www.eprawisdom.com e-ISSN : 2347 - 9671, p- ISSN : 2349 - 0187
EPRA International Journal of Economic and Business Review Vol - 4, Issue- 10, October 2016
Inno Space (SJIF) Impact Factor : 5.509 ISI Impact Factor : 1.259 (Dubai, UAE)

A STUDY ON THE IMPORTANCE OF INVESTOR BIASES FOR FINANCIAL ADVISORS

Karthikeyan.P[1]
[1]Research Scholar, Research & Development Centre, Bharathiar University, Coimbatore, Tamil Nadu, India.
Dr. Santhosh. V. A[1]
[1]Professor, TKM Institute of Management, Kollam, Kerala, India

ABSTRACT

A strong financial market with broad participation is essential for a developing economy like India. But, the proportion of retail investors in India's equities markets is strikingly low. In the globally integrated financial markets, financial advisors have a big role in attracting individual investors, because people often must rely on the relative expertise of financial advisors while making investment decisions. At times the advices provided by these incentivised advisors even though they are suitable for clients, they may not be optimal for their investment needs. This may due to the reason that these advisors do not take into consideration the investor behaviour, including their biases while giving recommendation. This study based on a survey of investors from two districts of Kerala finds these biases are prevalent among investors. This work looks at three such biases namely, overconfidence, loss aversion and optimism exhibited by investors and discusses on what should be done by the advisors in such situations. This work is limited to the extent that only three of the biases are discussed, further studies can be done to look at other biases and also the interaction between them.

KEYWORDS: *Investor preferences, financial advisors, behaviourial biases, behavioural finance.*

1. INTRODUCTION

A strong financial market with broad participation is essential for a developed economy. With India's growth story unfolding, there is a need to raise resources for companies to fuel the capital needs of the economy and also ensure that the benefits of growth percolate to bottom of the socio-economic pyramid. India's household savings, one of the highest in the world at about 25%, can be channelized through equities, bonds and other instruments to achieve greater financial inclusion and improve the financial markets in India. But, according to a Bloomberg report, the proportion of retail investors in India's equities markets is strikingly low. Less than 1.5 percent of the population invests in securities, compared with almost 10 percent in China and 18 percent in the U.S. Just 2 percent of India's household savings are exposed to equity; in the U.S., the long-term average is 45 percent.

Due to the reason that the financial markets are getting globally integrated; they are increasingly exposed to macroeconomic shocks that affect markets on global scale. The equity markets have been characterized by increasing volatility and fluctuations which has been a concern and has affected all the participants in this market including individual investors and institutional investors. Individual investors as a category are seen to exhibit certain strong patterns in their trading activities in all the stock markets in the world (Sankar, 2010). First, they are

the biggest players in the market, and second, they are seen to almost consistently lose to other categories of investors, especially the institutional investors. With respect to Indian market Sankar (2010) finds that individual investors account for not only a larger number of investors (account holders) and a larger number of trades, but also a larger volume of trades in rupees than all other categories of investors, including institutional investors. He also finds that individual investors as a category have been the biggest loser in the market.

This being the case it is necessary to understand the trading behavior of these individual investors who constitute the majority of the participants in the market. Understanding the behavior of individual investors is important for all involved with these markets from participants to the intermediaries and the regulators. Availability of information is one of the important determinants of investment. It is more often seen that information availability, including the sources and its usefulness influences the individual investors while trading in securities. Thus information availability and its value have a big influence on investment decisions. One of the prominent points of contact between individual investors and the market are the brokers/ financial advisors. It is through them that the individual investors interact for information and their transactions. It is also these people who disseminate information/ advice regarding various investment avenues. These dealings are crucial for attracting and retaining new and existing investors to the capital markets. For these interactions to be beneficial, the advisors have to have a good understanding about the requirements of their clients, especially the biases inherent in them. Usually, while giving recommendations, brokers/ financial advisors do not consider these biases and the result is sub-optimal or wrong decisions. This may lead to investor discontent resulting in him/her moving away from the market. Thus considering the importance of financial information and its impact on individual investors, it is important to understand the perception of individual investors towards various sources of information. It is also important for the financial advisors to understand the biases exhibited by investors and its implications on their advices. In this regard, this article is based on a study on investor in Malappuram and Kozhikode districts in Kerala. This paper is structured with next section discussing the literature related to the subject, followed by sections on research methodology, findings and conclusion.

2.LITERATURE REVIEW

With reference to investment in financial information, it is considered that there is a positive association between the frequency of individual investors trading and the financial information they collect (Barlevy & Veronesi,1999). The quality of the information signals is also considered to influence investor trading behavior, Epstein and Schneider(2008) are of the opinion that news from a trustworthy source should lead to more trades than news from a less reliable one. Ivkovic and Weisbenner (2007) claim that the word-of-mouth effect is a broad phenomenon that affects financial decisions making by individual investors. Margarida and Victor (2012) find that there is a strong and positive relationship between investment in information and intensity of trading in financial assets, and this is sensitive to the sources of information used by investors. They are also of the opinion that overconfident and non-overconfident investors do not rely on the same sources of information.

While making decisions people often must rely on the relative expertise of others. This is particularly true given the increased complexity of modern financial instruments; the average investor no longer has the time or ability to actively manage a portfolio of investments and instead must delegate that responsibility to financial intermediaries (Donald, 2009). Fischer and Gerhardt (2007) are of the opinion that financial advice from professionals should lead to a more rational investment decisions, with a clear positive impact on trading. Guiso et,al. (2008) shows that for Dutch households, generalized trust in others has a large and significant effect on stock market participation. They estimate similar effects for the trust in brokers and bank officials among customers of a major Italian bank.

Sub-optimal advices due to the conflict of interest will affect expectations and hence the future participations of investors in financial markets. This problem is further enhanced by the fact that such financial advices are tend to be used more by less informed or less sophisticated investors who could be easily misled. Financial advice is only deemed appropriate and reasonable if it is made with due regard for 'the client's objectives, financial situation and needs' as a reasonable basis for the advice (McCrae, 2006). Hence it is considered that there has to be a better understanding of the investor's requirement and their behaviour. For such a change that would minimize investor confusion and better protect investors, there has to be a paradigm shift in the way the markets and investors are viewed.

Market theory passed through two distinctly different paradigms in the past eighty years and is experiencing the rise of a third. The first paradigm started in 1934 with Graham and Dodd's (1934) Securities Analysis, which provided the first systematic approach to analyzing and investing in stocks. They argued that it was possible to build superior stock portfolios using careful fundamental analysis and a set of simple decision rules. This paradigm lasted until the ascendency of modern portfolio theory put forward by Markowitz (1952) in which market prices were considered "*informationally efficient*." A consequence of this theory was that it was not worth conducting a Graham and Dodd type of analysis, since the investors are influence by their risk–expected return profile. Modern portfolio theory considered that there were enough rational investors to arbitrage away pricing mistakes committed by the emotional investors. Meanwhile another paradigm was developing; this parallel research stream explored how individuals actually made decisions and studied the effects of psychological, social, cognitive, and emotional factors on the economic decisions of individuals. It is considered that the investors were irrational and that emotions and heuristics dominated decision-making.

Bringing in a paradigm shift Kahneman and Tversky (1979) proposed the prospect theory which is considered to provide a better description of investors' choices than the mean-variance model of Markowitz (De Giorgi & Hens, 2009). Unlike the Markowitz analysis, the prospect theory focuses on the significance of investment losses. In their studies, Kahneman and Tversky found that most investors are averse to loss. This means that investment losses must be compensated through the opportunity for higher returns. For most investors, these returns must be at least twice as high as the potential loss.

The paradigm through which the advisors view the markets has important implications on their understanding of the investors and on the advices they give. While in the traditional rational-agent model of economics presupposes a rational decision maker who maximizes his utility—that is, a person weighs the costs and benefits of all his options and chooses the option that maximizes his benefits, and it is based on this presupposition that predictions about human behavior is made (Demina, 2014). In contrast, behavioral economics demonstrates how traditional economics is limited by its assumptions: even when the traditional theory suggests that an investor can be expected to act rationally, behavioral economics posits that this is not actually the case in many instances (Paredes, 2003). According to Antonides and Van Der Sar (1990), individual investment decision making can be seen as the outcome of the confrontation between expectations and preferences, given the restrictions imposed by the budget and the market. They are of the opinion that all, the perception of economic phenomena is governed by psychological factors.

According to Pompian and Longo (2004), no longer can advisors take for granted an investor's ability to execute the elegant Markowitz portfolio selection model. Also Kahneman and Riepe (1998) are of the opinion that financial advising is a prescriptive activity whose main objective should be to guide investors to make decisions that best serve interests of the investors. They feel that to advise effectively, advisors must be guided by an accurate picture of the cognitive and emotional weaknesses of investors that relate to making investment decisions. The identification of individual investor behaviors or biases inconsistent with classical economic theories of rational behavior has reported in the behavioral finance literature (Odean, 1998; Kahneman & Riepe, 1998; Malloy, 2011). Several well-documented heuristics have been found to affect investor decision making. A study by the Financial Services Authority in the United Kingdom found that investors exhibit a large number of cognitive biases that prevent them from investing efficiently and effectively (De Meza et. al., 2008). Thus an understanding of these biases and their implication for financial advisors and investors is considered essential for all the participants in financial markets. It will be especially useful to financial advisors for providing efficient advices and for the investors in making optimal investments.

3. RESEARCH METHODOLOGY

This study which intents to understand the perception of investors regarding the various sources of financial information for making investment and biases exhibited by the investors is based on data collected from investors from Malappuram and Kozhikode districts in Kerala. Data was collected from one hundred and fifty individual investors from these districts using a structured questionnaire consisting of three sections. While the first section had questions to understand the demographic details of the investors, the second section had questions to regarding sources of information and the third section dealt with the biases. From the large number of biases, only three; overconfidence, loss aversion and optimism have been considered for this study. This study was conducted with the following objectives

- To identify the various sources of information used by individual investors in capital markets.

- To study perception of individual investors regarding the sources of information available to them.
- To understand the various behaviourial biases and its implication for financial advisors.

4. FINDINGS

The data collected from the respondents were analysed and the findings are summerised in this section. Earlier studies have observed that demographic characteristic influence the behaviour of investors.

Table 1: Demographic Profile of the Respondents

Variables	Particulars	Percentage
Gender	Male	86
	Female	14
Age	< 25 yrs	32
	25 – 35 yrs	46
	>35 yrs	22
Education	Below graduation	8
	Graduate	66
	Post- graduate	26
Occupation	Govt. employment	18
	Pvt. employment	48
	Business/ self employed	34
Monthly Income	< Rs. 30000	65
	Rs. 30000 - 50000	31
	>Rs. 50000	4

As seen in Table 1, the percentage of female respondents as well as and investors above the age of 35 years are less. Individuals in these categories have to be attracted in order to increase the participation in financial markets. Majority of the investors have education of graduation or above and the participation of government employees are found to be less.

Table No. 2 gives the details regarding the investments made by individual investors and their motives. Since the survey was done among investors in stock markets all the respondents have invested in stock market, but is is seen that respondents investment in traditional products like post office savings and National Savings Scheme are low. This could be due to the reason that majority of the respondents aim for high returns. This could be linked to the fact that the government employees are less among the respondents.

Table 2: Characteristics of Investments

Variables	Particulars	Percentage
Avenues of investment	Stock market	100
	Bank deposits	96
	Mutual funds	46
	Post Office deposits	32
	National Savings Scheme	28
Objectives of investment	High returns	56
	Moderate returns	32
	Low returns	12

Regarding the sources of information used, Table No. 3 gives the details. It can be seen that almost all the respondents use electronic media (Television) and print media as a source of information. Only few of the investors do own analysis and rely on financial advisors. With respect to reliability of various sources, it is seen that financial advisors have least reliability. This is a important observation which throws light to the earlier discussion regarding the role and effectiveness of financial advisors.

Table 3: Sources of Information and Reliability				
Source	Percentage using this source	Reliability		
		High	Medium	Low
Electronic Media - TV	96	54	30	16
Print Media	94	62	30	8
Internet	54	64	24	12
Financial Advisors	58	32	56	24
Friends & Family member	68	52	26	22
Own Analysis	52	68	24	8

With respect to the behaviourial biases exhibited by the investors, in this study only three of the biases – overconfidence, loss aversion and optimism have been considered. From the Table 4, it is seen that majority of the investors exhibit all the three biases. The implication of these biases for financial advisors is discussed below.

Table 4: Behaviourial Biases among Investors	
Type of Bias	Percentage
Overconfidence	79
Loss aversion	67
Optimism	65

Overconfidence:-

Overconfidence refers to the habit of overestimating own ability to perform in given tasks. People tend to be overconfident about own capabilities and level of knowledge. Overconfidence can be summarized as unwanted faith in one's intuitive reasoning, judgments, and cognitive abilities. In short people think that they are smarter and have better information than they actually do. Financial decision making is very likely affected by overconfidence. The present study on the individual investors found that about 79% of participants rate themselves as average or above average with respect to their investment skills. This shows that vast majority of the participants are highly confident or overconfident about their investment skills. Existence of such overconfidence among investors have been reported by many studies (Barber and Odean, 2000). Further it is seen that there is no significant correlation between age and overconfidence. So it can be concluded that investors in all age group exhibit overconfidence bias. This is in tune with the findings of Salma and Ezzeddine (2008) who in their study of Tunisian investors have found that age and income are not significantly related to confidence.

The effects of overconfidence on financial decisions are serious and can be risky to financial well being. According to Lewellen et al (1977) overconfident investors trade more, believe returns to be highly predictable and expect higher returns than what less confident people do. Odean (1998) finds that overconfident investors will overestimate the value of their private information, causing them to trade actively. He is of the opinion that the more overconfident an investor is, the more he trades and the lower his expected utility, and they have unrealistic beliefs about their expected trading profits. Overconfidence is not only affecting individual investors but also the professionals. Montier (2004) finds that 74% of fund managers perceive themselves as above average at their jobs while only a small minority believes that they are below the average.

Overconfidence, however generated, appears to be a fundamental factor promoting the high volume of trade we observe in financial markets. This could result in more transaction yielding lower returns and also increase the total transaction costs. Eventhough more trade would result in higher income and incentivised broker-dealers would favour high volume of trade, but it has to be taken into consideration that lower than expected return would create a shorter-term client-advisor relationship.

Loss Aversion:-

As described by prospect theory, studies of human decision making demonstrated that investors typically feel the pain of financial loss much more intensely than the pleasure felt from financial gain of the same size (Kahneman & Tversky, 1979). This is termed as loss aversion and simply put; the pain of losing Rs.100 is approximately twice as great as the pleasure of winning the same amount. The pain often results in risk – averse behavior, or risk avoidance that is disproportionate to the expected outcome. This loss aversion can cause investors to shun investment strategies that have demonstrable long – term success because they are not always profitable in the short term. In the present study among investors from two districts of Kerala, it was found that majority of the

respondents (67%) exhibited loss aversion, and it was also noted that loss aversion was higher for younger age group compared to older respondents. Arora and Kumari (2015), from their study among investors in north India report that loss aversion is present among investors. Gachter and Herrmann (2006) have found that individuals who are older and less educated are more likely to be more loss averse than the young individuals.

The implication of loss aversion on the investment behavior is important and the financial advisors have to take into consideration this bias when making their recommendations. Loss aversion can lead to suboptimal investment decisions for any type of investor. Deviating from a long-term portfolio strategy as a result of such bias may cause an investor to fall short of reaching his or her risk and return objectives. Loss aversion is an important psychological factor responsible for investor paralysis. When people see the value of their portfolio decline, their intuitive mind reacts nega tively, and they experience psychological pain. Under these circumstanc es, people become much more reluctant than usual to take risks. How can an advisor overcome this? It can be overcome by means of what we can call "fuzzy mental accounting." According to prospect theory, in judging gains and losses, people are exquisitely sensitive to what is called the "reference point" (Kahneman & Tversky, 1979). If an investor were to put all their cash into the market in one single transaction, then that amount of money would become the reference point. Any movement of the market that increased or decreased the value of the investment, above or below the reference point, would then be very easily calculated, and then the intuitive mind would respond very negatively to losses. If, however, an investor were to invest a specific proportion of his portfolio, say 20 percent, at regular intervals, such as every one or two months, then there is no readily obvious refer ence point. There is no single figure against which to measure performance. In which case, loss aversion is much less likely to kick in. Thus it is to be noted that investments should not be recommended at one time but spread throughout a period like the SIP.

Optimism:-

Optimism is a bias reflecting the extent to which people hold generalized favorable expectancies for their future. Excessive optimism occurs when people overestimate the frequency of favourable outcomes and underestimate the frequency of unfavourable outcomes (Shefrin, 2007). Optimism bias may also lead individual investors to overestimate their own investment results. They subconsciously choose results from their portfolios that match their optimistic self-perception as investors, and fail to measure the results of their entire portfolio. In this study, it was found that majority of the investors (65%) exhibit optimism bias. It is also seen that this bias is present more in younger age group compared to older ones. In the case of new investors as well as investors with long trading experience, this bias is seen to be prevalent.

Optimists not only exaggerate their investment skills, but also underestimate the likelihood of bad outcomes over which they have no control. Optimists are also prone to an illusion of control; they exaggerate the degree to which they control their fate. They tend to underestimate the role of chance in human affairs and to misperceive games of chance as games of skill. This bias prevents investors from taking efficient investment decisions. Since this bias occurs unconsciously, people are unaware of its influences and thus do not take steps to over-come it. The combination of overconfidence and optimism is a potent brew, which causes people to overestimate their knowledge, underestimate risks and exaggerate their ability to control events. It also leaves them vulnerable to statistical surprises.

As far as financial advisors are concerned they have to be cautious about the optimism bias in their clients. Over-optimism about the future can lead to clients underestimating the need to think ahead and take actions that could be sub-optimal or wrong. Clients have to be made aware of all possible realities and given research on the area or asset class they're thinking of so they have a good understanding of 'realistic' returns. Kahneman and Riepe (1998) advice the financial advisors to resist the natural urge to be over optimistic about the courses of action they recommend to their clients and think of things that could go wrong. Similarly they feel that advisors should communicate realistic odds of success to their clients and while presenting historical data to clients, resist the temptation to focus on the upside. They also advice, because advisors are more likely to remember their successes, they should keep a list of past recommendations which they made that were not successful. They are also of the opinion that optimists who are also regret-prone have the worst combination of traits, both for themselves and for the professionals who try to help them. Early identification of such tendencies is essential for the beneficial for both.

CONCLUSION

While making decisions people often must rely on the relative expertise of others and this is particularly true in the case of investments, given the increased complexity of modern financial instruments. An average investor no longer has the time or ability to actively manage

a portfolio of investments and instead must delegate that responsibility to financial intermediaries. At times the advices provided by these incentivised advisors even though they are suitable for clients, they may not be optimal for their investment needs. This may due to the reason that these advisors do not take into consideration the investor behaviour, including their biases while giving recommendation. This study based on a survey of investors from two districts of Kerala finds these biases are prevalent among investors. This work looks at three such biases namely, overconfidence, loss aversion and optimism exhibited by investors and discusses on what should be done by the advisors in such situations. This work is limited to the extent that only three of the biases are discussed, further studies can be done to look at other biases and also the interaction between them.

REFERENCES

1. *Antonides, G., & Van Der Sar, N. L. (1990). Individual expectations, risk perception and preferences in relation to investment decision making. Journal of Economic Psychology, 11(2), 227-245*
2. *Arora, M., & Kumari, S. (2015). Risk Taking in Financial Decisions as a Function of Age, Gender: Mediating Role of Loss Aversion and Regret. International Journal of Applied Psychology, 5(4), 83-89.*
3. *Barber, B. M., & Odean, T. (2000). Trading is hazardous to your wealth: The common stock investment performance of individual investors. The journal of Finance, 55(2), 773-806.*
4. *Barlevy, G., & Veronesi, P. (1999). Information acquisition in financial markets. Review of Economic Studies, 67, 79–90.*
5. *De Giorgi, E., & Hens, T. (2009). Prospect theory and mean-variance analysis: Does it make a difference in wealth management?. Investment Management and Financial Innovations, 6(1), 122.*
6. *De Meza, D., Irlenbusch, B., & Reyniers, D. (2008). Financial capability: A behavioural economics perspective. London: Financial Services Authority.*
7. *Demina, P. (2014). Broker-Dealers and Investment Advisers: A Behavioral-Economics Analysis of Competing Suggestions for Reform. Mich. L. Rev., 113, 429.*
8. *Donald C. Langevoort, (2009). The SEC, Retail Investors, and the Institutionalization of the Securities Markets, 95 Va. L. Rev. 1025, 1030.*
9. *Epstein, R., & Schneider, M. (2008). Ambiguity, information quality, and asset pricing. Journal of Finance, 63(1), 197–228*
10. *Fischer, R., Gerhardt, R. (2007). The missing link between investors and portfolios: Introducing financial advice. <http://ssrn.com/abstract=967374>.*
11. *Gachter, S., Johnson, J.E., & Herrmann, A. (2010). Individual-level loss aversion in riskless and risky choices. CEDEX Discussion Papers 2010-20, Centre for Decision Research and Experimental Economics.*
12. *Graham, B., & Dodd, D. L. (1934). Security Analysis.New York: McGraw - Hill.*
13. *Guiso, L., Sapienza, P., & Zingales, L. (2008). Trusting the stock market. the Journal of Finance, 63(6), 2557-2600.*
14. *Ivkovic, Z., & Weisbenner, S. (2007). Information diffusion effects in individual investors' common stock purchases: Covet thy neighbors' investment*
15. *choices. Review of Financial Studies, 20(4), 1327–1357.*
16. *Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decisions under risk. In Econometrica.*
17. *Kahneman, D., & Riepe, M. W. (1998). Aspects of investor psychology. The Journal of Portfolio Management, 24(4), 52-65.*
18. *Lewellen, W. G., Lease, R. C., & Schlarbaum, G. G. (1977). Patterns of investment strategy and behavior among individual investors. The Journal of Business, 50(3), 296-333.*
19. *Malloy, C. (2011). The psychology and sociology of investing: incorporating behavioral finance and network analysis into equity research and portfolio management. In CFA Institute Conference Proceedings Quarterly (Vol. 28, No. 3, pp. 9-17). CFA Institute.*
20. *Margarida, A., & Victor, M. (2012). Information, overconfidence and trading: Do the sources of information matter? Journal of Economic Psychology 33, 868–881.*
21. *Markowitz, H. (1952). Portfolio selection. The journal of finance, 7(1), 77-91.*
22. *McCrae, M. (2006). Profiling the Risk Attitudes of Clients by Financial Advisors: The Effects of Framing on Response Validity. Faculty of Commerce-Accounting & Finance Working Papers, 36.*
23. *Montier, J. (2004). Global Equity Strategy. If it makes you happy, Dresdner Kleinwort Wasserstein Securities Limited (www. drkwresearch. com 17.06. 04).*
24. *Odean, T. (1998). Volume, volatility, price, and profit when all traders are above average. The Journal of Finance, 53(6), 1887-1934.*
25. *Paredes, T. A. (2003). Blinded by the light: Information overload and its consequences for securities regulation. Wash. ULQ, 81, 417.*
26. *Pompian, M. M., & Longo, J. M. (2004). A new paradigm for practical application of behavioral finance: creating investment programs based on personality type and gender to produce better investment outcomes. The Journal of Wealth Management, 7(2), 9-15.*
27. *Salma, Z., & Ezzeddine, A. (2008). Overconfidence And trading volume: Evidence from an emergent market. Annales Universitatis Apulensis Series Oeconomica, 1(10).*
28. *Sankar De (2010), Does Sign Matter More than Size? A Behavioural Explanation for Individual Investor Performance, ISB INSIGHT, Vol 8(2), pp. 9-12.*
29. *Shefrin , H., (2007). Behavioural Corporate Finance: Decisions That Create Value. McGraw-Hill Companies, New York.*