AN EMPIRICAL STUDY ON EMOTIONAL BIAS AFFECTING INVESTMENT DECISIONS OF INVESTORS

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ABSTRACT

Investor's investment decision is a complex phenomenon. Their financial decisions get influenced by cognitive & emotional biases. Investors make use of rules framed by them for investment decisions in complex and uncertain market, but in reality investors are not rational. They are frequently influenced by emotions while taking investment decision. Emotions can get in the way of making prudent financial decisions. It is human nature that they react differently when they are in a different state of emotions. The primary objective is to study the various emotional biases that influence the investment decisions of the investors. Here the various literature were gathered and studied and was based on the secondary data. It was concluded that the various cognitive and emotional biases have an impact on the investors while making investment decisions.

Keywords: Emotional Biases, Emotions, investment decisions.

I. INTRODUCTION

Year 2015 has been turbulent years for the Indian Stock market with, turbulent equity movement, dismal corporate earnings, sub normal monsoons, plunge in commodity and oil prices along with surprise interest rate cuts. The S&P BSE Sensex ended 5% lower at 26,117.54 levels, while the Nifty50 closed 4% lower at 7,946.35 for 2015 as compared to their respective closing figures as on December 31, 2014. The corporate failed to perform the market expectation, as a result of which year 2015 turned out to be complicated for investors. The momentum started to fade away after the announcement of the budget in Feb 2015; actual earnings trajectory turned out to be flat or negative, contrasting the 18-20% projected by consensus estimates. Domestic politics have also eluded market expectations as the dilution of political equity of the Modi government compounded following the state electoral results in Delhi and Bihar. The declining political strength implied that the critical bills like Land Acquisition Amendment Bill and GST Bill failed the parliamentary approval. The year 2015 has witnessed the continued flows received by domestic institutions, particularly mutual funds, from retail participants who saw great opportunity in exploiting the valuation arbitrage created from the earlier run-up in the benchmark indices and large cap stocks.

Among the emerging market (EM) peers, India remained in a bright spot amid a slowdown in global economy on the back of multiple rate cuts by the RBI and its efforts to keep inflation under check and capital infusion by the domestic investors. In addition, Foreign institutional investors were net buyers in Indian equities to the tune of Rs 17,269 crore in 2015 till December 29. Thus investors sentiment/ decisions do get effected by the various factors that affect the market overall. Moreover investors are also emotionally attached towards the market, which leads to irrational investment decisions. The fluctuation in stock market from the year 2007 to 15 is shown in figure 1.

Refer figure 1

It is observed that the Investment Decisions are based on market sentiments. In Behavioral Finance, "sentiment" is synonymous with "error". Several studies have identified influence of psychological factors on stock market. (Daniel Kahneman 2000), reports that market has a psychology or a character. It has thoughts, beliefs, moods, and sometimes stormy emotions. The main characteristic of the market is extreme nervousness. The market sways with the moods and powerful emotional preferences of investors.

During 1980's many empirical studies were conducted which revealed that market is not efficient as explained by EMH, because of certain market anomalies like small firm effect & others. The traditional neo classical finance theories have ignored the investor's behavior & are not covered within the frame work of traditional finance. (Simon 1986) states that, "Sometimes, the investors make irrational decisions and do not behave rationally because of their limitations of capacity to process the information." The studies conducted by Kahnman that representatives and anchoring heuristics are sometimes present in decision making of investors in uncertain situation, where investors use their judgment in order to facilitate the process of dealing with vague and complicated information. They also proposed the prospect theory which states that attitude of investors is not consistent when dealing with prospects of gain or loss, but will be opposite in these prospects. This inconsistency in the behavior of investors is against the hypothesis of neoclassical finance which states that Investors attitude is consistent in profit or loss prospects. On a contrary it is also found that "Investors are rational and they efficiently respond to new information available towards the stock market products. In other words, any information revealed will have impact on the investor's decisions. There are no chances of abnormal returns in the market in the long run, even if the assets prices are not properly valued, they will come to reasonable price level through arbitrage. “(Fama,1988).

It is learn that Investors who have experienced loss in past, formulate the new investment decision keeping in mind their past experience. After taking into consideration these factors along with some other factors, investors formulate their potential return from their investment taking in consideration risk attitude, risk perception, risk aversion of the investors. Investors will prefer to invest in those products which offer the return suitable with the risk level of those products, i.e. Low return products are accepted if the risk attached with them is low and high risk products are selected if risk premium associate with risk level is offered to investors.

So, Behavioural finance aims at analyzing the phenomena of the market keeping in mind the psychological factors involved with the investors behavior. The fundamental rules & principles of investment remains same, but the investment climate and investors behavior change from time to time and from place to place. Some observed investors behavior, un explained by the traditional finance are:

1. Premiums paid by investors for some stocks have been found to be irrationally higher compared to the returns they generate;
2. Winning bids often bid at a value higher than the intrinsic value of the asset;
3. Capital markets exhibit seasonal effects as average monthly returns of small firms have been found to be higher in January than other months of the year;
4. Inability of traditional framework to explain many empirical patterns;
5. Better performance of certain behavioral mutual funds than their non-behavioral counterparts and S&P 500 index funds, (Colby Wright, Prithviraj Banerjee & Vaneesha Boney 2006); and
6. Numerous stock market bubbles in Japan, Taiwan & the U.S.A

The mood of an investor changes from Exuberance to Complacency and Panic in the Emotional Life cycle. This is also reflected in market sentiments. The upheaval of Enthusiasm and Over Confidence due to recurring gains may decline drastically on a huge loss, causing repeated biasness in consecutive decisions. This Emotional cycle repeats again after a short span, on recuperation of the market.

Refer Figure 2

An attempt is made to explain the irrational behavior of investors which affects the investment decisions.

II. OBJECTIVES OF THE STUDY

- To provide comprehensive reviews of studies on emotional biases affecting investment decisions.

- To identify emotional biases and other emotions affecting investment decisions of the investors.

III. METHODOLOGY

The study is descriptive study and the data collected for the study are through the secondary sources of data collection like research papers, journals, articles, magazines and other sources.

IV. LITERATURE REVIEW

Emotions are painful or pleasurable feelings occupying the mind or originated from it. They contribute to a person's motivations and thus affect its decisions. Emotions can we thought as a mental state that arises spontaneously rather than consciously. Emotional biases are related to impulse and intuition and majorly include: Loss-aversion, Overconfidence, Self-control, Status quo, Endowment, Regret aversion, etc. Few important reviews on these biases are expresses as under;

A Loss Aversion

The psychological propensity that losses loom larger than equal-sized gains relative to a reference point – can occur in riskless and in risky choices, as argued in two seminal papers by Amos Tversky and Daniel Kahneman (Kahneman and Tversky 1979; Tversky and Kahneman 1991). Risk aversion can be understood as a common behavior of investor, nevertheless it may result in bad decision affecting investor's wealth (Odean, 1998). Loss aversion refers to the difference level of mental penalty people have from a similar size loss or gain (Barberis & Huang, 2001). There is evidence showing that people are more distressed at the prospect of losses than they are pleased by equivalent gains (Barberis & Thaler, 2003). Moreover, a loss coming after prior gain is proved less painful than usual while a loss arriving after a loss seems to be more painful than usual (Barberis & Huang, 2001). In addition, (Lehenkari and Perttunen 2004) find that both positive and negative returns in the past can boost the negative relationship between the selling trend and capital losses of investors, suggesting that investors are loss averse.

As individuals are more sensitive to losses, they will work harder to avoid a loss than to experience an equivalent gain. Recent work has explored whether the design of incentive contracts can exploit this insight to increase efforts and performance in the work place (Hossain and List 2012, Fryer et al 2012). These studies find that framing incentives as losses (i.e., bonuses workers could potentially lose) increases productivity relative to payoff-equivalent contracts where the same bonuses are framed as gains.

B. Overconfidence

According to (Shefrin 2000), Overconfidence pertains to how well people understand their own abilities and the limits of their knowledge. When people overestimate the reliability of their knowledge and skills, it is the manifestation of overconfidence (DeBondt & Thaler, 1995, Hvide, 2002). Overconfidence is believed to improve persistence and determination, mental facility, and risk tolerance. Overconfidence can help to promote professional performance. It is also noted that overconfidence can enhance other's perception of one's abilities, which may help to achieve faster promotion and greater investment duration (Oberlechner & Osler, 2004).

Many studies show that excessive trading is one effect of investors. There is evidence showing that financial analysts revise their assessment of a company slowly, even in case there is a strong indication proving that assessment is no longer correct. Investors and analysts are often overconfident in areas that they have knowledge (Evans, 2006). "In this most basic form, Overconfidence can be summarized as unwarranted faith in one's intuitive reasoning, judgments, and cognitive abilities" (Pompian, 2006). Also, (Fagerström 2008) found in their study that analysts of the S&P 500 were exaggerated by the problems of over confidence and the over optimistic biases. It also confirms theory of Anchoring and Herding.

C. Self Control:

According to (Shefrin 2000) self control means controlling emotions. Some investors value dividends for self-control reasons as well as for reasons that stem from hedonic editing. (McClure et al 2004) has investigated the neural systems that underle decisions about delayed gratification. Much research has suggested that people tend to behave impatiently today but plan to act patiently in the future. When offered a choice between 10 today and 11 tomorrow, many people choose immediate option. However, if asked today to choose between 10 in a year & 11 in a year and a day, many people who went for immediate option in first case now go for second option. (Montier 2007).

While (Rabinovich and Webley 2007) found that households with longer time horizons and greater self-control tended to implement their saving plans. The best evidence to date of the value of self-control is provided by (Rha, Montalto, and Hanna 2006) showing the benefits of savings rules. Self-control is conceptually similar to self-regulation, the process by which people exert control over their thoughts, feelings, and impulses (Baumeister, Gailliot, DeWall, & Oaten, 2006). Studies have shown that self-regulation is related to financial behavior (Howlett, Kees, & Kemp, 2008; Vohs & Faber, 2007). Howlett and colleagues found that when self-regulatory resources were depleted, college seniors were less likely to indicate they plan to participate in a retirement plan. Similarly, consumers whose self-regulatory resources were depleted were more likely to spend impulsively (Vohs & Faber, 2007). Some of the strongest evidence on self-control and savings comes from a pioneering study by (Rha et al. 2006) which demonstrated the strong link between savings and self-control mechanisms.

D. Status Quo

Status-quo-bias refers to an agent whose choice behavior is affected by the existence of an alternative he holds at the time of choice (called the status-quo). One implication of loss aversion is that individuals have a strong tendency to remain at the status quo, because the disadvantages of leaving it loom larger than the advantages. (Samuelson and Zeckhauser 1988) have demonstrated this effect, which they term the status quo bias. (Chernev 2004), stated that prevention focused customers show strong preference towards status quo than promotion-focused customers. According to (Gal 2006) Status quo bias means, individuals' tendency to prefer to remain at the status-quo - is similarly attributed to loss aversion: It is assumed that the loss of the status-quo option looms larger than the gain of an alternative option (e.g., Kahneman et al., 1991).

(Gubaydullina et al 2011) examined the status quo bias in analysts of bond market that weather this bias exists in them or not while performing in the bond market. For this purpose forecasts of interest rate trends of government bonds with ten year maturities were examined and were revealed that analysts were biased towards the current interest rates and thus were affected by status quo bias.

E. Endowment

The observation that people seem to attach additional value to things they own simply because they belong to them—the “endowment effect”—has had a substantial influence on economics. Endowment effect experiments are used as evidence for theories of reference-dependent preferences, such as (Kahneman and Tversky's 1979) prospect theory, (Thaler 1980) coined the term "endowment effect" to refer to the finding that randomly assigned owners of an object appear to value the object more than randomly assigned non-owners of the object. For instance, in one well-known series of endowment effect experiments, (Kahneman, Knetsch and Thaler 1990) found that randomly assigned owners of a mug required significantly more money to part with their possession (around $7) than randomly assigned buyers were willing to pay to acquire it (around $3). (Kahneman et al. 1990, 1991) and (Tversky and Kahneman 1991) attributed this result to loss aversion: owners' loss of the mug loomed larger than buyers' gain of the mug.' (Gal 2006) From the very beginning then, the empirical phenomenon of the endowment effect has been linked to a loss-aversion explanation: the loss in utility associated with giving up a good is greater than the gain in utility associated with getting that good. Or, more simply: losses loom larger than gains.

Both the status quo bias and the endowment effect are part of a more general issue known as loss aversion. "Simply put, the endowment effect says that once you own something you start to place a higher value on it than others would. (Montier 2007, 2010).

F. Regret Aversion

Decision making is biased by regret aversion across a wide range of domains. People anticipate regret over any decision whose future outcomes are uncertain, and could fall short of expectations. Anticipated regret causes disutility, reducing the expected welfare of the choice it burdens. It also can bias decision making towards a suboptimal choice, because people anticipate systematically more regret over losses from some choices than others. Regret is an emotion occurs after people make mistakes. Investors avoid regret by refusing to sell decreasing shares and willing to sell increasing ones. Moreover, investors tend to be more regretful about holding losing stocks too long than selling winning ones too soon (Forgel & Berry, 2006,; Lehenkari & Perttunen, 2004).

Regret theory rests on two fundamental assumptions: first, that many people experience the sensations called as regret and rejoicing; and second that in making decisions under uncertainty they try to anticipate and take account of those sensations. In other words, regret theory assumes that agents are rational but base their decision not only on expected payoffs but also on expected regret (Pompian, 2006). Anticipated regret also induces an endowment effect: owners resist selling entitlements or increase the sales price because they experience more anticipated regret over selling in error than over failing to make a deal when they should have (Thaler 1980; see Loomes and Sugden 1982; Landman 1987; Knetsch and Sinden 1984; Bar-Hillel and Neter 1996; Connoly and Zeelenberg 2002; Nicolle et al 2011, providing fMRI evidence; Korobkin 2014).

G. Other Reviews:

Regarding emotional biases affecting on financial investment decision in addition to main biases cited as above, some important literature indicating other emotional biases are as below:

Investor's decision get affected by mood and emotions, though these words are different, they are used interchangeable in real life situations. Mood is long lasting emotional stage, less specific and not focused on specific objects or events, whereas emotions are more specific and focused or directed on specific objects or events (Beedie, Terry, and Lane 2005).Emotions as explained by (Slovic 2004) is a feeling which is based on positive or negative stimulus, whereas mood is related to non specific state whereas emotions are specific and linked with cognitive appraisals (Bagozzi, Gopinath, and Nyer 1999; Siemer 2005; Sizer 2000; Watson and Clark 1997). As explained by (Kahneman and Tversky 1973, 1979), investors have different perceptions towards gain and losses. Investors explore positive emotions from a gain and negative emotions from a realized loss. This makes them to sell the winners intuitively and hold the losers (Shefrin and Statman 1985; Barber and Odean 1999). Importance of emotions on investment decisions have given importance on behavioural finance research (e.g., Hopfensitz and Wranik 2008; Loewenstein 2000; Thaler 2000). Risk and uncertainty determine one's emotional state(Schwarz 1990; Forgas 1995; Isen 2000; Lowenstein, Weber, Hsee, and Welch 2001). Emotions affect individual's choice and action (e.g., Peterson, 2007; Shefrin, 2000). In view of (Phelps 2006), cognition can be understood only after understanding the importance of emotion. (Finucane, Alhakami, Slovic and Johnson, 2000) concludes that emotions as a heuristic, and it includes experience cognitions and memories. According to(Lo and Repin 2002), investors emotional state can be determined by trading or investment situation. (Schunk & Betsch, 2006) have explained the relationship of emotions and risk taking attitudes. Positive outcomes can be associated with positive emotions, whereas negative outcomes can be associated with negative emotions (Lo, Repin, and Steenbarger, 2005). (Seo and Barrett 2007) found that experienced investors display more intense emotions than inexperienced. This was supported by Dane and (Pratt 2007) where they argued that emotions play a significant role on investor's intuitive decision making. Positive emotions may display matured intuitions and negative emotions display immature intuitive decisions. Matured intuitions associate with optimum results and immature intuitions associate with unsuccessful investment decisions.

From a psychological viewpoint, emotions have important effects on decision making. Emotions can influence decisions indirectly. That is, the affective response can be incidental to the choice options: this influence indirectly affects the subjective value attributed to some option. For example, if in a group of options, one of them elicits a fear reaction, this feeling will contribute to a negative assessment of that option. As a consequence, the subjective value attributed to this option would be negative and the option's significance will be overlooked. The emotional influence in decisions can be also direct. The emotional reaction does not need to affect the subjective value of a choice option but rather it can become incorporated into the calculation as an option in itself. (Lempert and Phelps 2014).

From a neuro-scientific point of view, the merging of cognitive and emotional functions is striking. First of all, in the last decade empirical studies have shown that there is no clear distinction between an emotional and a cognitive system. Cognitive processes are commonly performed by several interacting and interconnected (cognitive and emotional) areas. More importantly, it appears that "there is no evidence for a single unified 'system' that drives emotion" (Lempert and Phelps 2014). For instance, evidence shows that the amygdala, which has been traditionally considered as a brain structure responsible for emotions, is in fact responsible for both emotional and cognitive processing and plays an essential role in decision making (Vuilleumier and Driver 2007, Livet 2010, Gupta et al. 2011). Second, an important number of studies show that brain damages in emotional structures (e.g., the amygdala) have detrimental consequences in rational behaviour. Finally, signals from affective centres in the brain influence cognitive structures even before the decision-making process consciously occurs.

IV. FINDINGS

A. Model Group

Major biases through literature review were found as below;

1. Loss-aversion
2. Overconfidence
3. Self-control

4. Status quo
5. Endowment
6. Regret aversion

They have effect on the investment of the investors. Besides these cognitive biases, other emotions like;

1. Moods,
2. Positive emotions,
3. Negative emotions,
4. Present state of mind do have an effect on the investment decisions of the investors
5. Clarity of investment Objectives

These are the major behavioral factors crucially affect investment decision. Education & well designed training program may help investors to get alert from biases & make more rational decision.

V. CONCLUSION

Human being is a emotional creature on the earth. Education can ignite rational thinking but while taking a decision on investment emotions , feeling , Moods & as a result of these biases plays influencing role in investment decisions. Emotional state has two sides, one is positive side and other is negative side. The success or failure of an investor in the market depends on how he uses these emotions. The researches have shown that cognitive emotional biases like overconfidence, self control status Quo, Endowment and Regret Aversion affect the investment decisions of investors, besides these biases moods and emotions, risk and uncertainty, positive, negative emotions do have some effect on the decision making. Besides this one problem identified was the lack of clarity while defining the emotions.

The nagative effect on investment can be controlled by intense educational training to investors by increasing awareness & shaping their thought process.

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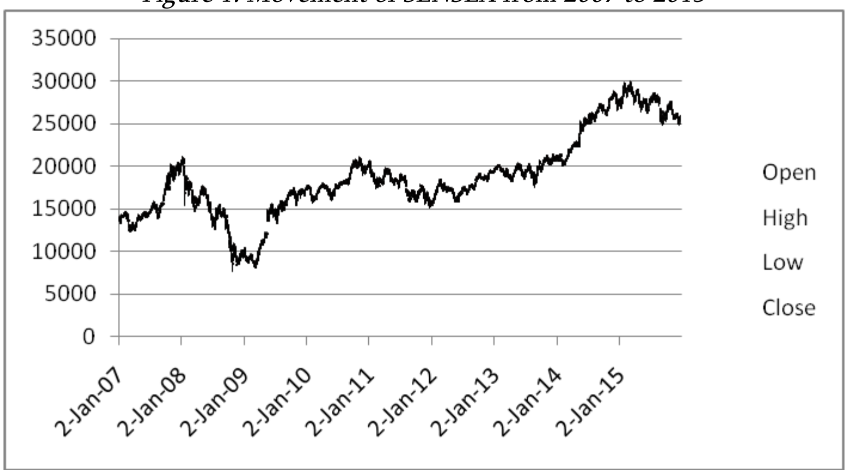
FIGURES AND TABLES

Figure 1: Movement of SENSEX from 2007 to 2015



Source: www.sebi.gov.in

Figure 2: Cycle of investor emotions

Source: Barclays.

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