Role Of Emotional Bias On Investment Decision From Behavioural Finance Perspective

Ruchi Priya Khilar, Dr. Shikta Singh

Abstract—The human mind is capable of taking complicated decisions at very ease but sometimes they also do mistakes and fall prey to certain biases. Such biases lead them to take the wrong decisions which results in suffering losses. As emotion plays a very vital role in the human decision-making process, it sometimes leads them to wrong investment decisions. This is why it becomes very evident to study in detail the various emotional biases in investors’ decisions. Therefore the purpose of this present research paper is to address the role of different emotional biases in investors' investment decision making in the Indian context. Maximum number of research papers has been reviewed in this regard and most relevant literatures have been quoted here in the paper. This paper has tried to explain some of the emotional biases such as overconfidence, loss-aversion, home bias and endowment effect which work as a guideline that can be considered by the decision makers while making invested related decisions. This paper would contribute to the extinct literature of behavioural finance and also helps the investors to identify their own bias and take corrective measures to reduce such bias in their investment decision.

Index Terms—Cognitive bias, Emotional bias, Endowment effect, Home bias, Investment decision, Loss-aversion, Overconfidence

1 INTRODUCTION

Investment is the allocations of available money to different prospective avenues which in turn give some future benefit to the investor or may make him incur loss. The very purpose of making an investment is to get some good return out of such investment from an investor’s point of view. Investment can be done in many ways like investing in stock market, real estate, banks, post office, insurance company etc. Choosing a correct avenue for investing which can meet the investor’s objective is a crucial task on part of an investor. It takes lot of time to analyze and decide “where to invest”. Proper analysis of different avenues available is very much vital before making an investment. For instance, if an investor wants to invest in share market then he needs to properly analyze the performance of the shares of the companies trading in stock market, their values, the market trend and every nitty-gritty related to it. Investing without proper analysis is a disaster so it has to be done very carefully and mindfully. Still it has been seen that after putting so much of effort in analyzing the stocks, people suffer losses from their investment. This happens due to the misinterpretation of the information available by an investor. This misinterpretation can be caused because of the lack of information available, several behavioural biases such as cognitive and emotional biases etc

1.1 Behavioural Biases: Cognitive and Emotional Bias

In standard finance theory, it is assumed that the investors always take rational decisions i.e. they always make investment decision correctly and logically. If this would have been the case then none of the investors would have to suffer losses but in reality we see investors suffer losses too which means that this assumption doesn’t hold true in real sense. This has led to the emergence of a new paradigm in the world of finance known as “Behavioural Finance” which deals with the irrational beliefs of the investors that may influence the investment decision making process of an investor and make them fall prey to the various behavioural biases. Behavioural bias is predominantly divided into two types such as cognitive bias and emotional bias. Cognitive bias involves decision making based on some established concepts or rule of thumb in the mind of investors which may or may not hold accurate or factual in real sense [1]. An investment decision said to be influenced by emotional bias when taken spontaneous based on the person's intuition and his personal feelings associated with it [1]. The purpose of the current paper is to explore the various emotional biases influencing the investment decision in Indian context by reviewing various literatures pertaining to the objective of the present paper.

2 REVIEW OF LITERATURE

In this part, the most significant literatures relevant to the objective of the present paper have been discussed. Three authors named Thaler, Kahneman and Tversky are regarded as the father of “Behavioural Finance”. These authors have laid down the foundation stone on which the present theories of behavioural finance stands. Thaler being a finance theorist was of the opinion that investors do not behave rationally hence they tend to make mistakes while taking investment decision [2]. Kahneman and Tversky came up with “prospect theory”. Prospect theory can be treated as an alternative to expected utility theory, rational expectations theory and the EMH (Efficient Market Hypothesis) [3]. A significant amount of previous studies suggests that various behavioural anomalies lead to poor judgement and mispricing of securities in financial market.

2.1 Emotional Biases Influencing Investment Decision

Previous literature suggests that investor’s personal feelings, spontaneous emotions, their intuition affect their investment decision. This part of the paper tries to identify the different prominent emotional biases which have an impact on investors’ decision basing upon the prior literature done in the given context.

A. Overconfidence: Investors are said to be influenced by overconfidence bias when they try to rely more on their own belief, knowledge and intellect. In short, it is a kind of egoistical belief that I am better than actually I really is. Such kind of beliefs lead to overestimation of one’s own skill and talent and overestimation leads to

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International Journal of Scientific & Technology Research Volume 9, Issue 03, March 2020
ISSN 2277-8616

www.ijstr.org

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overconfidence [4], [17], [18]. An overconfident investor relies more on the information gathered by him than to the market generated information [5]. Overconfident investors overreact to the market information and it leads to the stock market’s excessive trading phenomenon [6]. Overconfidence bias is often triggered by self-attribution bias which ultimately leads to over optimism that affect the rational decision making process of an investor [7], [15], [17].

B. Loss aversion Bias: Another more interesting bias which has been widely studied in different context is loss aversion bias. This bias leads the investors to irrational decision-making [3]. In this bias, investors become frightened towards incurring losses so much that they stop investing in portfolios which could entail them gain. Here, pain of loss is way more than the gain in an investment. Investors are very sensitive to loss which they always want to avoid it and thus their decision gets influenced [8]. Loss aversion is associated with the feelings of guilt, fear, anguish [9]. It was also found during the review that female investors are more loss averse than the male investors [23], [24].

C. Home Bias: According to this bias, investors are more inclined towards their domestic companies than to the foreign companies. This bias better describes “the sense of belongingness” in the minds of the investors [10]. They tend to invest more in domestic companies even if the returns are lower. They do so because of the higher transaction cost involves in trading in foreign securities [25].

D. Endowment effect: It is yet another type of emotional bias which influences the investors’ decision making. According to this bias, investors’ tends to value the assets more which are currently being held by them than its actual market value [10]. This bias exists widely with the investors who have attached some emotional feeling towards certain asset or stock. For instance, shares gifted by a father to his son and the son develops an emotional feeling towards the stock which compel him to retain it with him even if the stocks aren’t doing well in current market scenario. Panel data analysis is an increasingly popular form of longitudinal data analysis among social and behavioral science researchers. A panel is a cross-section or group of people who are surveyed periodically over a given time span. Panel methods will be summarized along with their related disadvantages and advantages.

3 RESEARCH QUESTIONS
• Does emotional biases such as overconfidence, loss-aversion bias, home bias and endowment effect has any impact on investors’ investment decision-making?
• What is the impact of above said emotional biases on Indian investor’s investment decision-making?

4 RESEARCH OBJECTIVE
The objective of the present research article is to address the various emotional biases such as overconfidence, loss-aversion, home bias and endowment effect that have influence on investors’ decision making by reviewing various literatures available in the above context. This research will review only those papers which have studied one, two or multiple biases.

5 CONCEPTUAL FRAMEWORK

6 METHODOLOGY
The methodology followed for the present article is a review of literature. It involves reviewing the previously published research work pertaining to the topic of the current research. Due to certain limitations all the extensive amount of literatures could not be reviewed but a considerable amount of relevant literatures related to the topic has been reviewed and findings has been drawn basing upon it. For this study, research articles have been downloaded from peer-reviewed journals. The research articles are being gathered from Emerald Insight, Elsevier, JStor, EBSCOHost, Google Scholar and SSRN. The keywords provided in this study have been used to search for the relevant research articles pertaining to the topic. Those search result helped us in finding the various articles describing the relationship between different behavioural biases and investment decision-making of investors. This particular paper includes those research articles which had studied various emotional biases in their study and had drawn conclusions accordingly. The literatures reviewed for the current paper includes both on individual investors and institutional investors. This study includes the articles on the pertaining topic from the evolution stage of the concept of behavioural finance [2] till the most recent study on emotional bias affecting the decision making of the investors. The present research paper has followed certain criteria for selecting the articles for the current study. The research articles selected for the purpose of reviewing are as follows:

- The article should have been published in a peer-reviewed journal,
- The research article must have been published in English language with full-text access,
- Only those articles have been taken into consideration which have studied one or more emotional biases in their study
- Research articles having the above said keywords in their studies have been taken into consideration for this study

We have taken only those articles for this study which have fulfilled the above laid criteria. Articles with the help of above
keywords had been searched thoroughly throughout the internet and had been included in this study. Around 125 articles have been reviewed and out of those only 22 articles have been found relevant within the said context. Most of the articles reviewed have been found to be based on secondary data analysis.

7 RESULT AND ANALYSIS

Most of the research papers found in the area of behavioural finance have pointed out towards the existence of various behavioural biases in their studies. They have concluded that most of the times investor’s investment decisions are influenced by behavioural biases. Investors do fall prey in the trap of emotional biases and take wrong investment decisions which make them suffer losses too. Past literature shows that overconfidence, home bias does influence the investors’ decision [10]. Overconfidence leads investors to take excessive risk which in turn makes them less cost efficient [11], [20]. Among investors, overconfidence bias seems to be dominant, and hence, investors may tend to be more overconfident rather than more loss-averse [12], [13], [19], [22]. Basing upon the past literatures, it has also been seen that investors are also get influenced by home bias and there exist a strong association between the cultural factor and home bias [13], [14], [15], [16]. From the literatures reviewed for this present paper, following table has been prepared to see the frequency of the studies done on a particular emotional bias in the given context.

Table 1
STUDIES ON EMOTIONAL BIASES

<table>
<thead>
<tr>
<th>Sl. no.</th>
<th>Emotional biases</th>
<th>No. of time studied</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Overconfidence</td>
<td>10</td>
</tr>
<tr>
<td>2</td>
<td>Loss-aversion</td>
<td>07</td>
</tr>
<tr>
<td>3</td>
<td>Home bias</td>
<td>03</td>
</tr>
<tr>
<td>4</td>
<td>Endowment effect</td>
<td>02</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>22</td>
</tr>
</tbody>
</table>

Source: Author’s own

From the above table, we can note that out of the various literatures reviewed pertaining to the objective of this research paper, it has been found that overconfidence bias has been studied the maximum number of time followed by the studies on loss-aversion bias. During the reviewing process very lesser amount of literatures has been found on home bias and least number of studies has been done on endowment effect bias. More number of studies are required on home bias and endowment effect to know the wide impact of these biases on the investors’ investment decision making. The literatures reviewed so far shows that the investment decisions are affected by the emotional behavioural biases.

8 RESEARCH LIMITATION

The present study only covers up the literatures which have studied the impact of emotional biases such as overconfidence, loss-aversion bias, home bias and endowment effect onto the investors’ decision-making. This limits the scope of this research within these four biases affecting the investment decision. This study had put more emphasis on the previous studies done in Indian context due to which the findings cannot be generalized in other culturally different context.

9 CONCLUSION

Behavioural finance can be proved beneficial in many ways. This would not only help the individual investors in their investment decision but also the financial advisors, issuing companies and financial intermediaries could be able to understand the movement of the market performing in a certain way. They would be able to clear out their doubts by properly understanding this phenomenon and be able to take better financing and investment decision. A thorough understanding of these emotions, sentiments, moods involves human behaviour would make investors understand the market behaviour better. This would also help them to detect the mispricing of securities and help them to take their investment decision accordingly. Thus it has become very necessary to study these biases thoroughly to make the decisions correctly which would entail a maximum benefit to the investors. The outcome of this research work provides a clear insight to the future researchers about the types of researches happening on this area and the need of research to be done on different dimensions of the same area. More researches are required on the unpopular biases such as home bias, endowment effect bias in order to know the true impact of such biases on the investors’ decision-making.

10 RESEARCH IMPLICATION

The present paper offers direct implications to the individual investors as well as institutional investors as the various emotional biases discussed above have a direct impact on their investment decisions. This also offers an indirect implication to the policy makers and economic advisors as these biases could affect wherever decision-making is involved. This paper helps in making them aware of such biases so that decision can be taken without any bias or with minimum influence of bias in it.

REFERENCES