Article

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Information bias and mistakes in investment decision making

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Abstract:
Investment is a much sought after activity by individuals. Making investment decision is a difficult task in itself as it involves consideration of numerous factors and psychological biases. This paper focuses on comprehending the behaviour of individual investors in the financial markets and the various mistakes they are intended to make in their decision to invest while referring to market related information. Investors are flooded with useless information most of the times across the media comprising of articles, reports from broking houses and stock market tips in media. This often creates dilemma in the minds of an investor while taking future investment decisions. Due to information bias the investor often times act in an irrational manner by selling worthwhile investments in the short-term as the share prices show a downward trend. Investors based on predefined notions work on a rule of thumb model which might not hold true most of the times. The outcome of this research work is to highlight the common mistakes made by an average investor while taking crucial investment decisions and to suggest some remedial measures for the same. This research work will contribute in enabling individual investors in analyzing available information correctly in order to make informed choices on investments.

Keywords: behavioural finance, information bias, investment decision making, common investment mistakes, psychological biases in investing
Research Theme: Information Bias in Investing
Research Topic: Impact of Information Bias in Investment Decision Making

Executive Summary

Individual investment decision making is a tough process in itself because an individual comes across host of information sources. To review and authenticate those information sources takes a considerable amount of effort and time on the part of these individuals. While encountering such sources, an individual may suffer from a common bias namely "Information Bias" whereby the individual is bound to make mistakes in their investment decision process. The theme of this research paper is to provide an overview of information bias instigated behaviour amongst individual investors and probing on the internal and external influencers of such mistakes.

The paper has tried to create distinction between rational and irrational investors. Research has revealed that irrational investors suffer from memory loss due to the plethora of information and also encounter cognitive biases, overpowering their judgmental prowess in rational decision making. Information Bias is a cognitive bias and it is one of the important ones to shape the investment decision making process of an individual investor. An in depth literature review asserts that in the previous studies media has been found to reinforce and dominate the mindset of investors thereby influencing the future stock prices in the financial markets. It has also been found that educated and informed investors give more importance to the advice of the financial advisor.

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As part of the analysis, a questionnaire comprising 15 questions was designed and online survey had been carried out amongst college students, academicians, corporate professionals and businessman. Detailed reviews of the questionnaire presented the fact that investors are more inclined to easily invest in conventional financial products like stocks, bonds and bank fixed deposits and possess limited knowledge about unconventional products like Exchange Traded Funds (ETFs) and Derivatives. On further examination, it was found that investors were often influenced by the suggestions of close friends, relatives and acquaintances which in itself may instigate investors to make errors in investment decisions. To make future investment decisions checking the past trends may not be many times beneficial which has also been captured in the study. Few remedial measures which may be feasible have also been put forward to make the research study foolproof like carrying out detailed fundamental analysis of company stocks as well as gaining deep insights of the financial markets by attending investors meet on a frequent basis.

Introduction

Decision making by an individual is one of the inherent part of their lives and often times considered as intellectual procedure to come to a point of consensus with the self. Once the decision making process starts the individual gradually sets the criteria based on which he/she zeroes down on an alternative from a number of alternatives. To make an investment decision is one of the trickiest activities an individual performs at different point in time. Some of the important considerations to be made while taking investment related decision is to understand the current market condition, risk bearing capacity, investable surplus, expected return and regulatory requirements, etc. After doing a thorough study and analysis of all the mentioned factors the individual is able to take an informed investment decision. Any rational investor would always like to optimize risk and maximize expected return.

On the basis of rationality, investors are categorized as rational and irrational, Irrational investors behave in a peculiar way while taking investment decision due to the lack of accurate information and memory errors. Few of the empirical research studies have revealed that there are certain cognitive biases that have a direct bearing on the investment decision making capability of an individual. Due to the existence of these cognitive biases certain emotional factors come into play such as anxiety, fear, greed and excitement which overshadows the power of investment decision making.

One of the identified biases is information bias which is alternatively referred as observation bias. Information bias is referred as the tendency to evaluate information even when it is useless to address the issue at hand. The important aspect of informed investment decision making is to carefully evaluate relevant information and discard irrelevant information. Investors' everyday comes across loads of useless information in the form of newspapers, financial commentators, stockbrokers, media and television channels which creates confusion in their minds with respect to an investment decision. There are numerous instances where the investor with a view of short-term gain will make quick decision of selling off low priced stocks. Eventually in future they realize that some wonderful investments have been sold off mid way, which would have easily helped them earn a fortune if held for a longer time horizon. In fact, market timing is very important for an investor to enjoy the long-term fruits of capital gain. It is observed that in general investors are likely to make superior investment decisions if they are able to ignore daily share price movements. If the investors start ignoring daily share price movements they would be able to overcome the dangerous effects of information bias. This research paper tries to explore such other common place techniques to avoid information bias and the various facets of the bias to deal with the same effectively.

Review of Literature

Dong, H., Ren, J., et al in their research study tried to find out the impact of information bias in the stock markets. It was proposed in the piece of study that information in the stock markets may be biased as irrational traders affect the quality of information distribution and rational arbitrageurs try to use this biased information with a hope to gain a fair share of the stock markets. The study focused on empirical evidence establishing the facts that investors mostly exhibit confirmation bias by reading and using information that is relevant as per past beliefs, media channels presenting information that reinforces these past beliefs and irrational traders as well as rational arbitrageurs are both using biased information which may not help in correcting the asset prices in the short run. This research paper tries to fill the gap by asserting the fact that error in asset pricing results from systematic information biasness present in the stock markets. An effort has been made on the part of the researcher to identify the cause and plausible effects of information bias to the individual investor. Contribution by this research paper has been in three plausible ways- the researchers tried to provide information based explanation to asset pricing error, it identifies the influence of media channels on the stock market and the findings of the researchers facilitates to enrich the literature on investors' information search behaviours. Overall, the study concludes that in a large market base media influences a lot due to which biasness is existent as media has the power to slant news in order to increase viewership and investors with varied mindset interpret it as per their set beliefs because they suffer from another form of mental bias called confirmation bias. Due to this cyclical effect stock prices easily deviate from their true value and distortion happens in the stock markets.

Upadhyay, D. & Shah, P. in their contemporary research work on behavioural finance pointed out that psychological factors play an important role in taking investment decisions under uncertain conditions. This piece of work tries to understand the effect of behavioural finance on investors on investment decision making of individual investors. The researchers undertook this study with some variables under consideration and found out that advancement in education level was an important determinant of investment behaviour thereby proving that educated people like graduates and undergraduates had more overconfidence bias as compared to less educated people. The study also intended to find out the inter relationship between gender and emotional bias and the fact was established that females are more prone to emotional bias while taking investment decisions and they strongly rely on their intuition and gut feelings when taking decisions related to investment. The study was conducted within the limited geographical frontiers of Ahmedabad city to find out the relevance of behavioral finance theories and its impact on the investors rational decision making. A total of 181 responses were collected and the study concluded with the fact that investors are not rational and they are most often affected by the behavioural biases while undertaking the process of investment decision making.

Mittal, S.K. & Shrivastava, D jointly conducted a research work and found that people often make errors while picking stocks and do not make rational choice of a portfolio. Most of the investors make decision based on their intuition rather than exhibiting deliberate and controlled behaviour. This study conducted in depth research and the researchers stated that the growing earning and safe investment scenario in India presents an immense opportunity to the investors towards customized financial products and instruments. This research paper revealed that both individual and institutional investors are affected by different types of behavioural biases while making investment decisions and the degree of deviation depends on the expertise, skill, knowledge and experience in the field of finance. If the investors were able to identify these biases at the early stages of investment it helped them in taking better investment decisions and efficient portfolio of selected stocks. The financial market is positioned well enough to be more customer-oriented than product oriented and offers customized products/services.

Khilar, R.P., & Dr. Singh, S. in the mentioned research study brought to the fore the insight that human mind gets trapped in the different behavioural biases and makes mistakes while taking important investment decisions. Emotions play a pivotal role in such types of investment decisions and often times leads to financial losses on the part of the investors. The research paper took into consideration certain emotional biases such as overconfidence, loss-aversion, home bias and endowment effect while taking investment related decisions. The present research work offers direct implications to both individual and institutional investors and proves that emotional biases have a direct impact on the investment decisions of investors. Overall, it has been proved out of this research that issuer companies, financial advisors and intermediaries should have a thorough understanding of the different emotional biases to understand financial market behaviour in a better manner. This will help in curbing the act of mispricing of securities to a greater extent thereby improving the quality of investment decisions.

Sukheja, G.M. in her contemporary research work aimed to understand the role of biases, moods and emotions and their impact on the investment behaviour of individuals. This research paper has tried to explore the new facets of behavioural finance. Behavioural finance undertakes the in depth study of investors psychology before making any investment decision. The researcher has emphasized in the study that in behavioural finance the role of human oversight in modeling financial markets is of paramount importance and contemporary financial market experts have ignored the importance of emotions in decision making, who rather try to rely on the mathematical models for investment decision making. The focus of this study is to understand the fact that an average investor makes investment decisions based on emotions and not on logic. The objectives of the study were to uncover the genesis of behavioural finance and identifying certain behavioural factors that may have probable effect on expected investment decisions. The recommendations made revealed that financial advisors should match up to biases at high wealth levels and exhibit necessary corrective behaviour at lower wealth levels.

Data Analysis and Interpretation

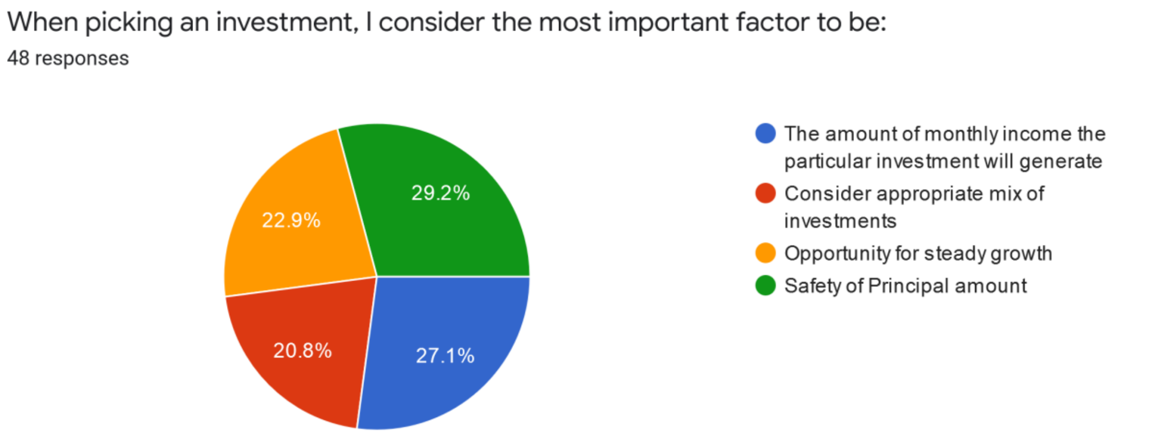
The research study undertaken presented responses which were collected from 50 respondents (since the topic of information seeking is of sensitive nature) comprising college students, members of faculty, staff, parents of students, corporate professionals and businessmen. The analysis which is of significance is as mentioned below:

Demographic Profiling of Respondents:

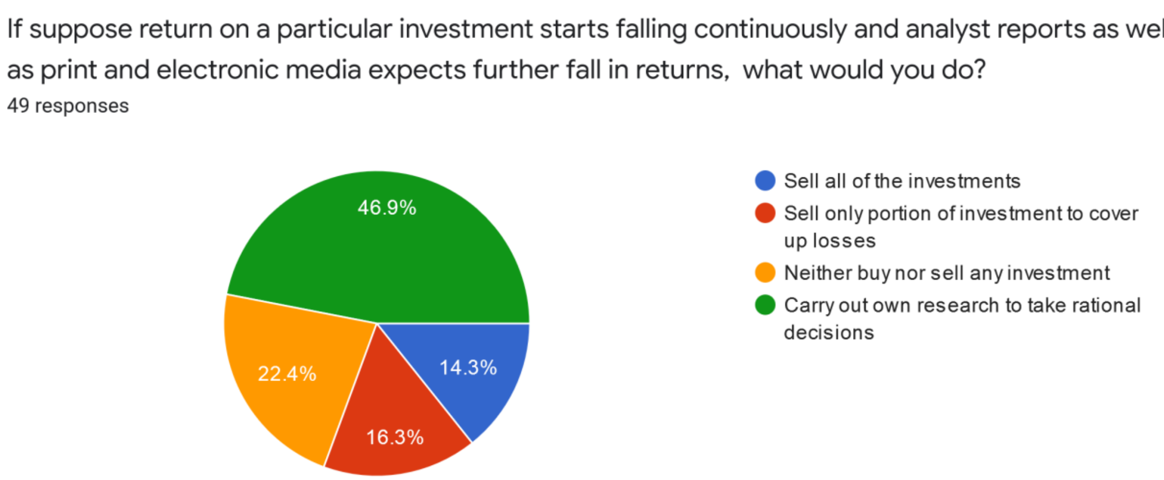
Sl. No.	Variable	Analysis
1	Gender	• 51.9% respondents are male and 48.1 % respondents are female
2	Age Group	• 67.3% respondents fall in the 18-25 years age group category
3	Level of Education	• 51.9% respondents are graduates and 19.2% of respondents are post graduates
4	Estimated Average Annual Income	• Majority of the respondents income lie between Rs. 200,000 to Rs.400,000
5	Occupation	• 34.1% of the respondents are into Business or Service and 24.4% are Professionals
6	Investment Horizon	• 69% respondents recorded investing in financial products ranging between a time horizon of 1-3 years
7	Investment Products	• The most preferred investment products by respondents are Bank FDs (52.1%), Mutual Funds (47.9%) and the least preferred investments are ETFs (6.3%) and Derivatives (6.3%)
8	Purpose of Investment	• Carrying out Family Responsibilities ranked at the top (1st), Accumulating Capital to start a business venture ranks next (2nd) followed by the Objective to fight out Inflation (3rd)

***Source*: Collected by the Author**

The next set of analysis highlights the core of the topic in discussion. These are highlighted below: Some of the significant findings are shown in the form of charts and patterns.

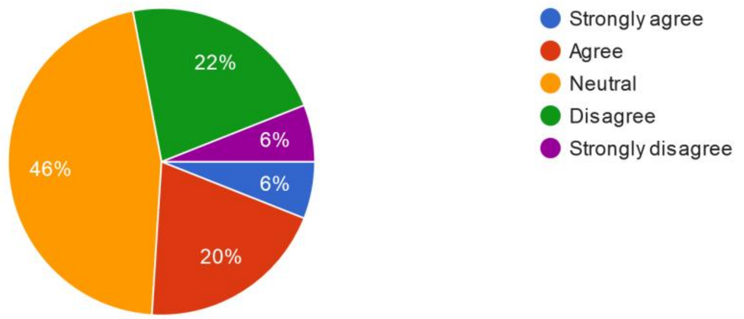


This was one of its kind interesting analysis I came across while conducting the survey wherein 29.2% respondents do investment with the objective of ensuring safety of principal amount invested, 27.1% respondents carry investment with the expectation of generating some amount of monthly return, 22.9% looks for steady opportunity for growth of capital and 20.8% want to keep it safe by considering appropriate mix of investments to optimize the investment risk.



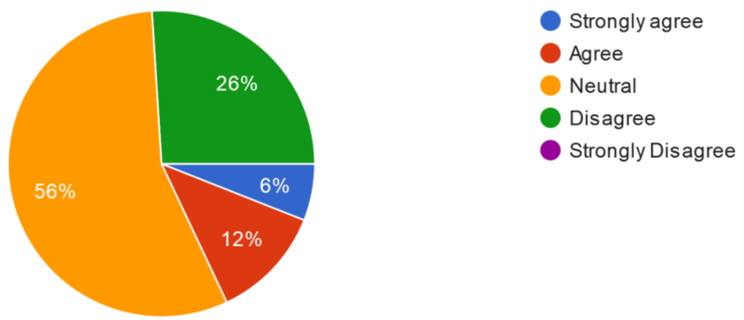
Most of the investors in this analysis (46.9%) revealed that they are not carried off by investment bias as they do not have a panic mentality and are able to take rational decisions. Only a small proportion (14.3%) would go ahead to sell off all their investments if they see the share prices going down consistently over time.

I choose investments based on recommendations or influence of other investors
50 responses

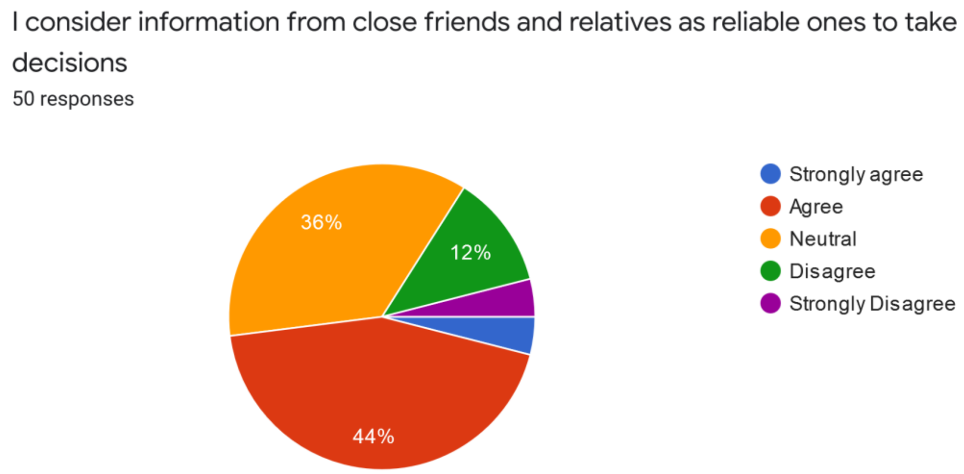


The above analysis reveals that a rational investor has the capability to take their own investment decisions and other investors do not influence their individual investment decision making.

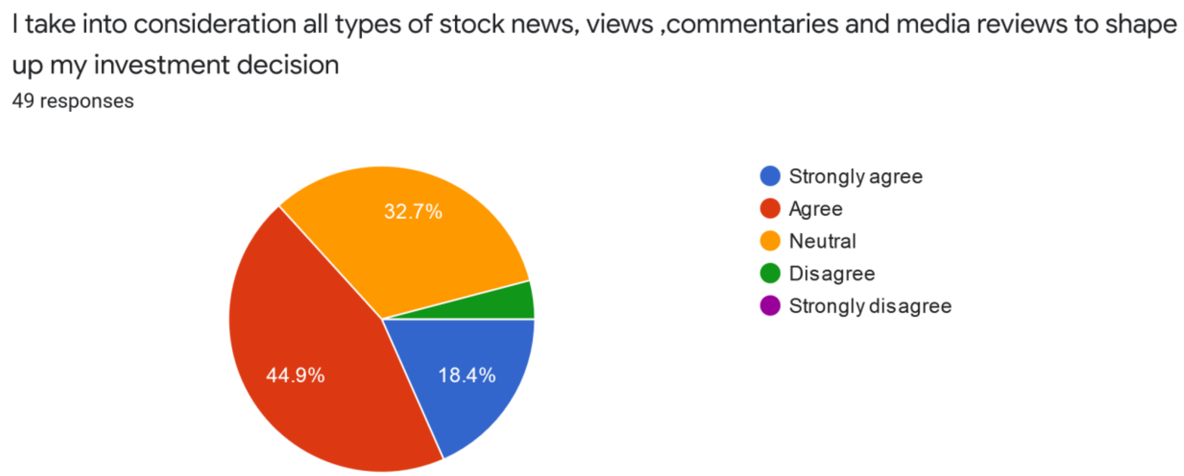
I react quickly to the changes sought after by other investors and try to follow them and their reactions
50 responses



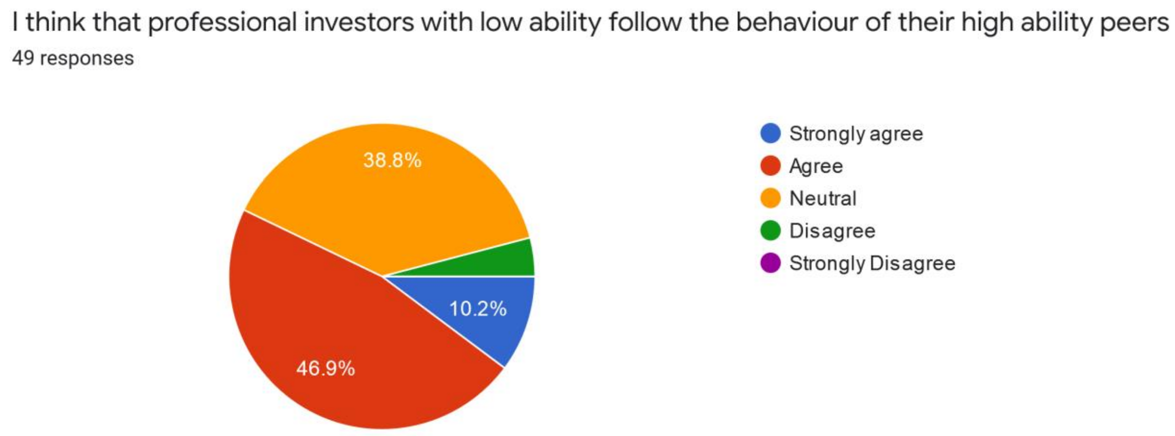
Only 6% of total respondents brought it to the fore that they react quickly to the changes experienced by similar set of investors and majority of them (56%) remained neutral to such sort of market movements.



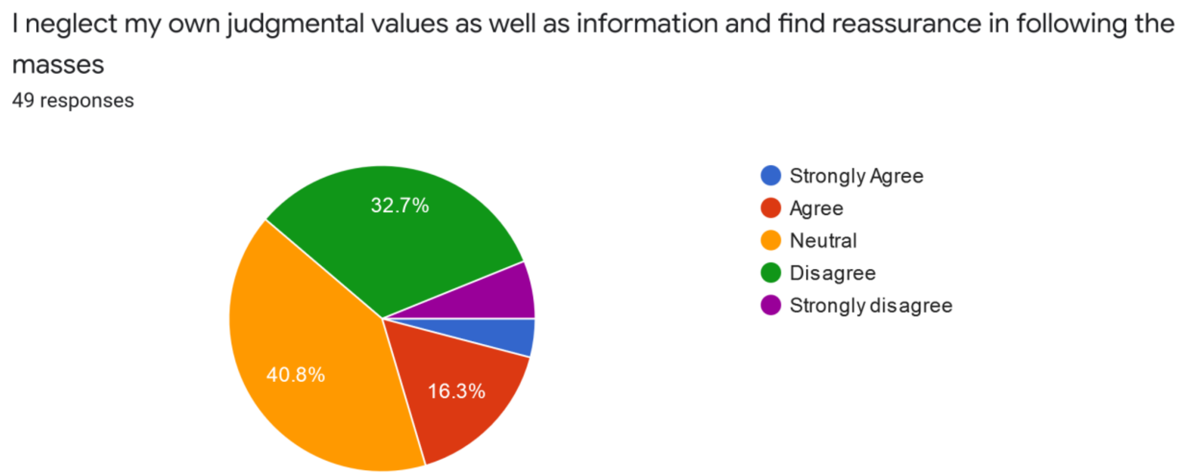
This analysis is quite significant as well as alarming which reveals that 44% of respondents blindly have belief and faith in the information collected from their friends and relatives based on that they take investment decisions which in itself may sometimes prove to be detrimental.



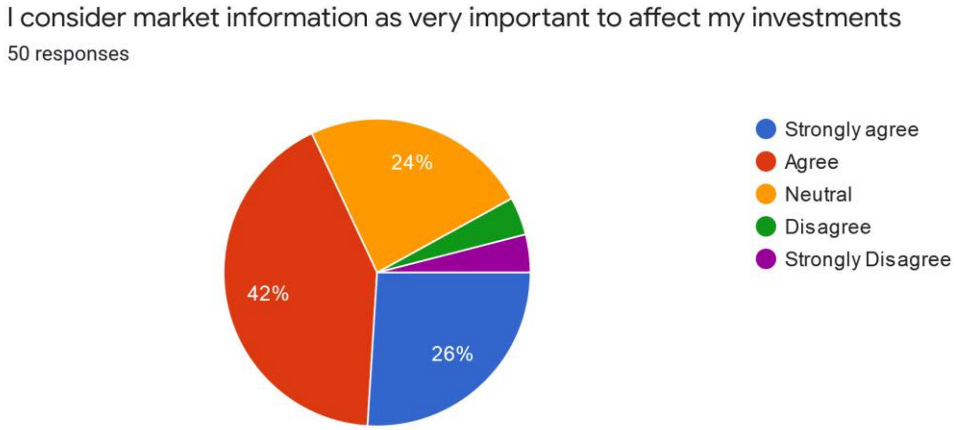
As per the analysis, it is depicted that majority of investors (44.9%) have very high reliability on stock market news, views, commentaries and media reviews which they use extensively to take investment decision or picking up a stock.



In the above diagram it is represented that 46.9% of professional investors (Doctors, CAs and MBAs) often try to imitate the behaviour of their highly influential peers. This may often lead to not so accurate investment decisions.



A substantial number of investors (40.6%) are not affected by the reassurance from the masses regarding investment decision making, which in itself is a positive sign. Only 16.3% investors of the surveyed lot agree with the masses while considering a new investment decision.



This is quite a sensitive analysis revealing in the study and strong reversal of this trend is needed because 42% of the investors surveyed believe in market information strongly. When we blindly start believing in market information, it may result in distortions in investment decision making process
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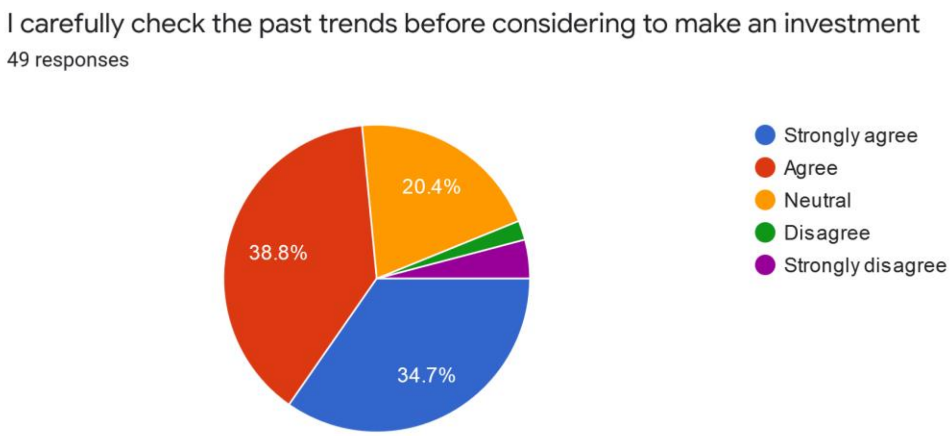
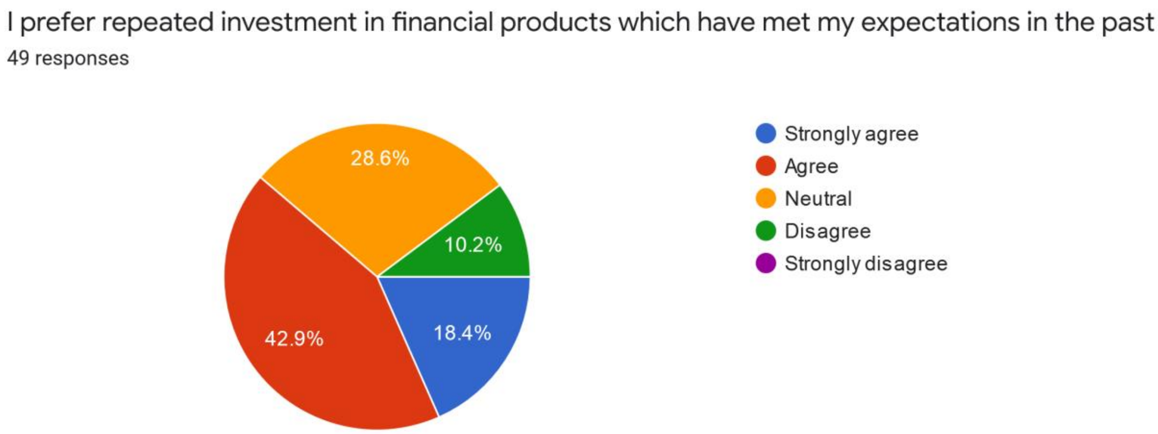
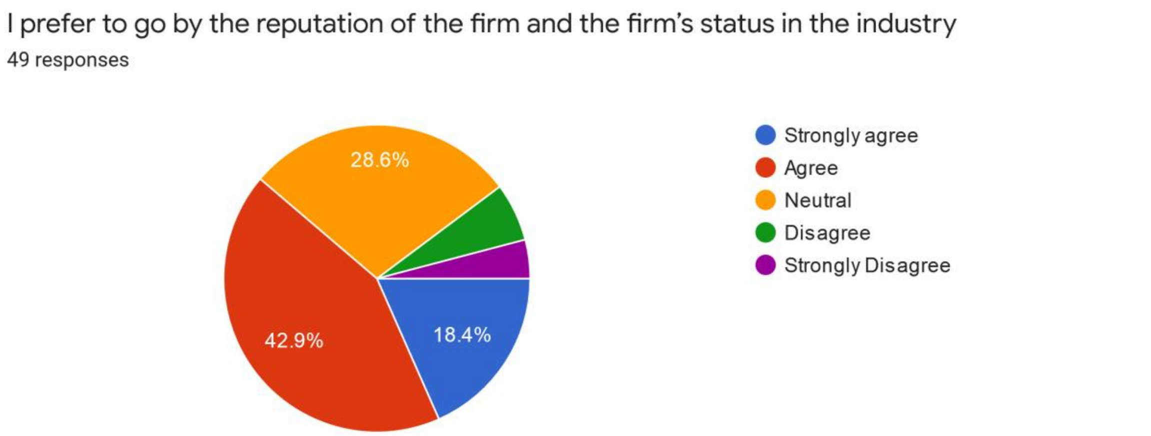


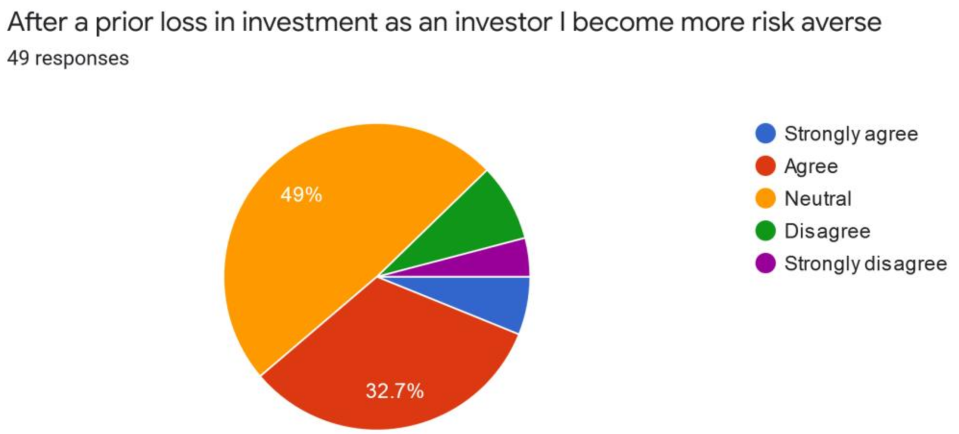
The above analysis again stands to be a myth. Trends reveal that 38.8% investors prefer to check past stock trends before taking any future investment decision. Every time studying the past trends does not guarantee success in the present.



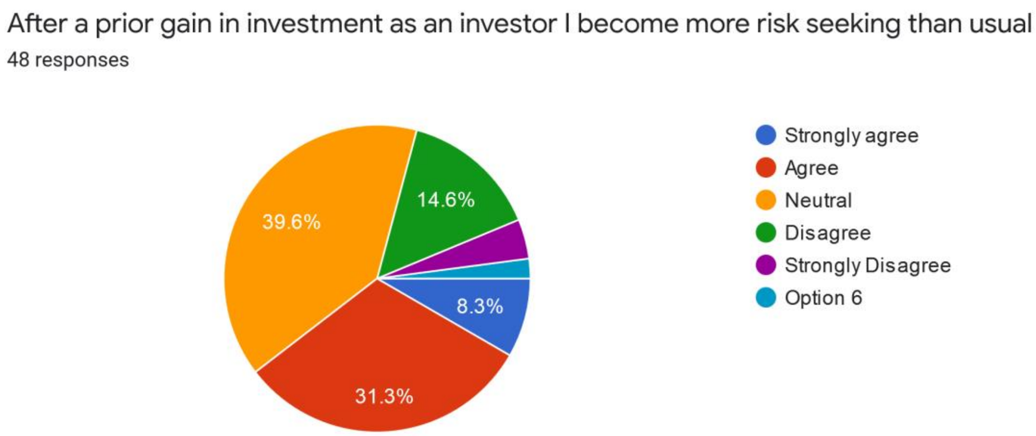
This is a strange phenomenon experienced out of the survey. 42.9% of the respondents surveyed reveal that they believed in repeat purchases of financial products, if in the past that has been able to meet investor's expectations.



In this question, 42.9% of the survey respondents said that they strongly believe in the reputation of the firm and firm's status in the industry to take major investment decision which in itself is a healthy sign of a rational investor.



This is a chance factor analysis, in which the survey carried out revealed that almost 50% of the respondents remain neutral to a situation of previous loss making scenario in investment and by nature investors are conservative while deciding for a fresh investment.



This strategy again does not work wonders always and the survey analysis depicted the fact that almost 40% of investors remain neutral to such a situation and do not want to take any new form of risk.

Conclusion

Most of the respondents surveyed included students and working professionals. There were very less responses from businessmen and other professionals which if possible might have been much more comprehensive research study. Geographical boundaries were never a limitation for the study as the responses have been collected from across all locations and the best way forward in this regard was that the responses were collected online with minimum effort and cost. The collected responses however have been able to provide justice to the study.

One of the questions that analyzed the financial awareness levels of investors revealed that investors have very little knowledge about ETFs and Derivatives (only 6.3%) whereas most of them preferred conventional investment products like bonds, debentures and bank fixed deposits. A remedial measure to reverse this trend would be to work in collaboration with investment advisors to organize monthly/quarterly investor meets as per feasibility of both the parties to help investors understand newer forms of financial products in a better way and start investing in the same.

Another set of question revealed an alarming analysis that most of the times certain investors ought to take investment decisions based on recommendations of close friends, relatives and acquaintances. It is an advice to them to spend some time doing their own fundamental analysis of the sought after stock to decide on the future investments. In order to carry out fundamental analysis a SWOT Analysis of the company and also proper financial analysis needs to be undertaken to decide on the best stock for the purpose of investment.

An analysis also revealed that most of the investors checked past trends before making a future investment decision. This may at few times prove to be beneficial but what if a reversal in the trend is experienced and investors start to bear the brunt of wrong decision making? To overcome this situation investors again have to rely on fundamental analysis apart from carrying out technical analysis too through its various tools and indicators to understand the behaviour of a particular stock both in the short term and long term in order to help them take rational investment decisions.

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