ISSN No.: 2454- 2024 (online)

International Journal of Technical Research & Science

INVESTOR BIASES IN INDIAN STOCKMARKET

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Abstract: Behavioural investing seeks to bridge the gap between psychology and investing. All too many investors are completely unaware of the mental pitfalls that await them. Even once we are aware of our biases, we must recognize that knowledge does not equal behavior. Huge amount of information is readily available and it is upon the investor to differentiate and select. This selection of information is described as a study called Behavioural Finance. Behavioural finance therefore studies the influence of psychology on the behavior of portfolio investors and their consequent reactions in stock market investing. This paper mainly deals with – Investor biases and how these influence investing decisions in the Indian stock market by analyzing the Indian stock market during the last decade. The effect of one major bias, the confirmation bias will be studied through questionnaire approach. The paper will also assist individual investors to avoid these "mental mistakes and errors" by recommending some important investment strategies for those who invest in stocks and mutual funds.

Keywords: Investor biases, Behavioural Finance, Stock Market, Cognitive biases, Strategies to avoid biased decisions

1. INTRODUCTION

The objective of any investment is to make money. In the early years, investment was based on performance, forecasting, market timing and so on. This produced very ordinary results, which meant that investors were bestowed with very normal returns, and not much peace of mind. However available returns and actually received returns were different in reality and a valid justification was therefore required. While examining the process, they identified that it is caused by fundamental mistakes in the decision-making process, i.e. they were making irrational investment decisions. In recognizing these mistakes and the means to avoid them, they realized the impact of psychology in investment decisions to transform the quality of investment decisions and therefore return. This resulted in active research in the field of Behavioral Finance to understand the psychological processes driving these errors.

Lintner defines behavioural finance as being 'the study of how humans interpret and act on information to make informed investment decisions'. Olsen asserts that 'behavioural finance does not try to define 'rational' behaviour or label decision making as biased or faulty; it seeks to understand and predict systematic financial market implications of psychological decision processes.'

1.1 Indian Stock Markets during the last decade

India has the lowest Exports/GDP ratio, yet when the world was in trouble, the Indian stock markets were hit the most. An analysis of the Indian stock market reveals that it has witnessed extreme activities and is slowly gaining more importance due to its high volatility. Indian stock market trends have shown integration with the global markets and the dependency of the Indian market on the activities in markets abroad. Any small development in the world stock market has always affected the Indian stock market immensely. The analysis of the Indian stock market has revealed that Indian capital markets have performed in coordination with their international counterparts.

1.2 Analysis of the Indian stock market during the last decade

In September 2008 the Indian stock markets saw a consistent fall with the S&P CNX NIFTY, showing the second sharpest fall since January 2008, with a decline of around 10%. Due to the happenings in US financial markets and its crisis bug, an estimated amount of Rs 2.3 trillion of shareholders' wealth were eroded in the Indian stock markets.

1.3 Global meltdown and how it has affected the Indian stock market

The Indian stock markets are nervous. The impact of the global sub-prime crisis emanated from the US and spread its wings across the world. This has resulted in a whirlwind, sweeping the Indian capital market off its feet. The Sensex fell from an astronomic high of 21,200 as on January 2008, to below 9,000 mark as on October 2008, with a fall of 35% in the month of October alone.

1.4 Reason for the fall in the Indian stock market

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The Foreign Institutional Investors (FIIs), in the last few years have been a strong growth driver for the Sensex. They have been investing billions of dollars in the capital markets, fuelling high valuations, which in turn sharpened the appetite for expansion, acquisitions and higher corporate growth. Based on supernormal profits (CAGR of 33% in last five years as against the lack luster performance in the 1990s) in the corporate sector, they have been planning aggressively for capital expenditure and suitable acquisitions even in the global markets.

The Indian retail investors too were encouraged by the strong economic growth and they indulged in ambitious investments with a desire to collect above normal returns. The result was high commodity and real estate prices.
All the three stakeholders - the market, investors and corporate management now have to share the 'spoils' of the market. Contraction, deflation and recession - all these have become the buzzwords in economies worldwide. In the context of globally 'integrated markets', the sub-prime crisis had different levels of impact in the emerging capital markets including India.

The US financial crisis and the global liquidity crunch forced the FIIs to liquidate their positions in the Indian stock market leading to the steep fall in the Sensex. The redemption pressures on mutual funds also had an impact. Locally, investors - retail, HNI and institutional have shown an indifferent approach towards the warning signals from the economy and markets and continued to take a bet, initially based on fundamentals and then on emotions and sentiments.

Mainly retail investors have been caught unprepared by the steep fall in Sensex and are now sitting on huge losses. While the underlying fundamentals of the economy still remain strong, quite a few sectors like exports, real estate, IT and commodities (not all of them with inherent speculative tendencies) are facing most of the brunt of a slowing economy. Some corporates, with cash-rich balance sheets had been taking on ambitious expansion plans and that too over a longer time horizon. With credit flows from banks slowing down, due to distrust among banks, corporate are finding it difficult to carry out some of these plans as their valuations have come down and raising funds from other sources has become difficult.
All the three stakeholders appear to be pulled into a whirlpool of greed, overstated ambitions and 'irrational exuberance', reaching new highs.

2. HOW DOES BIASING AFFECT INVESTMENT DECISIONS IN INDIAN STOCK MARKET

According to science, the human brain is subject to an enormous amount of information every moment of the day. Even with the most evolved brain, humans find it impossible to analyze and interpret the sea of information available to them in real time. That is why the human mind selects information, by employing shortcuts and rules of thumb to arrive at conclusions, evaluate potential risks and rewards, and assess the likelihood of particular outcome. These mental selections are often based on immediate past experience, intuitions, feelings, familiarity, easy recall of events, following the mob, gender etc. The use of such shortcuts often biases investing decisions and make them act in apparently irrational ways. The literature on behavioural finance indicates that there are a large number of biases that affect our financial investing decisions. At any point of time, a person or an investor may be affected by even more than one bias, making the process of decision making a complex one. Also there is a difference in individual, group and community decision making that are affected by cognitive biases differently. At the same time, different people or investors may be affected by different combinations of biases, which make them react to the same situation in different ways. In stock markets such biases are observed commonly.

Table 2.1 Behavioral Finance Biases

• Anchoring	• Greed
• Financial Psychology	• Herd Behavior
• Cascades	• Framing
• Chaos Theory	• Hindsight Bias
• Cognitive Bias	• Preferences
• Cognitive Dissonance	• Fads
• Cognitive Errors	• Heuristics
• Contrarian Investing	• Manias
• Crashes	• Panics
• Fear	• Disposition Effect

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• Loss Aversion	• Under-reaction
• Prospect Theory	• Overconfidence
• Regret Theory	• Mental Accounting
• Groupthink Theory	• Irrational Behavior
• Anomalies	• Economic Psychology
• Market Inefficiency	• Risk Perception
• Behavioral Economics	• Gender Bias
• Overreaction	• Irrational Exuberance

3. NEW CLASSIFICATION OF INVESTORS IN INDIAN STOCK MARKETS

Our observation of the Indian stock markets indicates that depending on the combination of behavioural biases exhibited by the traders, we can classify them as Aggressive traders, follow-the-trend traders and conservative traders.

Aggressive traders are affected by overconfidence bias. They give preference to their own information and analysis and do not rely on publicly available information. These traders are likely to be contra traders, i.e., they bet on reversals in the market by entering long (purchasing stocks) in a falling market or short (selling stocks) in a rising market. These traders take high risks by timing the market reversals and are rewarded with proportionate returns. They are few in number but trade heavily and aggressively. Trading in large volumes, they can affect the market outcomes significantly. Foreign Institutional Investors (FIIs) and Domestic Institutional Investors (DIIs) are the aggressive traders in our analysis.

The trading strategy of some investors is to follow the trend of the market and move with the flow of the market by entering long in rallies (rising markets) and short in the corrections (falling markets). They have a high probability of success. They get squeezed and realize losses only when they enter long near the top or short near the bottom. This type follows the aggressive traders to enter the market and latch on to the trends after the initial profit has been booked by the aggressive traders. They usually trade in together and in smaller amounts. They affect the market more by their number than their trade volumes. High Net worth Individuals (HNIs) and large traders come under this category.

The retail traders or the conservative ones are affected by biases known as risk aversion, loss aversion, and short sightedness. Such traders are likely to sit on the fence for confirmation of any price trend and are the last ones to join the group. As they enter late and exit fast, their trading horizon is short, and they generally miss out on rallies and corrections and often get wiped out. Low payoffs result from low risk taking. Their desire for profits is limited. Such type is the largest in number but their trade size is the smallest.

At a point of time, all types of traders are seen in the stock market, but the dominant category affects the market outcomes.

4. CONFIRMATION BIAS AND ITS EFFECT ON DECISION MAKING

Confirmation bias is a cognitive bias, or tendency to interpret information in such a way that it confirms preconceived notions, while avoiding interpretations which contradict previously held beliefs (Shefrin, 2007). This occurs when investors have already made their choices and search for information to confirm their preconceptions. For example if an investor is interested in investing in Company A, he will look for positive information about the company so as to affirm his decision to trade.

In this study, the effect of one of the major biases, i.e. the confirmation bias has been exclusively studied among the Indian portfolio investors. To conduct the study, questionnaires were issued to investors in Indian stock markets with a minimum portfolio investment of 10 Lakhs and investing for 5-10 years. A total of 85 investors responded of which 69% were men and 31% were women. Data collected for this study was analyzed using descriptive statistics and Pearson Chi-square test. Pearson Chi-square technique was used to analyze the effect of confirmation bias.

Confirmation bias was measured by questioning the respondents as to what the respondents considered before buying a share. They were asked whether they identified the company first and then searched for information or searched for information first, and then selected a company. 64% of the respondents accepted the first alternative

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that they identified a company and then searched for information, while 36% searched first for information before selecting a company.
It was observed that women were affected more by confirmation bias at 67% as compared to men's rate of 65%. However, with a p-value of 0.15 it was observed that there is no significant correlation between the confirmation bias and gender even though women depicted a higher degree of confirmation bias.

5. HOW CAN INVESTORS OVERCOME THESE INVESTING BIASES?

As investors, we are obviously influenced by various behavioral and psychological factors. Individuals who invest in stocks and mutual funds should implement several safeguards that can help control the biases during investing. One way is to implement a disciplined trading strategy.

In the case of stock investments: the best way for investors to avoid biased decision making is to focus on a specific investment strategy over the long-term. Investors should keep detailed records as why a specific stock was purchased for their portfolio. Also, investors should decide upon the specific criteria for making an investment decision to buy, sell, or hold. For example, an investor should create a checklist for each of his investments that focus on the following:

- The reason for purchasing the stock.
- The investor's investment time horizon.
- The expected return from this investment one year from the purchase.
- What if a year from now the stock under-per-forms or over-performs his expectations?
- The plan of the investor on buying, selling, or holding his position
- Riskiness of this stock within his overall portfolio

The purpose of developing and maintaining an "investment record" is that over time it will assist an investor in evaluating investment decisions and to ascertain whether they were justified or not. With this type of strategy, investors will find it easier to admit their mental mistakes, and it will signal them to control their impulsive behaviour. Ultimately, the strategy to overcome emotional decision making is to trade less and implement a simple "buy and hold" strategy. A long-term buy and hold investment strategy usually outperforms a short-term trading strategy with high portfolio turnover. Year after year it has been recorded through many researches that a passive investment strategy beats an active investment philosophy approximately 60 to 80 percent of the time.

In the case of mutual fund investments: it is recommended that investors apply a similar "checklist" for individual stocks. Tomic and Ricciardi (2000) recommend that investors select mutual funds with a simple "4-step process" which includes the following criteria:

- Invest in only no-load mutual funds with low operating expenses;
- Look for funds with a strong historical track record over 5 to 10 years;
- Invest with tenured portfolio managers with a strong investment philosophy; and
- Understand the specific risk associated with each mutual fund by going through the terms and conditions of investment carefully

Essentially, these are good and strong criteria for mutual fund investors. The key to successful investing is recognizing the type of investor one is along with implementing a strict investment strategy. Ultimately, for most investors, the best way to maximize their investment returns is to control their "mental errors" with a long-term investment horizon.
Many similar researches have also concluded that the best trading strategy is a "long-term buy and hold" investment in a passive stock mutual fund such as S&P 500 index. Such investments are less susceptible to market risks, thereby ensuring good returns on the investment over a period of time.

6. SCOPE FOR FURTHER STUDY

This paper has attempted to study the investing biases and their prevalence in stock markets of India. It has also suggested ways to assist individuals to resolve these "mental mistakes and errors" by recommending some important investment strategies for those who invest in stocks and mutual funds. However there exists a further scope of studying each of the biases separately and its effects can be traced through the Indian stock market fluctuations over a period of time. Also a further study may be undertaken to study the comparison of Indian stock markets vis-à-vis

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the international markets and to understand how investing biases affect both differently. There may also be a study undertaken to separately study the biases in terms of long term investors' vis-à-vis the speculative traders. Indian stock market fluctuations may also be studied separately to understand the effect of a particular bias at any given point of time.

CONCLUSION

Behavioral finance therefore makes an attempt to explain and improve people's awareness regarding the mental factors and psychological processes of individuals and groups that invest in financial markets. This paper has established the presence of investing biases among individuals and entities, analyzed the Indian stock market over the last decade and has identified traders into three different types depending upon their behaviour in the stock market. An attempt has been made to study the effect of one of the biases, confirmation bias. It was found during the study that there is no significant correlation between the confirmation bias and gender even though women depicted a higher degree of confirmation bias.

This paper has also discussed some trading approaches for stock and mutual fund investors to assist them in understanding and controlling their psychological barriers. These strategies are a starting point for investors that encourage them to keep an investment track record and checklist regarding each stock or mutual fund within their overall portfolio. Hopefully, these behavioral finance-driven structured guidelines for making investment choices will aid individuals by drawing attention to potential mental blocks, hopefully leading to increased and consistent profits.

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