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"Behavioural Finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets" [Martin Sewell, University of Cambridge]. It helps explain why and how markets might be inefficient.

Human minds are impressionable and our thought process is garbled by exposure to the din of sponsored media campaigns, news bites, free investment tips et al, more often than we know. Investors tend to systematically overreact to unexpected news and dramatic events (engineered or otherwise), frequently overlooking the fundamentals. In specific, most retail investors fail to stick to their chosen investments, often exiting them pre-maturely / untimely. They spend so much time chasing hot asset classes (like a trending momentum stock with weak underlying fundamentals or a hot Mutual Fund that may have already posted its peak performance) that they almost always end up buying high and selling low, all the while incurring (avoidable) transaction costs that inevitably lower the true returns on their investment.

Key among the many behaviours rooted in heuristics, which cause investors to make costly financial errors are:

1. **Overconfidence** (which leads to frequent buying and selling of stocks),
2. **Overweighting** (relying on the recent past and identifying the trends which are not there),
3. **Risk Aversion** (possibility of losses have greater impact on preferences than possibility of gains),
4. **Disposition** (the tendency to sell winning investments too soon and hold losing investments for too long),
5. **Herding** (blindly following the on-going market trend or fad) and
6. **Anchoring** (concentrating on the cost of an investment, even when the same is no longer relevant).

As early as 1912, Selden based his book 'Psychology of the Stock Market' upon the belief that the movements of prices on the exchanges are dependent to a very considerable degree on the mental attitude of the investing and trading public. Later since the early seventies of the 20th century, two brilliant psychologists – Amos Tversky and Daniel Kahneman, extensively researched the subject of Behavioural Finance through a detailed study of heuristics and biases that are employed by the human mind when making judgements under uncertainty (as is the case for any player / participant of financial markets). The theories they propounded [Prospect, Framing] were referred and complemented by the works of several others in this field like Thaler, Shiller, Slovic, Werner, De Bondt and Knetsch. Despite essentially being a psychologist, Kahneman was awarded the Nobel Prize in Economics in 2002 "for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty", one which he would have shared with Tversky in all likelihood, had it not been for the latter's untimely death in 1996.

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Important heuristics include:

- **Affect**: The affect heuristic concerns `goodness' and `badness'. Note how quickly we sense the feelings associated with the stimulus words 'treasure' or 'hate'.
- **Availability**: Availability is a cognitive heuristic in which a decision maker relies upon knowledge that is readily available rather than examine other alternatives or procedures.
- **Similarity**: The similarity heuristic leads us to believe that `like causes like' and `appearance equals reality'. The heuristic is used to account for how people make judgments based on the similarity between current situations and other situations or prototypes of those situations.

And it is a double whammy of sorts for the retail investor segment of the market, which had traditionally reposed its faith in the hands of experienced institutional Mutual Fund Managers as an alternative to making direct investments in the financial markets. In his recent book "The Clash of Cultures: Investment Vs Speculation", Jack Bogle [Founder, the Vanguard Group] in fact questions the viability of even investing via a Mutual Fund anymore, since their Managers are mostly pretty poor stewards who lack astute judgements, turnover their portfolios much more frequently than in the past, rarely question the often biased actions of corporate executives and are incentivised to expand the amount of funds they manage, even though such expansion doesn't benefit the existing investors.

A recent paper[1] in the Financial Assets Journal found that the hidden costs at Mutual Fund Houses were, on average, higher than the funds' declared expenses and had a significant negative impact on returns. In contrast, another academic research[2] shows how private investors have actually fared much better. Based on an analysis of the record of around 11.6 million Indian investors between 2004 and 2012, it was found that the more experienced investors steadily improved their performance over time. They were more inclined to own "value" stocks, for example, and less inclined to sell winners prematurely.

Thus, Personal Financial Planning and taking direct charge of managing your Investments may be the only real uncompromised avenue for growing your hard-earned savings. While all investors are faced with the same behavioural biases, PRiS' services help you realize how you can reduce (if not altogether avoid) their impact through a detailed Planning, Execution and Tracking process that is customized for your specific Investment Objectives.

You may send any feedback on this article to research@pris.co.in

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[1] "Shedding Light on 'Invisible' Costs: Trading Costs and Mutual Fund Performance" , by Roger Edelen, Richard Evans and Gregory Kadlec, Financial Analysts Journal, Volume 69, Number 1

[2] Working Paper "Getting Better: Learning to Invest in an Emerging Stock Market", by John Y Campbell, Tarun Ramadorai and Benjamin Ranish (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176222)

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