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There's only one right way©

Introduction to Behavioral Finance

"With such positive good news from the company why is it stock going down?"

"I have knowledge of reading balance sheet as I am a qualified chartered accountant. I went through the financials of the company. At the current price the stock is too expensive. I would not buy it nor recommend the same to anybody. But I am surprised that for the last two weeks the stock is up 15%."

"My friend works with the company. He told me that the company was doing exceedingly well and have export orders worth crores in hand. So I bought the stock. Its six months I have been waiting but the stock is going down"

"The company has announced a 1 for1 bonus. Its good news and I bought the stock. However the stock went down instead of my belief that it would go up on such good news."

" I read this morning newspapers and was impressed by the Finance Minister's speech and his intention to give sops to the economy. The markets greeted the news positively and went up. I bought stocks. The next day the markets were down for no reason and I am losing on my investment."

" I heard the expert comments on TV on the current budget presented by the Finance Minister. They were not very happy with the same. I sold my stocks only to find that within a week the markets were up 10%. I don't know why I sold my stocks which I was holding for the past four years."

" I cannot understand the markets. I would rather stay away."

Aren't all these statements familiar? You have heard them and may be you also have made them. At some point of time I am sure you would have encountered the above situations. In an ever changing and an uncertain world we are trying to find some predictability where none exists. So what would one do? The easiest answer is to avoid such irrational markets. Well think before you feel that way. Avoiding the stock markets is not the answer. You would be missing out on one of the most favourable mode of investment. My sincere advise would be to catch the bull by the horn. Confront the problem rather than run away from it. Try to understand why this happens to most of the people instead of "wondering why is it happening to me". Heres my story.

During the recent IT bubble I also found myself bewildered and confused. The valuations of the Dot Com and IT stocks seemed inflated beyond imagining. Pundits in the market and the media were pontificating on the "new economy" and were giving convoluted justifications for what appeared to be sheer insanity. Was the entire world mad and I the only one sane or was I insane, and the world perfectly rational?

There was this client, who had invested around Rs.70 lacs in different IT stocks in 1998 on his friends recommendation. In 1999 his portfolio value was around Rs.3 crores and when he asked me for my advice I advised him to sell as I found that the PE multiples were very high and the valuations seemed far too stretched. He did not do so and six months later when we met he informed me that the portfolio value was around Rs.6 crores and asked me what he should do. I was a bit embarrassed with the question, as I knew that he was really not asking for advice but telling me indirectly that I was not in synch with the markets although that happened to be my profession. I insisted that he sell and he did not. Sometime later the portfolio value had gone to Rs.8crores. This was the frustration I had to go through. Being in the business of stocks and not being able to advise clients correctly. This was just a sample of my experiences. There were times where I would have sleepless nights fearing that the world was going too fast for me to understand. I doubted my abilities, my competencies and my knowledge. The inability to understand the madness and at the same time be proved wrong every minute, every hour added to the frustration. In fact I lost quite a few clients as they thought that I was too conservative and not in tune with the new economy that was emerging.

To find an answer to this question I did some serious soul searching. What was really happening? The natural conclusion of my desperate quest led to a fledgling, little known field termed Behavioural Finance. Behavioral Finance, a field where anthropology meets economics and psychology intersects with finance. Untaught in MBA curriculum across the world, it remains the domain of a few Gurus and special interest groups.

After an extensive study of the literature on Behavioral Finance I first started observing myself very intently and observed my own behavior when it came to decisions regarding money matters. Offcourse this had more to do with investing as it happened to be my profession. I made some practical observations and studied the behavior of my institutional as well as retail clients when they made their investment decisions. As an intermediary I came across many cases and incidents of investor irrational behavior and this increased my faith to pursue a deeper understanding of this field. The examples given in this book are all real and I am a witness to all the incidents in the course of my dealings with my clients, friends, colleagues and associates. I gained valuable insights and this made me confident to pursue this field. It would not only benefit me personally but also help me to add value and differentiation to the number of people who would come in my life. With my passion for the subject increasing, I decided that I needed formal training and an active interaction with the scholars who were pursuing this field. I would take every opportunity to enrol myself to such investment psychology or behavioural finance training seminars to get new insights and an opportunity to interact with likeminded researchers and professionals. Thus I officially joined the small band of cognoscenti on Behavioral Finance in the world.

I wish to begin sharing my knowledge with you. We may come across some theories of Behavioral Economics, which I may need to explain for your understanding. But please be assured that this is not a book on theories, there are a host of such books available and I don't intend to repeat the same. Moreover I am neither an economist nor an academician. I am an investor, a stockbroker, a financial planner and a professional.

The knowledge gained by me is due to the extensive reading of the works of various scholars, economists and academicians who have toiled and done extensive research on the subject. I would be failing in my duty if I do not acknowledge the original work on behavioural finance done by the great thinkers and scholars like Amos Tversky and Daniel Kahneman, Richard Thaler, Hersh Shefrin, Richard Geist, Robert Shiller, Benjamin Graham, Warren Buffet, Gustave le Bon, Charles D. Ellis, Max Bazzerman, Gary Belsky and Thomas Gilovich to name a few. I am only the facilitator to bring a part of knowledge of these great thinkers. I am still learning. This book helps me to share with you, my experiences dealing with various types of investors, fund managers, corporate, the media, students etc. An optimist as I am, I am fortunate that I am writing this book at the start of one of the biggest bull markets in Indian history. The learning and my inference from my experiences, I am sure will help you to be a better Investor. Even if you become aware and learn to identify some of the common psychological and cognitive errors that beset even the wisest investment professional, it may be enough. You will take a giant step forward

If Investments do well, why do Investors fare poorly?

We did some number crunching as to how different types of Investments have done over the past 20 years.

Historical returns over a 20 year period

Returns: 1984 - 2004

Equity	PPF	Cash
15.8%	11.2%	4%

Needless to say equities have done exceedingly well. But whenever we ask investors as to their performance in the stock markets, the majority would say that equity investments are risky and they have lost money in the stock markets. They always curse the volatility and blame it for their losses. Even well educated investors with an above average IQ do not do well in the stock markets. Is it not a Paradox **"Equity Investments have done well but Investors have done Poorly".** Actually everyone who invested in to equities should have done well with the equities returning 15.80% in the last 20 years.

But the reality is that human beings not only make decisions with their mind but also with their hearts. An integral part of this humanness is the emotion within us. Our emotions define us and make life worth living. Indeed, we make most of our life decisions on purely emotional considerations. Our logic and rationale only retrospectively justify these decisions; they do not determine them. Our emotions are subject to change rapidly and this affects our behavior and decision-making.

Emotions change Paradigms:

This is a true story of my friend who had started a coaching class with one of his colleagues. They started off to a very good start and within a couple of months they were full to capacity. After six months a few students came to my friend with a complaint against his colleague for his rude behavior with students. The allegation was that he was very short tempered and arrogant. They wanted him to be removed or else they all would discontinue the classes. My friend was worried. His colleague was his 50% partner and in no way he could be removed. Moreover he was a very brilliant professional and an able tutor. He did not know what to do. After a couple of weeks the colleague fell ill and remained absent for some time. The students were very happy and they thought that they had been successful in removing him. They all rejoiced at their achievement.

My friend one fine day got the news from his colleague's wife that the colleague had brain tumour and he needed to be operated upon. This news shocked my friend, as now his partner would be out of action for quite some time. He informed the students of this calamity. The students were totally shocked and this emotional shock changed their paradigm. Hatred and resentment gave way to empathy and love. They all gathered and fell very sorry for him. They went to the hospital with flowers and tears to greet him. They repented for their stand and prayed for his early recovery so that he could come back to teach.

The purpose of this story is to understand that we human beings are emotional people and all our behavior and decisions are guided by our emotions. The colleague was the same. Emotions made the students changed their attitude of hatred to that of empathy.

Frequently emotions prompt us to make decisions that may not be in our rational financial interest. Indeed, decisions that enrich us emotionally may impoverish us financially**. Behavioral Finance is the study of how emotions and cognitive errors can cause disasters in our financial affairs.**

Warren Buffet

“Success in investing doesn’t correlate with IQ once you are above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people in to trouble in investing”

Classical Economic Theory V/s Behavioral Economic Theory:

Classical Economic Theory talks about efficiency of the markets and people making rational decisions to maximise their profits. It assumes that the markets are efficient and no one can benefit or take advantage from its movements. It also assumes that humans are rational beings and will do all acts to maximize their gains.

However Behavioral Economists believe that the markets are inefficient and human beings are not rational beings.

If you and me were walking on a busy street of Colaba and you see a Rs.5 coin on the road. When you tell me the same I will shrug you off. How can it be possible? So many people would have walked this road and the markets being efficient someone would have definitely picked it up. However in real life we do come across such findings. This signifies the fact that the markets are not efficient, as they seem to be.

Moreover if we assume that people make rational decisions to maximize profits then how would one explain people giving to charities or throwing a party to celebrate a birthday or an anniversary? Definitely these are not acts for maximizing profits by rational people. Charitable organizations, the Rotary Club, the Lions Club would not exist. Following is another example of irrational behavior when we give tips to waiters.

TIPS: To Insure Prompt Service. I will give you an example of how irrational one can be: Why does one give tips to waiters at restaurants? The acronym TIPS stands for: To Insure Prompt Service. If it ensures good service one should be tipping before the service starts. Yet, we all give tips at the end of the meal. One even gives tips when the service is sub standard. Moreover one gives tips at places where one will never visit again. This tipping business is more a habit or a custom. We do it mechanically, unaware that we are behaving irrationally. Yet, in economic theory we are rational beings always intent on maximizing our economic status. This is a common mental mistake we make consistently without realizing its pure economic implications.

So we are human beings and we do not necessarily make decisions out of our mind. Being emotional beings we also make decisions out of our heart and that is the reason that even smart and intelligent people make big money mistakes. The study and understanding of Behavioral Finance is important especially when we are dealing with money. That means it includes not only our investment decisions but also all our spending decisions.

Behavioral finance researchers seek to bridge the gap between classical economics and psychology to explain how and why people and markets do what they do. Behavioral finance raises a couple of important issues for investors. The first is whether or not it is possible to systematically exploit irrational market behavior when it occurs. The second issue is how to avoid making suboptimal decisions as an investor. The goal is to close the gap between how we actually make decisions and how we should make decisions.

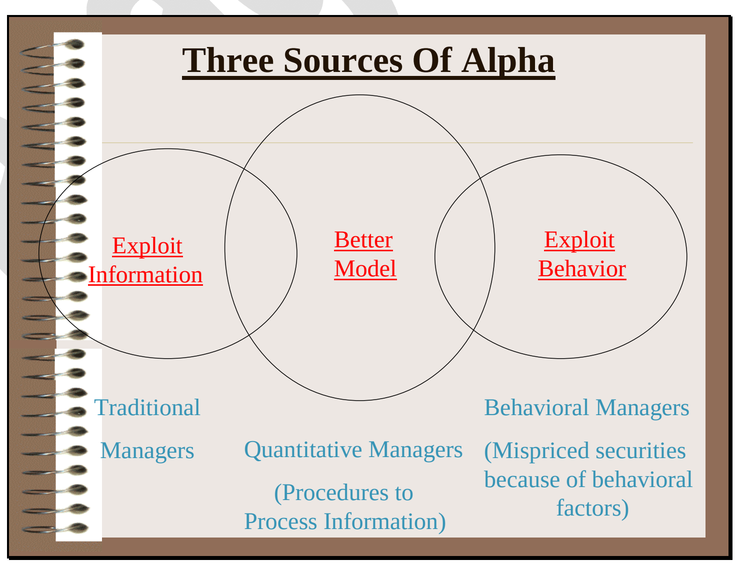
In the stock markets, Behavioral Finance explains why we:

- hold on to stocks that are crashing
- sell stocks that are rising
- ridiculously overvalue and undervalue stocks
- jump in late and buy stocks that have peaked in a rally just before the price declines
- take desperate risks and gamble wildly when our stocks descend
- avoid taking the reasonable risk of buying promising stocks unless there is an absolutely 'assured' profit
- never find the right price to buy and sell stock
- Prefer fixed income over stocks
- Buy when you have to sell and sell when you should be buying
- Buy because others are buying and sell because others are selling

Psychology can play a very important strategic role in the financial markets and its role is increasingly recognized. Students and proponents of behavioural finance create investment strategies that capitalize on irrational investor behavior. They seek to identify market conditions in which Investors are likely to overreact or under react to new information. These mistakes cause under priced or over priced securities. The goal of Behavioral Finance strategies is to invest or disinvest in and from these securities before most investors recognize their errors and to benefit from the subsequent jump or fall in prices once they do.

The Three Sources of Alpha for Superior Performance

Today all intelligent investors depend on information based strategies. They generate performance by obtaining better information about companies and processing it better than their peers. But gaining advantage through these methods is becoming increasingly difficult. This is due to an increasingly efficient market where electronically published information is easy to access and available to everyone equally. Here, Behavioral Finance investment strategies give you an edge over most traditional approaches to investing.



The recent stock market volatility and the losses suffered by so many investors' calls for a drastic change in the way we look at the stock markets. From this great crisis arises a greater opportunity to embrace the new concepts of Behavioral Finance as a strategy