, or so they can boast to others about their ability to pick good stocks. At the same time, investors may hold on to their poorly performing stocks because they are not ready to acknowledge that they made a mistake, and because they are afraid that the stocks may recover. The disposition effect is abnormal. It is the future value or appreciation of the stock is the decisive criterion that should determine the purchase or selling decision. Investors usually prefer selling winners to selling losers due to the disposition effect.

Specifically, Hirshleifer finds that individual investors are more willing to recognize paper gains than paper losses. People also tend to remember successes, but not their failures, thereby unjustifiably increasing their confidence. As John Allen Paulos states in his book Innumeracy, "There is a strong general tendency to filter out the bad and the failed and to focus on the good and the successful."

One mental shortcut, the representative bias, makes the assumption that certain qualities of an item imply other qualities for that same (or related) item, often in a positively correlated way. For example, investors may confuse a good company with a good investment. In actuality, Firms that generate higher earnings due to high sales growth or headed by quality management are deemed to be good companies to invest. Good investments are stocks that increase in price more than other stocks. Investors also make this error when examining past stock returns. For example, stocks with poor (strong) performance during the past may be considered losers (winners). Investors consider this past return to be representative of what they can expect in the future. Many investors buy stocks that have recently increased in price. Investors like to buy past winners because they believe that the past price trend is representative of the future price trend.

Herd Behavior

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one." Some make investments largely *because others invested and start selling them* as soon as they see others or start selling them even if they are against such decision. Many are comfortable in investing with the crowd, as in following a market guru or brokers buying a popular mutual fund. Stock brokers today no longer advice what is best for the investor but what is best in terms of earning incentives. This attitude among insecure investors to trust the crowd more than one's own ability and instincts can be termed as herd mentality. In the popular literature, "crowd effects" often have been associated with large fluctuations in market prices of financial assets. Men led by herd

mentality can act in frenzy. Then, buy whatever the crowd buys and sells whatever the crowd sells becomes the law. This probably accounts for the mad pursuit in stock market whenever the markets crashed. Investors follow the crowd and conventional wisdom so as to avoid the possibility of a regret if things go wrong. A number of recent studies observed that mimetic behavior among the undisciplined masses as a possible explanation for the excessive volatility observed in financial markets. This makes them become over optimistic in bullish times and go berserk in the bearish times. Herding hurts and exacerbates volatility, destabilizes markets, and increases the fragility of the financial system. It is surprising that profit-maximizing investor *endowed with market information react* similarly at more or less the same time at a rapid speed resulting unusual volatility. Herding occurs when investors think the information others have may be the privileged information about the return on investment that he/she may not have access to. Imitation also gives certain amount comfort to investors and reduces their uncertainty. When investors are influenced by others' decisions, they may herd on an investment decision that is wrong for all of them.

However, the passive investing either due to the broker's persuasion or by one's mimics harm the market.

Concerns

Plagued by several problems like tactical practices of the brokers, transparency, shady dealings by the companies, lack of accountability and insider trading, most investors feel deceived or influenced negatively. Hence, repeated assurances by the finance ministry or securities industry regulation should be stronger than what it is today. As investor behavior is highly vulnerable to the currents in the market place, an increasing emphasis is required to promote of ethics and demand accountability.

Conclusion

The behaviorists have yet to come up with a coherent model that actually predicts the future rather than merely explains the investor's behavior. This does not give the tips to beat the market but tells the psychology causes market rise or fall. It helps the companies to recognize psychological influences of the investors and exploit them by designing effective programs to woo the investors. These principles can help the investors to be watchful of their ineffective investment behaviors through a systematic appraisal of their psychology and avoid pitfalls that result in derailing their ambitions. They can install a system of successful investing decisions behavior by critically inspecting lucrative opportunities to invest. But such knowledge could become a tool in the hands of the speculators who can falsely induce the *investors to influence negative behavior by* floating rumors about the market. Such study also can advocate the concept of delegating the task of investing to financial wizards to reap greater benefits.

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