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Rational Investment Decisions of Irrational Household Investors

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ABSTRACT

Traditional finance appears to play a limited role in understanding issues such as how do individual investors perform, how do they choose their portfolios, and why do returns vary across stocks for reasons other than risk. Finance education in general can be more useful if it sheds specific light on active investing by addressing aspects such as what mistakes to avoid while investing, and what strategies in financial markets are likely to work in terms of earning supernormal returns. These are the main pedagogical goals of behavioural finance, which allows for explanations of financial phenomena based on non-rational behavior amongst investors. This paper explores some of the unanswered important questions about stock markets that can be examined and investigated by an emerging field, behavioral finance. This study has focused on understanding the behaviour of households as investors in various financial instruments which are traded in SEBI regulated markets.

KEYWORDS: Irrational Investors, Behavioral Finance, Equity Investments

Introduction:

Investors, today, are being loaded with information, thanks to the internet and the growing number of websites that are devoted to information on investment. The economic well being of an investor in the long run depends significantly on how wisely he invests. Investors have three objectives while investing their surplus money, namely safety of invested money, liquidity position of invested money, and return on investment in selected securities.

An investor can be classified as individual or professional who manages the funds on behalf of others. First there are inexperienced investor who needs to be properly advised about the intricacies of investment avenues and opportunities in corporate securities. Secondly, there are the experienced investors who understand the risks involved in the selected investment avenues and who need no advices from others, his response / order just to be executed without much time. Thirdly, there are occasional investors who seek advice and assistance once in a while with no desire to create a long term perspective

Depending on the risk profile of an investor, i.e. age profile and expected returns, proportion of each category of the total investment would vary. For instance, the risk appetite of a 24 year old person would be higher when compared to a 40-year-old working executive. For the former, the equity component is likely to be on the higher side and for the later, the real estate, fixed deposits and cash component would be proportionately higher. Investment in India has traditionally meant property, gold and bank deposits. The more risk-taking investors choose equity trading.

Investment Alternatives:

An investment is a sacrifice of current money or other resources for future benefits. Numerous avenues of investment are available today. They fall into two broad categories: financial assets and real assets. The important financial assets are equity shares, corporate debentures, government securities, bank deposits, mutual fund shares, insurance policies and derivative instruments. Real assets are represented by tangible assets like residential house, commercial property, agricultural farm, gold, precious stones, and art objects

Current saving patterns of household:

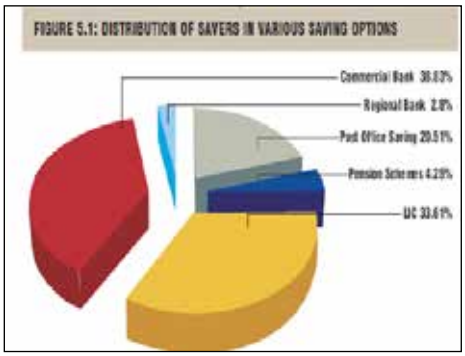
A nationwide survey of 38,412 households selected from 44 cities and 40 villages was conducted by National Council of Applied Economic Research (NCAER). The study estimated that India has approximately 227 million households, of which only 24.5 million invest in equity, debt, mutual funds, derivatives and other instruments in the capital market. That represents about 11% of the household sector. The remaining 89% are also likely to be net savers, but rely on non-risky avenues such as banks, insurance or post office savings instruments.

There is a significant magnitude of small savers among all households. 11 to 25 per cent of all households save in post office savings schemes. The degree of risk aversion is extremely high in Indian households. It is only at the margin that households engage in risky ventures.

Household income is a relatively minor determinant of participation in financial market. Instead, factors such as education, information, as well as quality information influence the magnitude and extent of participation to a greater extent. Only 21.25 per cent households prefer to invest in secondary markets. Households with a higher level of education invest more in this option.

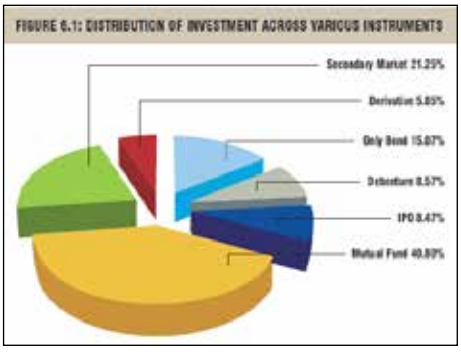
We find that the primary destination of savings across household categories is insurance schemes and banks. This reflects the need to provide for intra-household financial security. Post office savings schemes are, for oblivious reasons, preferred less than commercial banks. The single most important reason is that such schemes have cumbersome procedures and offer inadequate returns. Roughly 72 per cent of all households treat commercial banks and insurance schemes as their primary choice for savings.

Chart 1: Distribution of savers in various saving options



Source: www.sebi.gov.in

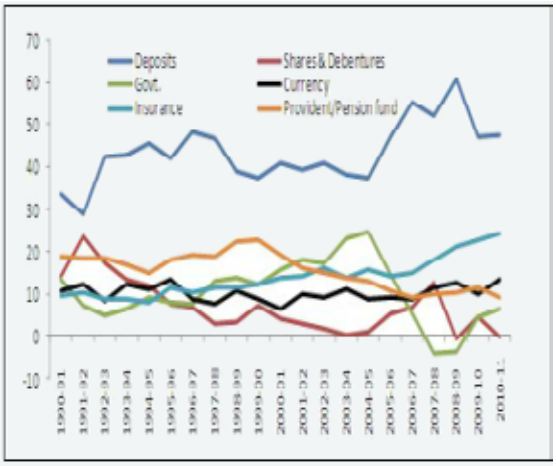
Chart 2: Distribution of investment across various instruments



Source: www.sebi.gov.in

Clearly, households seem to be quite risk averse, and prefer to invest in assets that are safe, familiar, and offer security of capital. Over a 20 year period when Indian capital markets have grown tremendously on many parameters, very few households have ventured too far beyond their bank, insurance agent, mandatory retirement funds and small savings. In fact, since 2000, household exposure to the capital market has crossed 7% only once, in 2007-08.

Graph 1: Trends in Portfolio Composition of Indian Households



Source: RBI Annual Report, various years

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Literature Review:

Chandra (1989) discussed the mistakes made by individual investors in designing their portfolios and suggested suitable remedial measures. Investors appear to be prone to the following errors in managing their investments: inadequate comprehension of return and risk, vaguely formulated investment policy, native extrapolation of the past, cursory decision making, simultaneous switching, misplaced love of cheap stocks, over-diversification and under-diversification, buying shares of familiar companies, wrong attitude toward losses and profits, and tendency to speculate

Gupta L.C. (1991b) argued that investors in India regard equity, debentures and company deposits as being in more or less the same risk category, and consider mutual funds, including all equity funds, almost as safe as bank deposits.

In his book, L.C. Gupta (1992) concluded that,

a) ndian stock market is highly speculative;
b) Indian investors are dissatisfied with the service provided to them by the brokers;
c) margins levied by the stock exchanges are inadequate and
d) liquidity in a large number of stocks in the Indian markets is very low.

Tversky and Kahneman (1992) superseded their original implementation of prospect theory with cumulative prospect theory. The new methodology employs cumulative rather than separable decision weights, applies to uncertain as well as to risky prospects with any number of outcomes, and it allows different weighting functions for gains and for losses

Prechter (2001) studied human behaviour and introduced a very basic human behaviour function: 'herding', based on 'impulsive mental activity' and in response to the actions of others.

In support of this theory, he explained that the human brain can be divided in three components. (a) The brain stem, (b) The limbic system, and (c) The neocortex. The limbic system is the primitive brain responsible for emotional response while the neocortex is the generator of rational responses and reason.

Role of Behavioural Finance:

It is hard to believe that people in the financial market, even though they can be very skilled, could always process information accurately without letting human nature to affect their behavior. The traditional finance theorems and concepts failed to predict the market behavior. A new area of financial research, Behavioral Finance is receiving a lot of attention from individual and institutional investors. Behavioral finance draws inputs from the field of psychology and finance in an attempt to understand and explain irrational stock market and investor behavior. The important heuristic-driven biases and cognitive errors that impair judgment are:

Representativeness: Representativeness refers to the tendency to form judgments based on stereotypes. Investors may become overly optimistic about past winners and overly pessimistic about past losers.

Overconfidence: People tend to be overconfident and hence overestimate the accuracy of their forecasts. Overconfidence stems partly from the illusion of knowledge.

Aversion to Ambiguity: People are fearful of ambiguous situations where they feel that they have little information about the possible outcomes. It means that investors have a preference for the familiar. This is manifested in home country bias (investors prefer stocks of their country), local company bias (investors prefer stocks of their local area), and own company bias (employees of a company have a preference for their own company's stock).

Innumeracy: People have difficulty with numbers. Economists call this "money illusion". People tend to pay more attention to big numbers and give less weight to small figures.

Prospect Theory: The prospect theory was proposed by Kahneman and Tversky. According to the prospect theory; people look at choices in terms of potential gains or losses in relation to a specific reference point, which is often the purchase price. This means that people experience pain when they lose, but twice the loss does not mean twice the pain. According to prospect theory, people feel more strongly about the pain from loss than the pleasure from an equal gain.

Mental Accounting: Proposed by Thaler, Mental accounting is the set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities.

Narrow Framing: Narrow framing means investors tend to look at each investment separately rather than the portfolio in its totality. Investors pay undue attention to short-term gains and losses, even when their investment horizon is long.

The Shadow of The Past: People seem to consider a past outcome as a factor in evaluating a current risky decision. In general, people are willing to take more risk after earning gains and less risk after incurring losses. After experiencing a gain, people are willing to take more risk.

Emotional and Social Influences: The emotions experienced by a person with respect to investment may be expressed along an emotional time line. Investment decisions lie at the left end of the time line and investment goals at the right end.

Herd Instincts and Overreaction: There is a natural desire on the part of human beings to be part of a group. It induces one to decide on the "feel" of the herd rather than on rigorous independent analysis.

Noise Trading: Some investors are not rational as their demand for risky assets is influenced by beliefs or sentiments that are not fully supported by fundamentals. Many investors trade on pseudo-signals, or noise, and not on fundamentals. They follow market gurus and forecasts and act in a similar fashion.

Conclusion:

This is a fact that a lot of research has been done to know the irrational behaviour of investors but there is a lot of scope from Indian investors' point of view. The investors form the backbone of any economy. By promoting the investment activity, the investors contribute to the generation of national income, prosperity of the society and higher standard of living of the citizens. They can contribute more in the development of Indian economy if their attitude towards investment decisions is analyzed properly.

To understand the investment decision of Indian investors is a complex

issue because they are conservative in nature and excessively rely on the government schemes. Indian infrastructure is entirely different from the infrastructure of developed nations. So the research must be done to know the actual reason of their preference towards investment instruments. Behavioural approach can be useful in understanding the irrational decisions of Indian investors in stock market.

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