

What is wrong with the way we invest?

What is wrong with the way we invest? Hmm...just where from does one start a discussion on this topic?

Commentators on Investment Management, especially from a Personal Finance point of view usually list out about 5 common mistakes that investors commit when it comes to investing.

1. Investors do not factor inflation and taxes in the investment returns. For example, a fixed deposit may return just 5% after all taxes. With inflation, as measured by the Consumer Price Index, reigning at 10% levels, the REAL rate of return is negative.

2. Investors often chase 'assured' or 'guaranteed' returns while ignoring the drawbacks usually associated with such instruments. Is an assured return of 8-10% all that is required? What about liquidity? Tax - efficiency? Safety? Potential for Capital Appreciation? Transparency?

3. Investors invest in risky investments - like stocks / equity - for the short term, while sticking to ultra-safe investments - like PPF / Single Premium Insurance policies - for the long term. While this may seem logical to some, it is not remunerative. If one has a time horizon of 10 - 15 years, Risk actually comes down substantially in stocks / equities. Just imagine this: Rs. 1000 invested per month @ 8% yields Rs. 9,57,367 after 25 years. If the same amount was invested @ 12%, the final value would be Rs. 18,97,635.

Thus an investor is better off investing in an index fund than PPF for her daughter's wedding, especially if the decision is being made early in life.

4. Investors tend to follow a herd. This is perfectly understandable. Everyone wants to buy the most popular design in a silk saree or eat in the most 'happening' restaurant. But this is dangerous in the investment world, as irrational behaviour tends to get justified and mistakes are compounded. In the investing context, why does everyone like crowds? Because crowds produce noise and hubris. And this provides a degree of comfort. This herd mentality affects almost all asset classes : Real Estate, Gold, Equities, Chit Funds, Plantation Schemes, IPOs etc.

5. And perhaps the most dangerous mistake of them all. Investors do not have a plan. At least an overall financial plan for their life. Most investors, as highlighted in a study by Hersh Seftin and Meir Statman, merely have plans for certain individual goals, but not one for their entire life. So, an investor, may be buying a lot of gold and investing regularly in PPF for his daughter's wedding, but would rarely be framing such an investment in the overall context of his various financial goals like retirement, building a house, children's education, overseas holiday etc.

But just why do investors behave in such ways? What are the underlying emotions behind such decisions? Surely, if so many investors choose to follow this behavioural pattern, it can't be too wrong, can it?

This is where the exciting new field of Behavioural Finance steps in. This is the overlap area between economics, finance and psychology. Traditional Finance assumes that investors are guided by logic and reason to reach a judgement. However, Behavioural Finance recognises that emotions and instincts have a huge judgemental role.

Traditional finance assumes that markets are efficient and that all available information is efficiently factored in to bridge the gap between intrinsic value and market value. However, in reality, Biases, Emotions, Herd Instincts and other Behavioural Quirks ensure a discrepancy between market and intrinsic value. Therefore an investor whose Behavioural Instincts are 'rightly tuned' can benefit from opportunities that arise from this.

There is one area of investing where Behavioural tendencies manifest themselves most prominently: RISK. In an ideal world, investors should be weighing Risk vs. Reward in a logical manner and then making logical decisions. However, in the real world, Risk is invariably colored by the manner or context in which it is framed. For example, after November 26, many people regarded staying in a 5 star Mumbai Hotel as most unsafe, although in all probability, it was the safest time to stay in any hotel in Mumbai. Or for that matter, several investors have viewed the decision of RBI to buy 200 MT of IMF Gold as a signal for an enduring bull run in bullion. It now remains to be seen as to where Gold prices will end in a couple of years time.

Just how does Behavioural Finance affect us in our everyday life?

There is a lot of behavioural finance in every decision we make. One of the earliest concepts in the field was 'Mental Accounting'. Mental Accounting is nothing but the slots that an investor has in his mind for various financial goals – be it saving, spending, investing or earning. Most Indian households practice / implement Mental Accounting. A household budget is a classic example (by the way, how many households these days have one). Or the fact that some investors save a particular stream of earnings for a financial goal.

How does 'Mental Accounting' affect our investment choice? Many investors choose defensive or conservative options because their Mental Accounting tells them to. For e.g. an investor may choose a Recurring Deposit because she is mentally committed to investing Rs. 2000 every month for the next 3 years. Or an investor may shun equities, because he wants an assured return of say, Rs. 5000 every month from the investment.

Daniel Kahneman and Amos Tversky, propounded the 'Prospect Theory', wherein they explained that the utility or joy of a gain was only half the pain of a loss. In other words, an investor felt as much pain in losing Rs. 1 as his experience of joy in gaining Rs. 2. Kahneman received a Nobel Prize in Economics for his pioneering work in this field, which probably explains why most investors are loss averse and will in fact assume more risk to avert loss than to achieve gains.

Another peculiarity which can be observed is that most humans seem to detect patterns when in fact there may be none. Or tend to ascribe reasons when not really needed or even tend to extrapolate data to reach inaccurate conclusions. This is termed as Heuristics. For e.g. if on your way to work, your car-pool colleague tells you that his investment in ABC Infrastructure IPO gave him listing gains of 50%, you may just register it marginally. However, if one more person talks about the same thing or you notice this in the Newspaper Headlines also, you may register it with greater conviction. And if in a couple of days, you come across an investment article that talks of XYZ Infrastructure's upcoming IPO, you are likely to give it serious thought.

The above mentioned peculiarities in combination, perhaps explains why most investors desert the stock market during a Bearish phase. But viewed from a dispassionate and clinical perspective, a bear phase is the best time to enter the markets.

'Endowment Effect' describes our inclination to over-value things that we possess. This tendency to cling on to investments and refuse to liquidate them at even realistic prices, is another behavioural trait. This can be observed in a whole gamut of investments / items – real estate, junk stocks, gold jewellery, cars, furniture etc. In the case of a junk stock, we tend to get 'anchored' to say, the IPO price. In the case of real estate, we often value the investment on some hazy or unauthenticated market price. Both cases lead to investment losses and hidden opportunity costs.

This also brings us to the issue of 'Sunk Cost'. Investors keep a watchful eye on the price at which they sell an asset. If for example, a flat was purchased at Rs. 2500 per sq ft, it is unlikely that the investor will sell it at anything lower than the purchase price, even if the real estate market is on a decline. The same can be said of shares too. In a portfolio with say 5 different shares, all of which were bought at Rs. 100 each, investors are likely to hold those that have not reached Rs. 100 in price yet. This explains why investors cling to the poor performers in their portfolio while selling their winners.

The world of Behavioural Finance is fascinating and is often the key that unlocks many secrets to successful investing. A better understanding and appreciation of behavioural finance will ultimately make us smarter investors.