

Influence of Traditional and Behavioural factors on equity investment decision and its impact on investment performance and satisfaction

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Received: 11.03.2020 Revised: 12.04.2020 Accepted: 28.05.2020

ABSTRACT: Efficient Market Hypothesis propounds that, the stock market is populated by many well-informed investors, stocks are appropriately priced and reflects all available information. According to Traditional Finance Theory, investment decision is done by identifying, analysing and finding out the risk-return of the scrip. In the history of Indian stock market there exists anomalies over various time period. Behavioural Finance Theory ensures that investors use some mental short cuts for making their investment decision. Hence there exists a prerequisite to study the underlying factors which influence the equity investment decision. The present study focussed on framing a conceptual framework on factors influence equity investment decision of retail investors. Investment decision, investment performance and investment satisfaction factors are considered as dependent variables in framing the conceptual model. This conceptual framework is expected to exhibit the influence of various dimensions in investment decision making, investment performance and investment satisfaction.

KEYWORDS: Traditional, Behavioural Finance Factors, Anomalies, Equity Investment Decision, Investment Performance and Investment Satisfaction

I. INTRODUCTION

“People in standard finance are rational. People in behavioural finance are normal.”Meir Stateman, Santa Clara University

Investment is the commitment of present funds in anticipation of receiving larger inflow of funds in future, the difference being the income. An investor hopes to be compensated for (i) foregoing present consumption, (ii) for the effects of inflation, and (iii) for taking a risk (Reilly and Brown, 2006). According to Khatri's (2011) investment means sacrificing some money value in the present with the expectation of making gains in the future.

The challenging activity of an investor is to take investment decision in a vibrant environment. Investors make their investment decision by identifying, analysing and finding out the risk-return of the stock and finally they invest. Investors analyse the company, industry and economic situations and also charts/graphs where they wish to invest in order to get return for their investments with admissible risks. Investors face difficulties in finding their equity investment choice out of ‘n’ number of securities listed on the stock exchanges.

According to Fama's (1965) Efficient Market Hypothesis, investors are rational; the stock market populated by many well-informed investors, stock value are appropriately priced and reflects all available information. In Indian stock market there exist certain anomalies such as January effect, value effect, size effect, post-earning announcement drift, etc. Investors also have emotional weaknesses and so use mental short cuts that lead to systematic errors for their investments.

Hence there exists a prerequisite to study the various factors influencing equity investment decision. There are many studies related to rational factors and few studies on irrational factors have been conducted in India but none of the studies were conducted by combing both the factors. To comprehend and give better justification for the investors' decisions, it is significant to survey which rational and irrational factors influencing the decisions of individual investors and how these factors impact their investment performance and ultimately on investment satisfaction.

II. REVIEW OF LITERATURE

Investor irrationality exist as long as the markets themselves have. During the 16th century, Tulip bulbs transported from Constantinople, introducing them to Holland. The first bubble and crash was happened during the year 1634-37. The amount the market declined from peak to bottom is difficult to calculate but it can be told that at the peak of the market, a person could trade a single tulip for an entire estate, and at the bottom, one tulip was the price of a common onion.

Abhishek (2020) reveals that in Indian history of stock crash in the year 1992, “Harshad Mehta Scam” 53%, 1996 “Asian Crisis” 40%, 2000 “Tech Bubble” 56%, 2008 “Real Estate – Lehman” crisis 61%, 2020 “COVID-19” 30% has plunged.

Fundamental analysis tries to find out the true value of securities so that the investors can decide on to buy, hold or not sell the securities at the current market prices, (Rustagi, 2007). Technical analysis is a method of evaluating securities by analysing statistics generated by market activity past prices and volume. It uses charts for patterns and other indicators to forecast the price behaviour. Investors who purchase shares in firms, their primary concern is “the amount they pay for the value of the shares and the analysis of information that focuses on valuation is called valuation analysis, fundamental analysis” (Penman, 2004).

Fama’s (1965) Investor’s make their investment decisions based on information which they get from various sources like friends, colleagues, television news, etc. The philosophical thinking behind technical analysis also known as charting or Chartism due to its focus on detecting trends and recurring patterns in share prices using stock charts, (Mayall, 2006) is different from that of fundamental analysis. Technical analysis provides investors a better understanding of the stocks and also provides right direction to go on further to trade the shares (Chitra, 2011).

In India the investment behaviour differs among the people of same society and same income level. The risk tolerance level also varies between different age group and gender (Kabra et al., 2010). Jing-Long (2007) revealed that most of the investors ignore objective data, and are influenced by news from mass media; they buy stocks when prices are high, and sell stocks when price decreases.

Investors behave normally and they commit lot of investment mistakes. Researchers distinguished the mistakes (biases) into two i.e., Cognitive and Emotional bias. The biases (Tversky and Kahneman (1974)) taken up for the study under Heuristics Behavioural Biases are of cognitive bias which includes overconfidence, availability, anchoring, gamblers fallacy and representativeness biases.

People are neither perfectly rational nor perfectly irrational; they possess diverse combinations of rational and irrational characteristics, and benefit from different degrees of enlightenment with respect to different issues (Pompian, 2006). Investment in stock market requires lot of knowledge about fundamental and/or technical analysis.

“Behavioral finance is the study of how psychology affects financial decision making and financial markets” Shefrin (2001). “Behavioural finance is a rapidly growing area that deals with the influence of psychology on the behavior of the financial practitioners” – Shefrin (2000).

Investment behavior is defined as how the investors judge, predict, analyze and review the procedures for decision making, which includes investment psychology, information gathering, defining and understanding, research and analysis. The whole process is “Investment Behavior” (Slovic, 1972; Oliver and Vicente, 2010).

Overconfidence can be summarised as unwarranted faith in one’s intuitive reasoning, judgements, and cognitive abilities (Pompian, 2006). The concept of overconfidence derives from a large body of cognitive psychological experiments and surveys in which subjects overestimate both their own predictive abilities and the precision of the information they have been given.

Representativeness is a cognitive bias, which is usually employed when people are asked to judge the probability for classifying objects or thoughts (Pompian, 2006). When people confront a new phenomenon that is conflicting with any of their pre-constructed classification, investors select a prediction value and match extreme of that prediction value with the extreme of predictive information for making an investment decision (Waweru et. al., 2008).

Phung’s (2008) says that when people are required to estimate a value of an unknown magnitude, people generally begin by conceptualizing some initial default number – an ‘anchor’ – which they then adjust up or down to reflect subsequent information and analysis (Pompian, 2006). The Availability bias is a mental shortcut that allows people to estimate the probability of an outcome based on how prevalent or familiar that outcome appears in their

lives. People exhibiting this bias perceive easily the recalled possibilities as being more likely than those prospects that are harder to imagine or difficult to comprehend.

“Crying over spilt milk” illustrates ‘loss aversion’ or the tendency to dislike loss more than gain. ‘Loss aversion bias’ developed by Kahneman and Tversky (1979) reveals that people feel a stronger impulse to avoid losses than to acquire gains. They are the pioneers within prospect theory and they studied how people reacted to a prospect of a loss. Loss aversion is the S-shaped utility representative value functions (asymmetric) that weigh all potential gains and losses in relation to some reference point (origin). The risk-seeking behaviour prevails below the reference point and risk-averse behaviour prevails above the reference point.

Regret aversion is a cognitive phenomenon that often arises in investors, causing them to hold onto losing positions too long in order to avoid admitting error and realising losses (Pompian, 2006). Mental accounting causes investors to take irrational step of treating various sums of money differently based on where these sums are mentally categorised the way that a certain sum has been obtained from work, inheritance, gambling, bonus, etc., or the nature of the money’s intended use such as leisure, necessities, etc.

The two-decade old theory of Behavioural Finance says that the investors are irrational and make mistakes in investment decisions. The investment decisions of investors are influenced by various behavioural biases like, Cognitive and Emotional and also the various demographic factors like, age, education, income, experience, marital status, etc., and societal factors like family status, friends, peers, etc.

Behavioural finance theory contradicting the traditional theory says investors make their investment decision based on applying some short cuts (heuristics), they make decision with lot of regret emotions and they do not consider any fundamental and technical analysis. Simon (1955) stated that decision-making process involves three stages: the intelligence stage - problem identification and data collection, the design stage - identification and planning of alternative solutions and the choice stage - selection of a solution from multiple alternatives.

From the literature study, it is revealed that many researchers have done either rational factors or irrational factors separately and also none of them taken investment decision, investment performance and investment satisfaction factors as dependent variables.

III. RESEARCH METHODOLOGY

Descriptive research design was conducted based on survey method. Accounting factor, Company factor, External factor, Industry factor, Technical factor, Advocate factor, Risk factor and Individual factor are considered Rational factors. Heuristics driven bias and prospect theory are considered Irrational factors. Survey consists of well-structured questionnaire collected from 465 respondents.

Rational factors and Irrational factors are undertaken as independent variables and Investment Decision, Investment Performance and Investment Satisfaction are taken as dependent variables. The proposed model with these factors which influence equity investment decision is depicted in Figure 3.1:

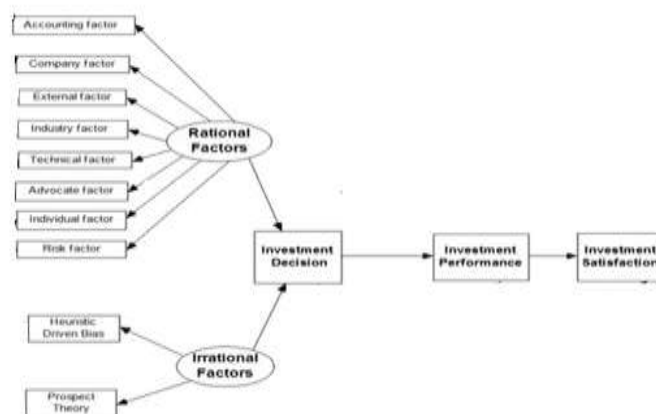


Figure 3.1 Proposed Conceptual Model

Hypothesis framed for the study is “The Model fit for impact of Investment decision on Investment performance in Equity shares is good”. Statistical package used for the study AMOS 16.1

IV. VALIDITY CHECK OF CONCEPTUAL MODEL

In the model Accounting factor, Company factor, External factor, Industry factor, Technical factor, Advocate factor, Individual factor, Risk factor, Heuristic Driven Bias, Prospect Theory, Investment Decision, Investment Performance and Investment Satisfaction are taken as observed variable. e1, e2, e3, e4, e5, e6, e7, e8, e9, e10, e11, e12 and e13 are error terms (residuals) for observed variables. Rational factors and Irrational factors are taken as unobserved variables which is depicted in figure 4.1:

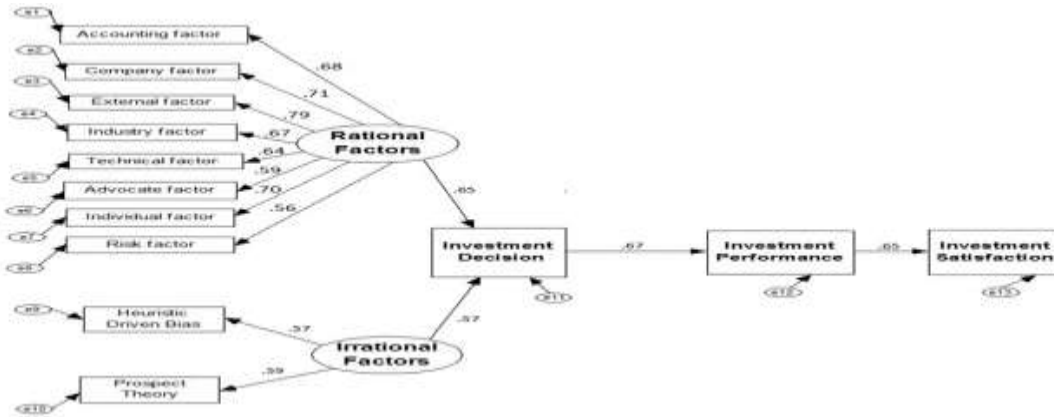


Figure 4.1 Model for impact of Investment Decision on Investment Performance

The model fit Chi-square $\chi^2 = 3.312$ and it is not significant at 5% level. This highlights that “The Model fitted for impact of Investment decision on Investment performance in Equity shares is good” is accepted. The goodness of fit index (GFI) is 0.913 of the model, shows reasonably good fit, and its adjusted goodness of fit (AGFI) is 0.901. The Root mean square error of approximation (RMSEA) is 0.096, a smaller value indicates better model, and Expected cross validation index (ECVI) is 0.101, which are within the acceptable range indicating a better model fit.

V. CONCLUSION

The present research work helps individual investors in associating stock investment behaviour for the investors to deal with and scrutinize the stock market trend before taking investment decisions. The proposed model is helpful for:

5.1 Investors

It will be helpful for the investors to know the important factor to consider and which bias affects them, which substantiate their reactions for better returns and that in turn will develop the prosperity of the economy. Given the fact that investors behave rationally before deciding to buy/hold/sell the stock but at the time of investment they behave irrationally, this research work may guide them in avoiding the behavioural mistakes at the time of investment. The result of the study may help the potential investors in understanding the factors and taking a wise decision on equity investment. Ultimately the number of potential investors will increase.

5.2 Financial Advisor/Planners

For the security agency firms, the research provides valuable reports about the influence of bias over the investors and accordingly they can guide their clients. Financial Advisors may also make use of this result for better understanding about their client investors to forecasting more accurately and give better recommendation. The financial planners can remember the various factors influencing at the time of creating new financial securities.

5.3 Academicians

For academicians, the research provides valuable insight in various factors influencing the equity investment decision and performance and also provides further scope of research on this area.

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