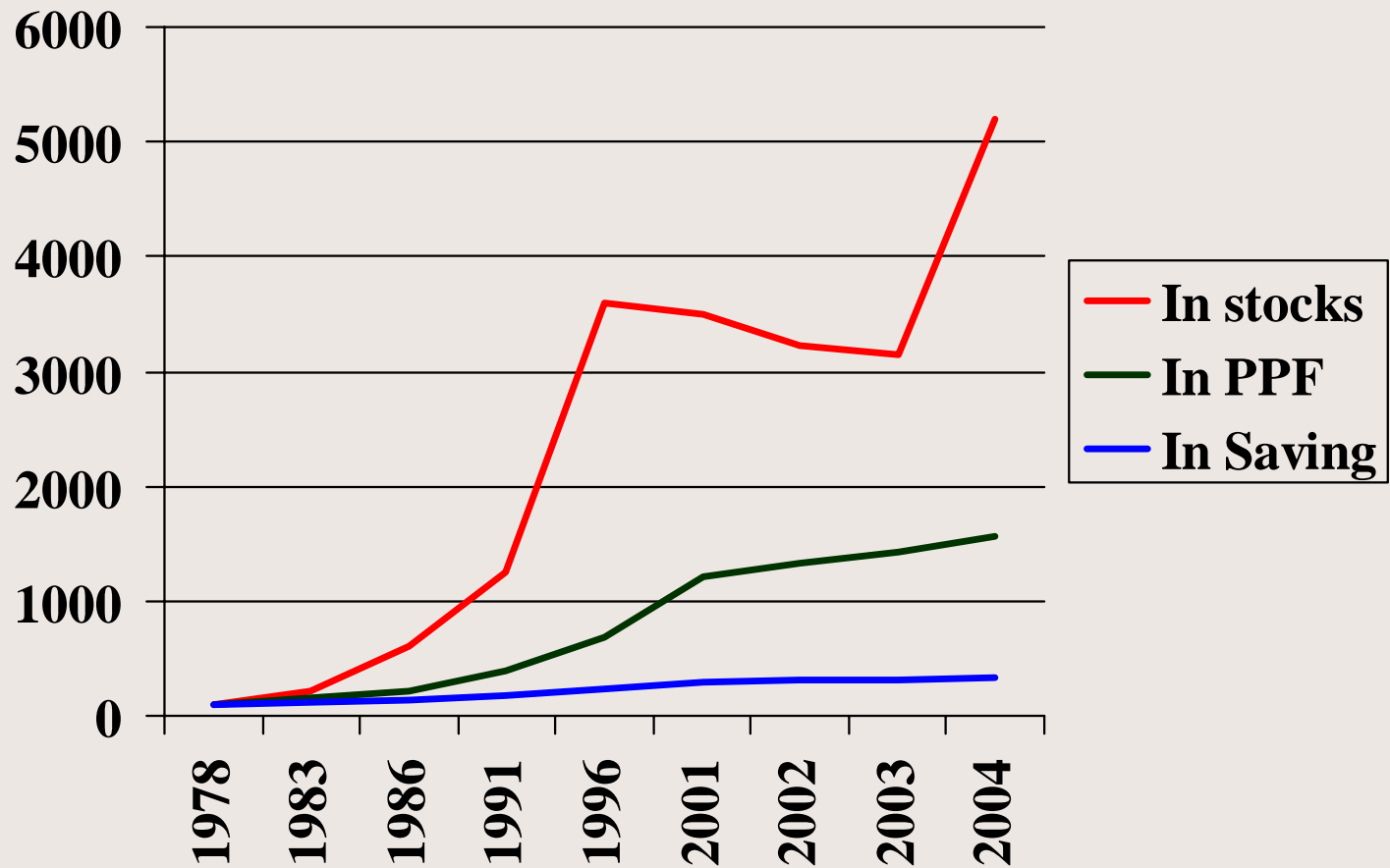


Introduction to Behavioral Finance

Parag Parikh Financial
Advisory Services Ltd.

Equity v/s Debt



PARADOX

- Investments Have Always Done Well
- Investors Have Done Poorly

Economic Theories

Traditional

Efficient Markets

People make rational decisions to maximize profits

Behavioral

Inefficient Markets

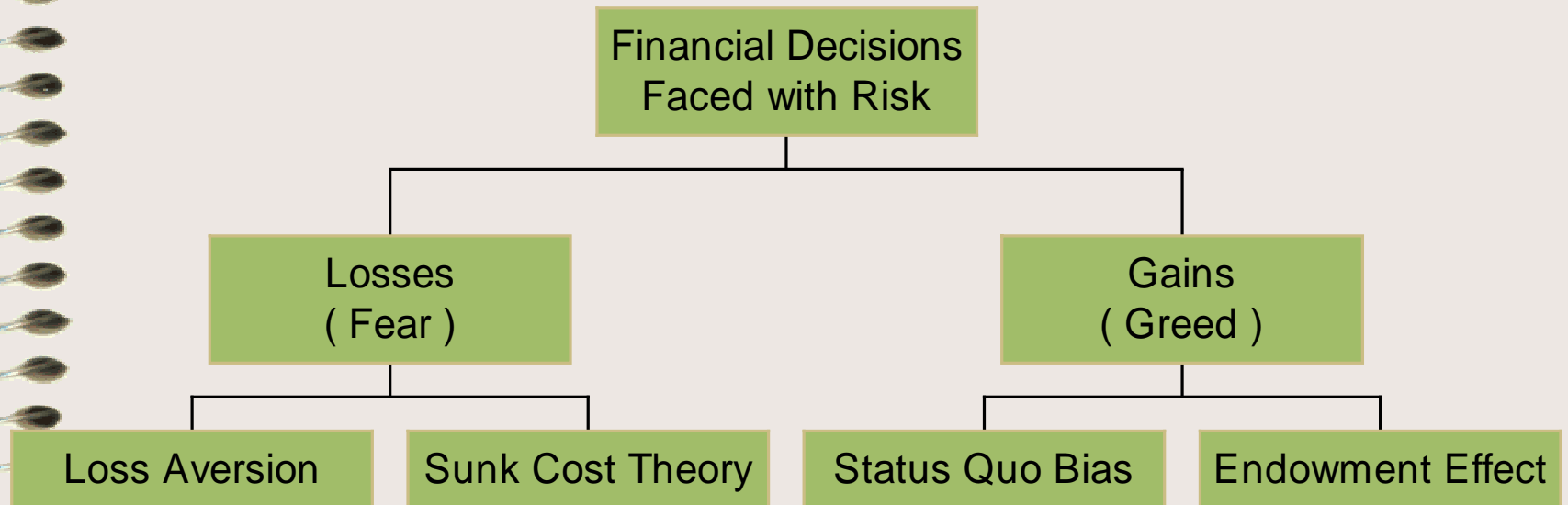
People are irrational



What Is Behavioral Finance?

Psychology + Finance

Financial Decisions



Quiz 1

You Are Given Rs.1000 And Two Options

- A: Guaranteed win of additional Rs.500
- B: Chance to flip a coin. If it's heads you receive another Rs.1000 and with tails you get nothing more

Quiz 2

You Are Given Rs.2000 and Two Options

- A: You are guaranteed to lose Rs.500
- B: Chance to flip a coin. If it's heads you lose Rs.1000 and with tails you lose nothing

Loss Aversion

Investors take more risk when faced with a loss and are more conservative to lock in sure profits.

Investor Behavior Due To Loss Aversion

- Investors tend to go for sure gains
- Take more risk when threatened with a loss.
- Investors prefer fixed income investments over stocks
- Tendency to hold losers and sell winners

Quiz 3

You Have Complimentary Tickets For
Filmfare Awards Nite

On the evening of the program there is a severe
rainstorm and traffic is disrupted due to floods.

You have to travel from your home in Nariman
Point to Andheri

Would you go?

YES

NO

Quiz 4

You Have Bought Rs.1500/-Tickets For
the Filmfare Awards Nite

On the evening of the program there is a severe
rainstorm and traffic is disrupted due to floods.

You have to travel from your home in Nariman
Point to Andheri

Would You Go?

YES

NO

Sunk Cost Fallacy

- Increasing your commitment to justify past actions.
- Ego gets tied to commitment

Banking Industry



- Borrowers
business runs into
trouble –
- Bankers lend
additional funds
to borrowers.

Sunk Cost Fallacy And Investment Decisions



- **Averaging cost of purchases**
- **Spending on repairs**
- **Government spending on favorite unviable projects**

Scenario 1

You inherited from your Uncle Rs 50 Lakh on the condition that you invest in the capital markets

Will you invest in

- Bonds
- Stocks
- Mutual Funds
- Public Provident Fund

Scenario 2

You inherited from your uncle Rs 50 Lakh in a portfolio of stock

Will You -

- Leave the portfolio as it is
- Sell the stocks and invest in Bonds
- Sell the stocks and place the money in PPF
- Sell the stocks and place it in Mutual Funds

Decision Paralysis / Status Quo



- going wrong
- make a loss
- look foolish
- unwillingness to take risks

Status Quo Bias - Examples

- IT stocks
- UTI
- Investors buy top performing funds
- Junk stocks

Quiz 5

You have been gifted a Souvenir jug worth Rs. 100 (in the marketplace). Someone offers to buy it from you.

What is the very least that you would expect to be paid for the jug?

A. 100

B. 80

C. 70

D. 50

Quiz 6

Your neighbor has received a Souvenir jug worth Rs. 100 (in the marketplace) as a gift. He offers you the jug for sale.

What is the most that you are willing to pay for the jug?

A. 100

B. 80

C. 70

D. 50

Endowment Effect

The value of a good increases when it becomes a part of a person's endowment.

Endowment Effects In Capital Markets

- Investors always mentally overvalue the stocks they hold
- Analyst Meetings and Company Visits

Example of Behavioural Anomalies

Mr. A Holding 7000 shares of HFCL @ 70

March

2000 – HFCL price - Rs 2500 (**Anchored** to this price)

June

2000 – HFCL price - Rs 1500 (**Loss Aversion** at this price)

Needs money but suffers from (**Decision Paralysis** between 2 options)

Real Estate or HFCL shares

June

2000 – Sold off real estate instead of HFCL shares.

June

2002 – HFCL price - Rs 56 (**Endowment Effect** at this price)

Thinks market is undervaluing HFCL & is still holding on to it.

You Are A Victim Of Loss Aversion and Sunk Cost

- Prefer Fixed income securities over Stocks
- Sell winning investments more readily
- Exit the stock Market when prices fall
- Have Tax Aversion
- Make important spending decisions based on your past spending

Be Free from Loss Aversion and Sunk Cost Fallacy

1. Test your threshold for loss
2. Diversify
3. The big picture: Investment Plan
4. Start Afresh
5. Reframe losses as gains
6. Segregate gains and integrate losses

You May Be Suffering From Decision Paralysis If You....

- Cannot choose between Investment Options
- Do not have a retirement plan
- Delay making decisions
- Buy on trials but never return
- Fall in love with stocks you own
- Go to company visits and buy stocks

Freedom from Status Quo Bias and Endowment Effect

Don't forget opportunity costs

Put yourself on autopilot

Change frame of reference

Don't fall in love with your stocks

There is no free lunch

Plan Of Action

- *Investment Plan On Paper*
- *Knowledge is important: Hire the right professionals*
- *Ignore money already spent and focus on future cost and benefits*
- *Don't get married to your stocks*
- *Understand your bias and use it to your advantage*

A spiral-bound notebook with a brown cover and a white page. The spiral binding is on the left side. The text "THANK YOU" is written in the center of the page in a black, serif font.

THANK YOU

Mental Accounting -
One of the other pillars of

Behavioral Finance



Money Is Fungible

This means that Rs. 100 in lottery winnings, Rs.100 in salary and a Rs. 100 tax refund should have the same meaning as they have the same purchasing power

REALITY

Mental Accounting

It is the tendency to place different values to the same sum of money

Types of Mental Accounts

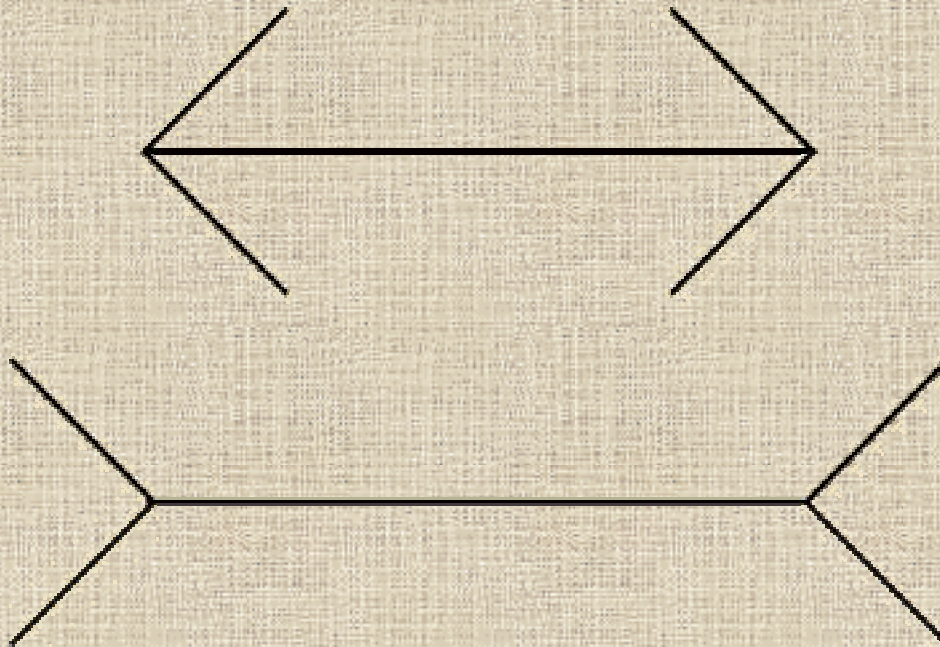
- Earned income v/s gift income
- Size of the money in question
- Large financial decision v/s small purchases
- Cheap money v/s costly money
- Sacred money

Investor Behavior due to Mental Accounting

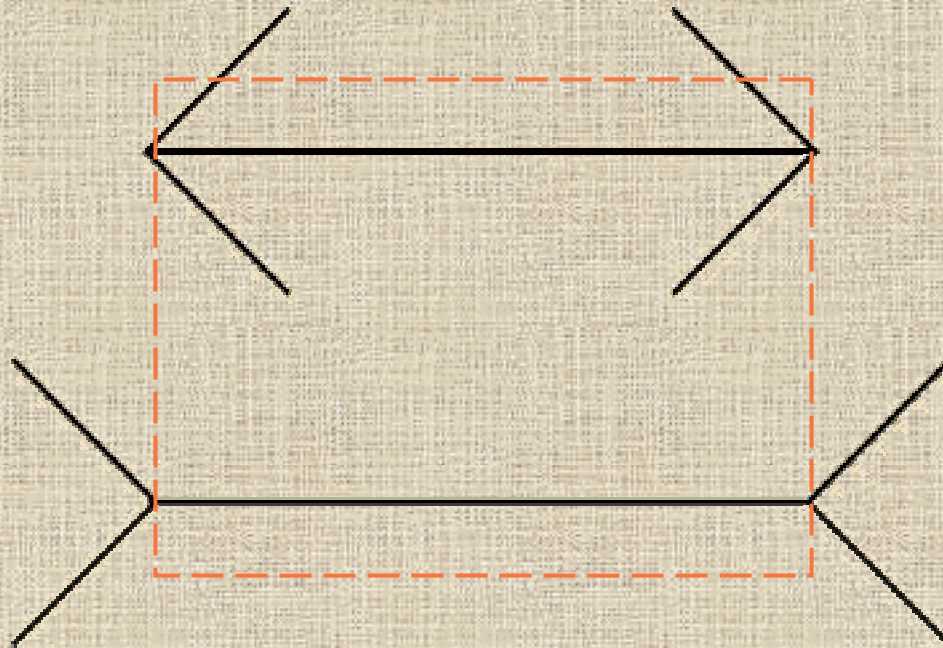
- Hold on to losing investments
- Earn less interest and pay more interest
- Bonus shares
- Day traders

Cognitive Illusions Are Like Optical Illusions

Which Line Appears Longer?



Measurement Tools Help Identify Illusions



Mental Heuristics

Cause Investors to form

Biased Expectations

Five Types Of Heuristics

- Availability
- Representative
- Saliency
- Overconfidence
- Anchoring

Availability: React to recall value

Mid Cap story

IPO fad

India Shining

*Leads to..... **HERD MENTALITY***

Representative: Similarity

Over react to new information

Second rated stocks : steel, banking, cement

Biocon.....

Company changing names to be with the current fads

Saliency: Events which occur infrequently

Over react to new information

- Good or bad quarterly results by a company
- Commodities Boom
- Treasury gains
- Higher expectations from Indian Equities

Overconfidence: Smarter than they really are

Under React to New Information

UTI misses opportunity to become NAV based

Mutual Funds launching Mid Cap schemes

Mega expansions due to low interest rates



What would you call a HOUSE?

An Asset

or

A Liability

Anchoring: Locked to the Past

Under React to New Information

- Investors could not exit IT stocks
- Black Monday pains
- High returns from Debt Funds

Causes Decision Paralysis

Warren Buffet

“Success in investing doesn’t correlate with IQ once you are above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people in to trouble in investing”

Three Sources Of Alpha

Exploit
Information

Better
Model

Exploit
Behavior

Traditional
Managers

Quantitative Managers
(Procedures to
Process Information)

Behavioral Managers
(Mispriced securities
because of behavioral
factors)

A silver metal spiral binding is visible on the left side of the page, looping through a series of holes in the paper. The binding is positioned vertically, extending from the top to the bottom of the page.

Thank You

You are prone to Mental Accounting if You.....

- 1. Don't think you are a reckless spender but unable to save enough
- 2. Have savings in your bank but revolving balances on your credit cards
- 3. Are more likely to splurge with a tax refund than with savings.
- 4. Tend to spend more when you use credit cards
- 5. Put retirement savings in fixed income or other conservative investments.

Plan of Action

- Imagine a world without Plastics
- Needles in Haystack
- Be Patient
- Imagine all income is earned income