



GETTING SMARTER SERIES

Behavioural Biases in *Investing*

DSP

Behavioural Biases : Cognitive and Emotional

In general, behavioral biases come in two forms: faulty cognitive reasoning, known as **cognitive errors**, and those based on feelings or emotions, known as **emotional biases**.

A **Cognitive bias** is a systematic error in thinking that occurs when people are processing and interpreting information in the world around them and affects the decisions and judgments that they make.

Cognitive errors can be corrected to an extent as they stem from faulty reasoning rather than emotional predisposition.

E.g. Hearing only news that confirm your thoughts, blaming others when things go south etc.

An **Emotional bias** occurs based on personal beliefs that stem from deeply rooted personal experiences one has faced in life. These experiences influence decision making. It is harder to overcome emotional biases.

E.g. To sell a real-estate property inherited or your memory of childhood attached to it etc. makes it difficult to make objective decision.

When you are making judgments and decisions about the world around you, you like to think that you are objective, logical, and capable of taking in and evaluating all the information that is available to you. Unfortunately, these biases sometimes sneak in, leading to poor decisions and bad judgments

Cognitive Biases

Confirmation

(mai apni favourite hoon)

- tendency to look for and notice what confirms preconceived notion and to ignore or undervalue whatever contradicts them.
- **Poor diversification as there could be higher concentration of some 'favourite' funds or stocks**

Representativeness

(Humare zamane me aisa hota tha)

- tendency to classify new information based on past experiences and classifications.
- **In appropriate asset allocation. 'Blue-chip' company will always give positive returns.**

Illusion of control

(Apun ich Bhagvan hai)

- people tend to believe that they can control or influence outcomes when, in fact, they cannot
- **Over trading as one feel they will go right.**

Hindsight

(Mujhe pehle se pata tha)

- believing past events as having been predictable and reasonable to expect.

Cognitive Biases

Mental accounting

- refers to mentally dividing money into “accounts” that influence decisions, even though money is fungible.
- **Poor Diversification**

Availability

(jo dikhta hai vo bikta hai)

- is an information-processing bias in which people estimate the probability of an outcome based on how easily information is recalled
- **In appropriate asset allocation**

Recency

- favors recent events over historic one.
- **High turnover as chase for the ‘recent’ best continues**

Emotional Biases

Over-confidence

(Mujhe sab aata hai)

- people demonstrate unwarranted faith in their own abilities.
- **Under diversified, higher number of trades with sub-optimal returns**

Status Quo

(sab moh maaya hai)

- people choose to do nothing (i.e. maintain the “status quo”) instead of making a change, even when change is warranted due to inertia rather than a conscious choice.

Regret aversion

(humse naa ho paai)

- people tend to avoid making decisions out of fear that the decision will turn out poorly.
- **Low risk products even if one has higher risk appetite.**

Overreaction

(Bhaagooo)

- emotional response to news about a security that is generally led either by greed or fear and pushes the price artificially high or low. Thus, the price does not reflect its fair value.

Emotional Biases

Loss aversion

- tendency to strongly prefer avoiding losses to achieving gains.
- **Sell winners, retain losers**

Endowment

(dil hai ke maanta nai)

- people value an asset more when they own it than when they do not so you wait for a higher price than fair value.
- **Inappropriate asset allocation**

Self-control

(Ae dil hai mushkil)

- people fail to act in pursuit of their long-term goals in favor of short-term satisfaction.
- **Borrow excessively, save insufficiently**

Herd Mentality

(sharmaji ka beta)

- tendency for people's behavior or beliefs to conform to those of the group to which they belong mainly arising from FOMO (Fear Of Missing Out)
- **Inappropriate asset allocation**

Product Development and Narratives

Products that address a few biases

Mutual Funds v/s Direct Equity

- Overconfidence (Over trading)
- Hindsight(Talking about winners more than losers)
- Illusion of control

Balanced Funds

- Mental Accounting
- Status Quo

Passives

- Regret Aversion
- Status Quo

Real Estate/Gold

- Endowment

Narratives that highlight a few biases

FAANG stocks

- Recency
- Representativeness

Increasing Demat accounts

- Herding (FOMO)
- Availability

Cryptocurrencies

- Herding (FOMO)
- Recency
- Availability (influencers, marketing)

Collapse of Dollar

- Framing
- Confirmation

So what should an Investor do?



Recognize and Acknowledge

- Self-Educate about biases
- List your investment objectives



Mitigate

- Risk Profiling
- Asset allocation
- Periodic Review and rebalance



Seek Professional help

- Registered Financial Advisors and Planners

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MUTUAL FUND

#INVESTFORGOOD



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