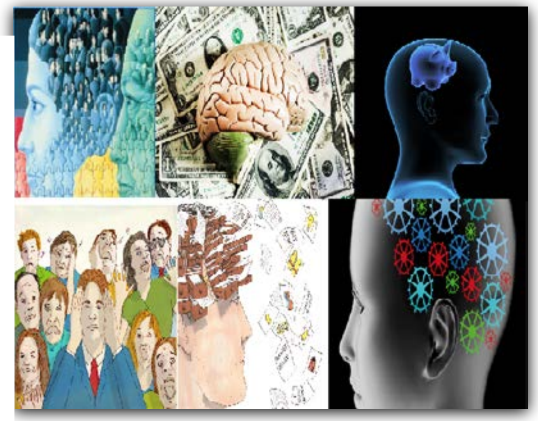
Understanding Behavioural Biases in Finance & Investing

Recognizing and Managing Biases in Investment Decision Making



Balaji Ganesan (Tribesman, Safal Niveshak)
www.safalniveshak.com

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Introduction to Behavioural Finance

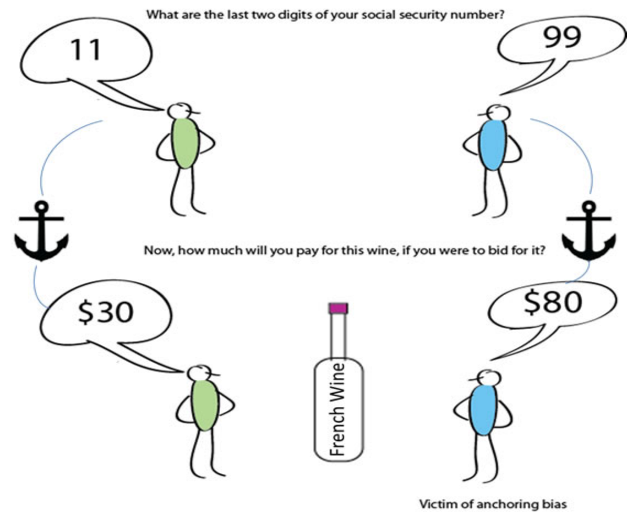
Behavioural Economics and Behavioural Finance are deep and vast knowledge areas that combine psychology with economics and finance and attempt to get into human brain to study in greater detail on how we make decisions in a given situation. Given below are few links that points to the definitions related to these subjects.

Behavioural economics and the related field, Behavioural finance, study the effects of social, cognitive, and emotional factors on the economic decisions of individuals and institutions and the consequences for market prices, returns, and the resource allocation. The fields are primarily concerned with the bounds of rationality of economic agents. Behavioural models typically integrate insights from psychology with neo-classical economic theory; in so doing, these Behavioural models cover a range of concepts, methods, and fields.

The study of Behavioural economics includes how market decisions are made and the mechanisms that drive public choice, such as biases towards promoting self-interest.

http://en.wikipedia.org/wiki/Behavioral_economics

Anchoring Bias – Focusing Too Much on One Piece of Information



Anchoring or focalism is a cognitive bias that describes the common human tendency to rely too heavily on the first piece of information offered (the "anchor") when making decisions. During decision making, anchoring occurs when individuals use an initial piece of information to make subsequent judgments. Once an anchor is set, other judgments are made by adjusting away from that anchor, and there is a bias toward interpreting other information around the anchor.

For example, the initial price offered for a used car sets the standard for the rest of the negotiations, so that prices lower than the initial price seem more reasonable even if they are still higher than what the car is really worth.

http://en.wikipedia.org/wiki/Anchoring

Examples of Anchoring Bias

1. An investor will have an attraction towards a stock which has fallen considerably from their previous or all time highs – say even from a 52 week high. The investor is anchoring on the high prices that the stock had reached and now believes this provides an investment opportunity. If the fall is due to overall market

sentiment and not due to any deterioration in business fundamentals then the investor has made a right decision. But, if it is otherwise the investor will stand to lose a substantial amount of capital soon.

2. Few times investors also would anchor to a price only below which they will buy. By this, they may miss the opportunity to invest. For instance, someone may want to buy stock X at Rs 500 or below but the price moved to Rs 550 and hence wanted to wait to come down to their anchored price (Rs 500). But, the stock further moved up to 600 and then 700. The investor would never buy that stock and in next few years it would have reached 1000 or even more. Here, clearly the investor has missed the opportunity. He should have only checked the fundamentals and margin of safety and if the price was right even at 700, should have bought it.

3. Similarly, investors will hold on to a price for selling. They want to sell a stock only if it reaches a certain price or a target (all time high etc.).

   For example, an investor has bought a stock at Rs.500 (which has fallen from its all-time high of Rs.1000). He may anchor his price at Rs.1000 to sell the stock. Even if the price reaches 800, the investor will not check the fundamentals and compare to the current price and decide to sell. He may just hold on to it to reach Rs.1000. But, the stock may fall to 500 and 400 and 300, but he may not sell and instead may accumulate more to sell at Rs.1000, the price which the stock may never reach in a decade too.

How to overcome Anchoring Bias

1. Just understand that these types of biases exist and evaluate if you are caught in this bias

2. Just be patient and check once if you are making an emotional decision or a data driven decision
3. Discuss with trusted resources, even to be specific 'devil's advocates' to take a critical thinking view
4. Check only the underlying fundamentals and if it is a great business, go ahead and buy, even if you have a reasonably fair enough margin of safety. Because, great businesses very rarely trade at mouth-watering valuations. Moreover, they will always trade at higher valuations, because of its future prospects derived from its moat and durable competitive advantages. This is also reiterated by Mr.SanjayBakshi in his recent interview to a magazine.
   http://business.outlookindia.com/article_v3.aspx?artid=285698

My experience with Anchoring Bias

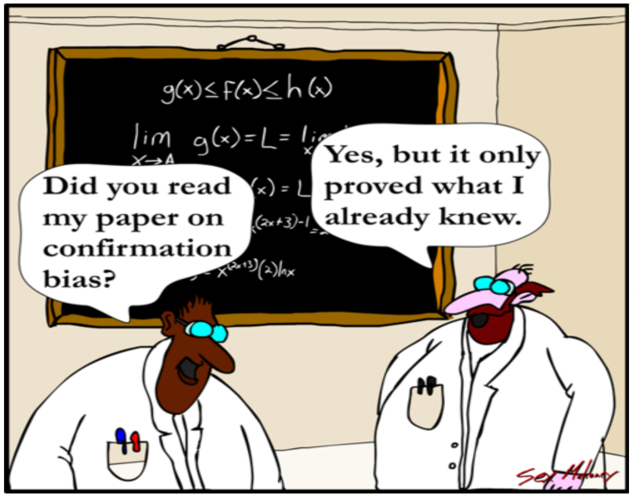
During the 2008 – 09 financial crisis, most businesses were knocked down to rock bottom prices. Among them were several jems with strong fundamentals, which were also pulled down due to market sentiments and fund outflows. Few of them were Asian paints, HUL, Nestle, HDFC Bank etc. At that time, I was always anchored to a certain PE and PB Ratio – I will hesitate to buy stocks that were trading above 18 PE and 2 PB ratios, assuming those would not provide not enough margin of safety.

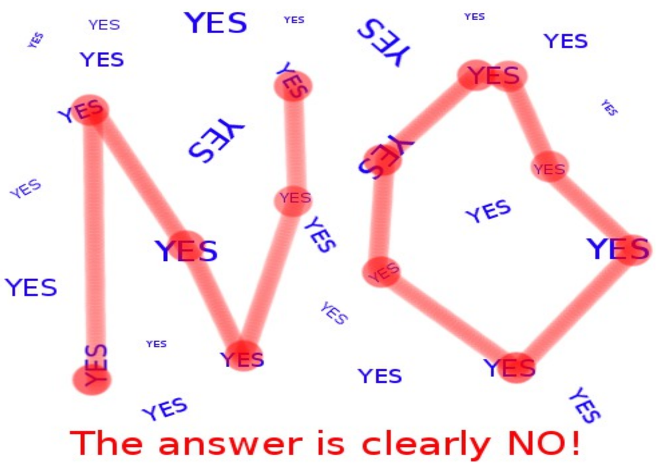
Hence, I missed several opportunities to buy into great businesses which, even though were beaten down, but, did not come below my anchored PE and PB ratios. One example was Nestle, which closed at 1400+ in early Jan 2009. When I checked the PE it was trading at around 21+ and double digits of PB ratio. Hence, I did not but that business and hence lost a great opportunity. Today, as of writing this post, Nestle is trading at 5000.

Confirmation Bias – In Search of Supporting-Only Information

Confirmation bias (also called confirmatory bias) is a tendency of people to favor information that confirms their preexisting beliefs or hypotheses. People display this bias when they gather or remember information selectively, or when they interpret it in a biased way. The effect is stronger for emotionally charged issues and for deeply entrenched beliefs. They also tend to interpret ambiguous evidence as supporting their existing position. Biased search, interpretation and memory have been invoked to explain attitude polarization (when a disagreement becomes more extreme even though the different parties are exposed to the same evidence), belief perseverance (when beliefs persist after the evidence for them is shown to be false), the irrational primacy effect (a greater reliance on information encountered early in a series) and illusory correlation (when people falsely perceive an association between two events or situations).

http://en.wikipedia.org/wiki/Confirmation_bias





Examples of Confirmation Bias

1. For example, an investor may get a news or information about a stock and its potential to move up in the short term. From then on he will be looking for information to prove this point of view, and he may unconsciously or wilfully ignore any news or information against this. Hence, he will collect more such positive supporting information and then even go ahead and invest in that stock.
2. For example, an investor who might have bought a stock which had fallen heavily and sitting on huge losses will also look for positive news and information about the company, just to support his decision to hold on to the investment to sell at a profit in the future. Eventually, the stock may not go up at all and still the investor will search for some good news somewhere to support his decision to hold the stock.

How to overcome Confirmation Bias?

1. Always understand that there cannot be single source of truth in investing
2. Only sound fundamental analysis and critical and contradictory thinking will provide you with proper data to make proper decisions
3. Understand you cannot always win the markets
4. Understand your risk taking ability and have proper margin for loss in case it occurs
5. Intentionally look for contradicting information and analyse them
6. Always have margin of safety in your investments and have stop loss in your trades

My Experience with Confirmation Bias

I entered Opto Circuits when it was trading at Rs.150. Then the stock fell down and upon analysis I came to know that their aggressive inorganic growth has stressed their balance sheet with debt. By this time stock was trading at Rs.100, and I bought again. I was of the understanding that the company made superior products in medical space and read reports that once the economic situation improves and interest rates come down, it will be good for the company. In the meantime, I was buying at every fall. By this time the stock was trading at Rs.49, and I bought again. Now, I have the average investment at Rs.76 and sitting on 69% loss. All through this, I was looking for good news about the company and I was also getting them and using them as a support for me buying into the stock at every fall.

You know what, I am still sitting on the hope that the company's fortunes will revive in future and will get my anchored price of at least Rs.150 (anchoring bias).

Overconfidence Bias – Better than Others Syndrome

The overconfidence effect is a well-established bias in which someone's subjective *confidence* in their judgments is reliably greater than their objective *accuracy*, especially when confidence is relatively high. For example, in some quizzes, people rate their answers as "99% certain" but are wrong 40% of the time. Overconfidence has been called the most "pervasive and potentially catastrophic" of all the cognitive biases to which human beings fall victim. It has been blamed for lawsuits, strikes, wars, and stock market bubbles and crashes.

http://en.wikipedia.org/wiki/Overconfidence_effect

Examples of Overconfidence Bias

1. In investing, Overconfidence investors and traders tend to believe they are better than everyone else in choosing best stocks and funds etc., and even better times to enter and exit a position.
2. People take excessive degree of confidence in one's ability in making decisions. That is under belief that we are better and wiser than others in choosing investments than we actually are. This often leads to swifter decisions that the investor later regret. This bias usually happens when an investor tastes a few easy successful investments. They don't realise that they were just lucky those few times. Instead, they start believing themselves and think they have the capacity better than others in selecting winning investments.

How to overcome Overconfidence Bias

1. Check if you are driven by a few bets which have rewarded handsomely and whether you have done proper analysis of the business before investing in them
2. Sticking to strict risk management rules
3. Check if you are trading frequently
4. Are ready to take blame on your part of wrong investing decisions
5. Are you self-aware of your investment bet skills and limitations

My experience with Overconfidence Bias

During the stock market boom of 2005-07, I was investing in companies of Capital goods, Infra and Power sector, and fortunately those stocks were rallying sky high. I invested in companies like Reliance Energy, L&T, BHEL, BEML, Tata Power to name a few. I was really confident that I was having enough skills and expertise in picking stocks, because, whatever I picked up went up almost daily. I was also entering into few hot IPOs.

Then when the tide turned in Jan 2008, my portfolio suffered. I realised that the financial meltdown in 2008 was going to be severe and sold off my entire portfolio at a loss – I was fortunate to sell at a smaller loss as I exited early.

Mental Accounting – What Money? From Where?

A concept first named by Richard Thaler (1980), means that people mentally frame assets as belonging to either current income, current wealth or future income and this has implications for their behavior as the accounts are largely non-fungible and marginal propensity to consume out of each account is different. http://en.wikipedia.org/wiki/Mental_accounting

Examples of Mental Accounting

1. Assume you have bought a movie ticket for Rs.100. When you reach the theatre, you realise that you have lost the ticket. Would you buy another?
2. Assume that you want to watch a movie and go to a theatre and when you go to the ticket counter to buy a ticket, you realize that you have lost Rs.100 in cash. But, you still have money to buy a ticket. Research says that most people will not buy a ticket in scenario 1 and willing to buy a ticket in scenario 2. Both scenarios are same and incurred a loss of Rs.100. However, in the second scenario you feel you haven't bought a ticket and have not yet spent the money for the movie. But, in the first case you have already spent the money for the movie, and hence not willing to buy another ticket.
3. Assume you go shopping and you find reading lamps in various sizes were on sale. Usually, the price differs as per the size of the table lamp set. But, in this sale all lamps sets are on sale for the same price. Which one would you choose? Most people would choose the larger ones, even though they may have a very small size reading table at home. Because, our mind perceives a 'larger' savings in buying a larger piece.
4. Assume you want to buy a cellphone and a laptop and you are shopping. You find the cellphone priced at Rs.5000 and a laptop priced at Rs.50000. The salesman tells you that if you drive down a few miles they have their factory outlet where the prices are Rs.1000 lesser on all products. Will you make a trip to the factory outlet. Most people would make the trip for the cellphone and may not for the laptop as Rs.1000 saving on Rs.5000 item seems larger than on Rs.50000 item, even though both Rs.1000 are same in savings.

5. Similarly, people tend to spend Rs.1000 tax refund on a dinner, and consider Rs.25000 tax refund as a huge amount worth saving, even though the source is the same and it's our money.

How to overcome Mental Accounting

1. Avoid dividing money into different mental accounts
2. Understand that all income is hard earned income
3. For every purchase, as yourself if you will be giving cash down right to buy it
4. Recordkeeping of all incomes and expenditures and check them regularly
5. Do not receive anything in cash. Get them directly credited to your savings account.

My experience with Mental Accounting

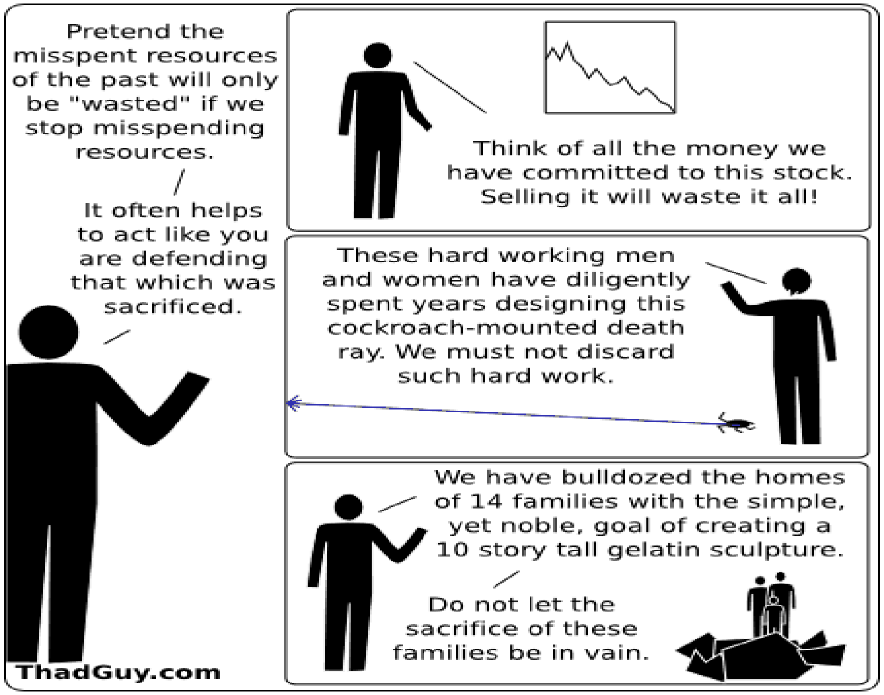
During my early days of investing, I used to get dividends and interests on deposits credited to my account, and usually ended up spending them on dinner or some gadget purchases.

Later, I have practiced to save the dividends and once they reach a decent amount, I will reinvest in the markets. Similarly, I have opted to get all my deposits in auto renewal mode – that is, once deposits are matured, both the principal and interest put together is reinvested again in a deposit.

Sunk Cost Fallacy – The Sunken Feeling

In economics and business decision-making, a sunk cost is a retrospective (past) cost that has already been incurred and cannot be recovered. Sunk costs are sometimes contrasted with prospective costs, which are future costs that may be incurred or changed if an action is taken.

http://en.wikipedia.org/wiki/Sunk_costs



Examples of Sunk Cost Fallacy

1. How many of us have kept on spending money on fixing washing machines and other electrical / electronic goods when they have problems. Most of us would have gone through this, even though the new equipment would have cost closer to same repair or annual maintenance charges, or even less? Same could be with 'my first car' sentiment, and keep on spending money on its repairs.
2. A Term plan is the great insurance for life cover, but, many of us have bought endowment and money back policies, which pay meagre 5% returns, but charge huge premiums. We also continue to pay premiums for these, just because we have paid few premiums already. They can consider surrendering the policy after 3 years or convert them to 'paid up' policies.
3. In a casino, we could have seen a lot of people playing again and again to win somehow to recover the cost or amount that they have already spent and sunk. They think that if they don't win the prize, the money spent already in the game will have been wasted.
4. A company might have invested a million dollars in building a factory unit. Halfway through they realise the market for their product is in a decline phase and hence in a dilemma of whether to continue with the factory or not. Maybe, they should consider a million dollars as a sunk cost and walk away from the project, instead of spending few more millions in building a factory to produce a product that market is no more excited about.

How to overcome Sunk Cost Fallacy

1. Admit mistakes, cut losses earlier, and exit.
2. Check for opportunity costs – cost of missing some better investments, just by keeping the money sunk in some bad investments
3. Above all, try to be as rational as possible, plan ahead, check pros and cons, analyse and evaluate before investing the money

My experience with Sunk Cost Fallacy

1. In 2008, some of the stocks in my portfolio were incurring losses. Almost on a daily basis, their prices were going down, I tried averaging some of them by purchasing more when they fell certain percentage points. But, after sometime, I realised that this fall is not going to end soon, and then took a hard decision and sold off my portfolio at a net loss of several thousands of rupees.
2. In recent times, an example is my investments in Opto Circuits. I started investing at Rs.145, and consistently bought the stock during every fall, and averaged my purchase price at around 76.58. I am still holding the stock – as I am not willing to sell at a loss of 69%.

Status-Quo Bias – Known Devil is Better than Unknown Angel

Status quo bias is a cognitive bias; a preference for the current state of affairs. The current baseline (or status quo) is taken as a reference point, and any change from that baseline is perceived as a loss. Status quo bias should be distinguished from a rational preference for the status quo ante, as when the current state of affairs is objectively superior to the available alternatives, or when imperfect information is a significant problem. A large body of evidence, however, shows that status quo bias frequently affects human decision-making.
http://en.wikipedia.org/wiki/Status_quo_bias

Examples of Status-Quo Bias

1. Keeping their deposits in their regular bank, even if they find better alternatives in other banks
2. Having higher risk taking capacity and alternatives, investing only in Gold, FDs, and Govt Bonds etc.,
3. Companies may not want to change their packaging, model, cover, advertisements etc.,
4. Taking the same driving route, Grocery from same old store, Coffee from same coffee shop etc.,
5. Employees may not want to take and try a different role or domain etc.,
6. Using the same brand and product regularly for years – for ex., soaps, toothpaste, washing powder etc.,
7. Keeping same services – for ex., cable network, internet and phone services, utility services etc.,
8. People may even reject an opportunity of a promotion when it comes with relocation

Overcoming Status-Quo Bias

1. Professor Luce points out that there are actually three status quo alternatives in most choice situations: 1) "make do" with what you have, 2) continue to search, and 3) select the dominant alternative. The key for us is in that third choice.
2. Voluntarily try something new. Start with simple things like changing the driving route to office, trying coffee from another outlet etc., If it doesn't work, you can always go back
3. Procrastination could help. When asked to make an immediate decision, 80% of the time people make the default choice – that is, no change. Given some time to think and decide, approximately 50% of the people chose no change.

4. Objectively analyse each situation, keeping emotions apart. Collect pros and cons and data points and analyse and then make a decision

My Experience with Status-Quo Bias

I took a home loan from a bank initially, and when interest rates moved up, I was still sticking with the same institution because I was for some reason not comfortable moving my home loan to other banks even though they offered loans at lesser interest rates. By this time, the interest rate difference between my home loan and the few other banks were more than 2%. Then, I decided to work out the cost of switching and savings on EMIs etc., and switched the loan.

Availability Bias – Driven by Recent Memories

The availability heuristic is a mental shortcut that occurs when people make judgments about the probability of events by how easy it is to think of examples. The availability heuristic operates on the notion that if something can be recalled, it must be important. The availability of consequences associated with an action is positively related to perceptions of the magnitude of the consequences of that action. In other words, the easier it is to recall the consequences of something, the greater we perceive these consequences to be.
http://en.wikipedia.org/wiki/Availability_heuristic

Examples of Availability Bias

1. If you have noticed a car accident recently, you will be driving more cautiously for next few weeks or months, after some time passes, however, your driving would be back to normal
2. Availability bias causes investors to over-react to market conditions whether they are positive or negative.
3. People buy lottery tickets because the recent wins are heavily advertised. So people think they also have a chance to win, than they really are
4. A doctor who has recently came across a new type of virus in patients for the past few days, would more likely look for the same symptoms in the next patient.
5. A smoker may continue to smoke without much of fear, because, he may have recently seen a news clipping where a smoker is living past 100 years.
6. Investors may buy mutual funds and ULIPs and other Insurance products that are heavily advertised, rather than doing their own analysis
7. Investors may decide not to invest in European companies as they are going through debt crisis in Greece and few other countries.

Overcoming Availability Bias

1. Do your own analysis and research before making any investment decisions.
2. Slow down your listening to media and news information. Do not give more importance to them.
3. Ask yourself if you are taking decisions emotionally.

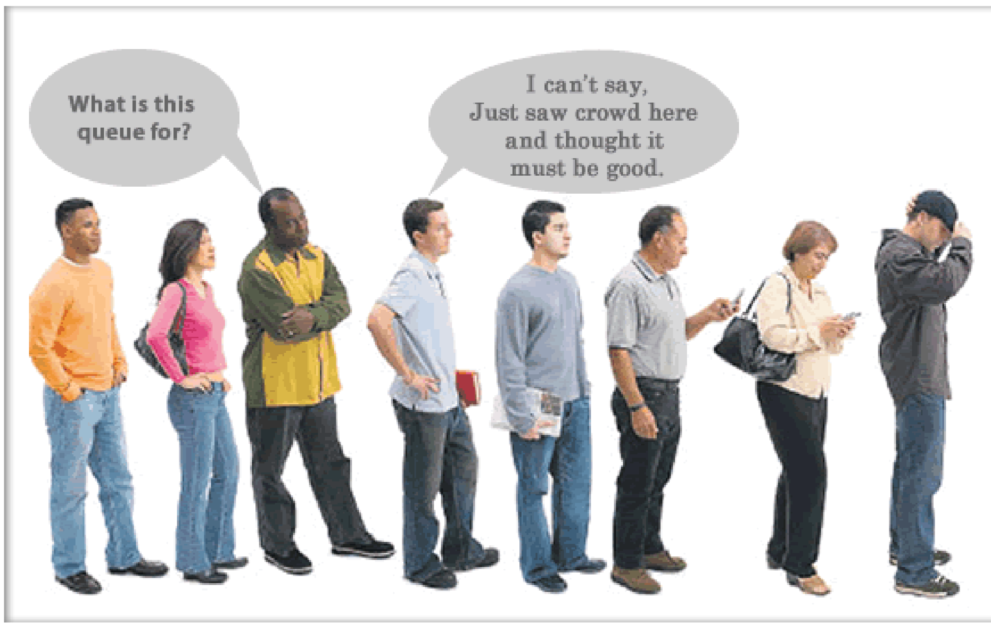
My experience with Availability Bias

1. During the 2007 bull market phase, I was attracted a lot by news and information flow about the Infrastructure sector and related IPOs and invested in them. The IPOs fell from their listing price and lost value over time. I had to sell them at a loss later and invested in better opportunities
2. Similarly, during 2007 there were a lot of mutual funds NFOs and influenced by my friends to buy a few of them. Fortunately, few performed better and I sold for a profit, and I had to sell the remaining at a loss.

Social Proof Bias – Everybody Else is Doing It

Social proof, also known as informational social influence, is a psychological phenomenon where people assume the actions of others in an attempt to reflect correct behavior for a given situation. This effect is prominent in ambiguous social situations where people are unable to determine the appropriate mode of behavior, and is driven by the assumption that surrounding people possess more knowledge about the situation. The effects of social influence can be seen in the tendency of large groups to conform to choices which may be either correct or mistaken, a phenomenon sometimes referred to as herd behavior.

http://en.wikipedia.org/wiki/Social_proof



Examples of Social Proof Bias

1. Investors in a crisis situation, for ex., during a bear market phase would like to follow the herd and make decisions accordingly. If many people are selling, they will also sell their holdings, even if booking losses.
2. Giving a Like status for a message in social media networks, just because, our friends have given a Like.
3. Checking online for reviews and deciding on the restaurant which has got the most positive reviews.
4. Following the experts' advice or peers' decisions in investing.
5. Advertisements when claim they have served a million people, others may take their product or service.
6. Following our friends or relatives for a vacation spot.
7. Can you stick to your portfolio when everyone else claims the market is about to go in recession?

Overcoming Social proof bias

1. Filter the news and information and take only the ones that is necessary
2. Ignore the big hue and cry or joy and greed, and look at things objectively, keeping emotions aside.
3. Ask yourself if the decision you are about to make is only after proper analysis, or are you just following someone else

My experience with Social Proof Bias

During my early days of investing, I have made several investments in stocks just because my friends have made, fortunately few of them gave good returns, and most of them were loss making. Even during 2007-08, I have invested in an IPO, which most of my friends also subscribed.

Regret Aversion Bias – Oh, I Made A Mistake!

A theory that says people anticipate regret if they make a wrong choice, and take this anticipation into consideration when making decisions. Fear of regret can play a large role in dissuading or motivating someone to do something.

http://www.investopedia.com/terms/r/regrettheory.asp

Examples of Regret Aversion Bias

1. An investor may wait for a stock to break a price point to buy. But, the price may not move up, and hence he invests the money elsewhere. Few days later the price breaks the point and moves up by 20%. The investor is left in regret.
2. Investors do not sell their profitable positions due to the fear that they might forgo the upside potential.
3. Choosing fixed income products, just to avoid regret investing in the stock market and risking the investment.
4. Most investors usually regret not buying into the markets, during a recessionary period.
5. Investing in only large cap companies, and later regretting to see several mid and small caps giving multi bagger returns.
6. Selling the winners so soon, at a small profit, regretting the decision after seeing the sold stocks' prices soar several times.
7. You buy a stock just based on a recommendation from a friend, and it goes up and you make handsome gains. Then the next time, you tend to take any recommendation from your friend. Instead, if the price falls and you suffer losses, you tend to analyse any of your friends recommendation.

Overcoming Regret Aversion Bias

1. Proper budgeting, and financial planning, and goals
2. Understanding clearly your risk taking ability, followed by appropriate asset allocation.
3. Taking help with un-biased analysts, friends and financial planners.
4. Having a proper approach and strategy in investing – both buying and selling.

5. Do not think about results of past decisions while taking present decisions.

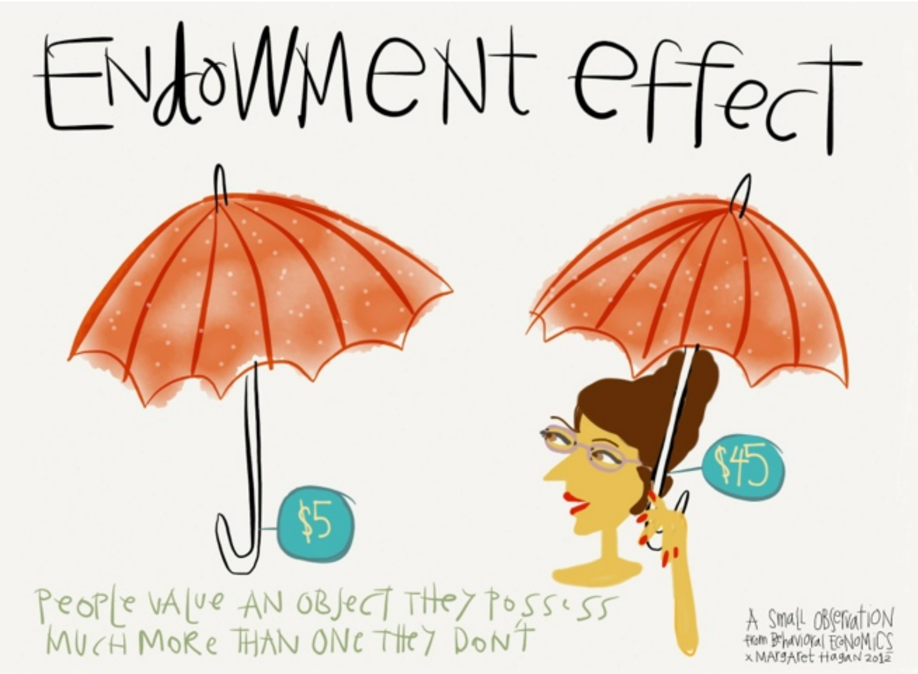
My Experience with Regret Aversion Bias

1. During my early days of investing, I used to invest heavily in ETFs, and Index funds, then I moved to large caps and then once I had some confidence in my analysis, I started investing in midcaps and small caps.
2. I invested in Axis Bank in 2009 for approx. Rs.631, and I sold it in early 2010 when it was around Rs.990. The stock all the way rallied up and crossed Rs.1400. Sure, I regretted the decision of selling to early.
3. I followed Nestle for a long time and wanted to buy. When it traded around 1400+ levels during 2008-09, a very attractive price with margin of safety. I wanted to wait for the stock to fall down further, but, it started moving up. I did not want to chase the upside and waited. But, it never came down and we all know where it is trading today. Of course, I regret even today for not buying in 2009.

Endowment Effect – Ownership Emotion

In Behavioural economics, the endowment effect (also known as divestiture aversion) is the hypothesis that a person's willingness to accept (WTA) compensation for a good is greater than their willingness to pay (WTP) for it once their property right to it has been established. People will pay more to retain something they own than to obtain something owned by someone else—even when there is no cause for attachment, or even if the item was only obtained minutes ago.

http://en.wikipedia.org/wiki/Endowment_effect



Examples of Endowment Effect

1. You might have bought a flat screen television for Rs.15000. But, unfortunately you found another superior model in the market in next few days at the same price, and hence willing to sell this TV. Fortunately, your friend is willing to buy it from you. What price will you quote? For sure, Rs.15000. Now assume you are in your friend's shoes and he is in your position. What price will you be willing to pay to buy the TV from your friend? For sure, less than Rs.15000
2. Once an investor buys a stock, he will be rating that stock at a higher value and unwilling to sell at a loss. They think their stocks are highly valuable
3. Most trial offers and money back guarantees are at work because once you have used the product for a few days and enjoy their benefits, you would like to keep it and not return back to the dealer.
4. How many products and things we stack at our lofts and wardrobes and unwilling to part away with it at a discounted price ask?
5. Would you be willing to sell your bicycle – 1 year old, for 30% discounted price, even if a newer bicycle of the same model sells at the same discounted price?
6. How many of you still have your old model mobile phones at home just because during the exchange offer your existing phone was asked for a steep discounted price?

Overcoming Endowment Effect

1. Try to evaluate anything as objectively as possible – keeping emotions apart
2. Check for opportunity cost during investing – cost of holding a bleeding stock VS a good opportunity to buy a good business at a bargain price

My experience with Endowment Effect

1. I have a few mobile phones at home which I did not want to tender for a meagre Rs.500 during an exchange offer
2. I was holding back my bicycle (bought for Rs.3000 approx) which was offered for Rs.1000, for a long time and then I had to sell recently for Rs.500
3. During my initial days of investing, I was holding dud stocks just because I have bought them at a higher price, and when markets provided opportunity with good businesses to buy, I did not have cash.

Choice Paralysis – Which One to Choose?

A decision can be treated as over-complicated, with too many detailed options, so that a choice is never made, rather than try something and change if a major problem arises. A person might be seeking the optimal or "perfect" solution upfront, and fear making any decision which could lead to erroneous results, when on the way to a better solution.

http://en.wikipedia.org/wiki/Analysis_paralysis

Examples of Choice Paralysis

1. Rise of Agile Development (iteratively develop, test and deploy the code) is coming more prevalent in Software Industry may be because of the longer cycles of traditional water-fall model development model (following a defined phases, sub-phases and steps and cycles to develop an entire system or phase, test and deploy as a whole).
2. At our office, we have lot of information like – several mails, phone calls, meetings, intranet, reports, in person, and casual talks have to be analysed before taking a decision.
3. How many of you have taken your kids to an ice-cream parlour, and how long did they took to choose?
4. How much time do we take to purchase a shirt or pant or shoes in a retail store?
5. Investing – information overload from media, internet etc., – tough to choose the best insurance policy or picking a good stock, or mutual fund.

Overcoming choice paralysis

1. The company should properly differentiate the list of choices, provide comparison charts between products, and as far as possible keep choices to the minimum so that customer is not confused and leaves without a transaction.
2. Talk to an expert on the field to understand the list of choices available, and get to know which ones are almost similar with very little differentiation, because most of the time those little differences do not matter for an end user.
3. Decide on a time by when you have to make a decision. The longer, more confusion to make a decision.
4. For any complicated problem, break them into smaller pieces, as it may help you make quicker decisions.

My experience with Choice Paralysis

1. I have a friend who keeps changing his cell phone model, at least twice a year. He always thinks the newer model on the market is better than the one he has. But, most of the time he does not use many features of the newer phone.
2. Earlier during my investing days, I used to do a lot of reading before pinning down on a Mutual fund or a stock, and later I would also add more to them as I find newer MFs or Stocks recommended by analysts. It took some time for me to get out of this clustering of information from the media.

Gambler's Fallacy – Betting on a Trend Reversal

The Gambler's fallacy, also known as the Monte Carlo fallacy (because its most famous example happened in a Monte Carlo Casino in 1913), and also referred to as the fallacy of the maturity of chances, is the belief that if deviations from expected behaviour are observed in repeated independent trials of some random process, future deviations in the opposite direction are then more likely.

http://en.wikipedia.org/wiki/Gambler%27s_fallacy

Examples of Gambler's Fallacy

1. In stock markets how many times have we heard, 'whatever goes up must come down', and vice versa. This may be true eventually, but for how long and when will the trend reverse?
2. In cricket, we have heard, he is long due for a 'back to form'
3. Investors see a pattern and begin to trade based on how they think that pattern will play out.
4. If someone rolls dice and continuously gets a 1, we feel the next roll will not be 1 – though there is still a probability for a 1
5. I have seen this stock falling for 'n' continuous trading day, and it cannot go beyond this – let me buy
6. Buying lottery for years, no gains, assuming that since there were continuous losses, we are due for a win

Overcoming Gambler's fallacy

1. Always have an investment and asset allocation plan and follow it
2. Remember that past continuous events are all independent and are not co-related and the probability of the same event is still possible
3. Before making a decision, just think if you are following just a trend, or making a rational decision

My Experience with Gambler's Fallacy

1. During my early days investing in stocks, I have bought index ETFs just because they have fallen enough and there are chances of revival.
2. I have also sold my positions after they have had a continuous run-up, just because I fear it is due for a fall.

Disposition Effect – Winners Get Out, Losers Stay Back

The disposition effect is an anomaly discovered in Behavioural finance. It relates to the tendency of investors to sell shares whose price has increased, while keeping assets that have dropped in value. Investors are less willing to recognize losses (which they would be forced to do if they sold assets which had fallen in value), but are more willing to recognize gains. This is irrational behaviour, as the future performance of equity is unrelated to its purchase price. If anything, investors should be more likely to sell "losers" in order to exploit tax reductions on capital gains.

http://en.wikipedia.org/wiki/Disposition_effect

" 'Buy low, sell high' is all I've figured out so far. Now go away."

Examples of Disposition Effect

1. Investors would like to sell the winners and hold onto the losers as they are entirely emotional driven. Basically, we feel better if we lock the gains and would not want to accept by selling the losers. They hold on to the losers at least until breakeven. This will result in holding assets that are losing in value.
2. I have seen people who hold on to a piece of real estate which is not moving up in value or making losses, but, instead when they need money, they will sell another piece of real estate which has moved up in value.
3. Rationally thinking they should sell the piece of real estate which is making losses, and invest them elsewhere to cover up the opportunity cost. Moreover, these can also provide us tax breaks like, adjusting losses against capital gains.

Overcoming Disposition Effect

1. Always look for opportunity cost and decide if we sell losing assets and invest in better ones
2. Always include tax related rules in your buying and selling decisions
3. Making rational decisions in all investments – reading a lot around behavioural finance and adjusting our behaviour while making investment decisions

My Experience with Disposition Effect

During the 2008-09 financial melt-down, I had invested in stocks and mutual funds. During the stock market collapse, my overall portfolio was in red, and few of the stocks and mutual funds were riding high. I was fearful of losing the gains recorded on the high riding assets, and booked profits in them. For the ones in red, I decided to hold on until they break even. Few of them broke even, few were languishing in red and few went further down. Finally, I decided to clean up the portfolio, sold off everything, and rebuilt from scratch.

I am sure I have missed some great opportunities to invest in during this time like Nestle, Asian Paints, etc., But, from the booked profits I managed to pick few other great businesses at bargain prices like Maruti etc.,

Cognitive Dissonance – I Believe in This, But I Did That

In psychology, cognitive dissonance is the discomfort experienced when simultaneously holding two or more conflicting cognitions: ideas, beliefs, values or emotional reactions. In a state of dissonance, people may sometimes feel "disequilibrium": frustration, hunger, dread, guilt, anger, embarrassment, anxiety, etc. A good example is "The Fox and the Grapes" by Aesop. When the fox fails to reach the grapes, he decides he does not want them after all. Rationalization (making excuses) is often involved in reducing anxiety about conflicting cognitions, according to cognitive dissonance theory.

Cognitive dissonance theory explains human behavior by positing that people have a bias to seek consonance between their expectations and reality. According to Festinger, people engage in a process he termed "dissonance reduction," which can be achieved in one of three ways: lowering the importance of one of the discordant factors, adding consonant elements, or changing one of the dissonant factors.
http://en.wikipedia.org/wiki/Cognitive_dissonance

Examples of Cognitive Dissonance

1. We believe we are good to all living beings, but, if we hit a pet or kill an insect, or even having a non-vegetarian food will cause dissonance
2. Knowing smoking and drinking are harmful but while liking to smoke or drink
3. Teaching our kids not to lie, but, we lie at times
4. Knowing stealing is wrong, taking off office supplies from workplace to home

5. Want to keep up made promises, but, could not complete them
6. An investor who claims or wants to be a long term buy and hold investor, but, trades too often on impulse
7. Talking about respecting traffic signals, and at times we cross them in red
8. Wanting to save more, but, could not control the urge of a fine dinner of few thousand rupees
9. When we buy a product and if it turns out to be bad, it conflicts with our purchasing abilities, and we console ourselves by trying to find good qualities of the product

Overcoming Cognitive Dissonance

1. Changing beliefs – that is bringing down the importance of conflicting beliefs
2. Changing the actions – Take actions that is in line with beliefs
3. Changing the perception of actions – if actions cannot be reversed

My Experience with Cognitive Dissonance

As a stock market investor, I have gone through during my early days when I used to read a lot about long term investing, buy-and-hold strategies, advice friends on the same lines, but, flip my investments quite often.

Similarity Heuristic – It's Same as That

The similarity heuristic is a lesser-known psychological heuristic pertaining to how people make judgments based on similarity. More specifically, the similarity heuristic is used to account for how people make judgments based on the similarity between current situations and other situations or prototypes of those situations.

At its most basic level, the similarity heuristic is an adaptive strategy. The goal of the similarity heuristic is maximizing productivity through favourable experience while not repeating unfavourable experiences. Decisions based on how favourable or unfavourable the present seems are based on how similar the past was to the current situation.

http://en.wikipedia.org/wiki/Similarity_heuristic

Examples of Similarity Heuristic

1. When purchasing a book, we will be influenced by our recent experience from reading a book and may look for to buy a book of the same author or story line
2. Investing or avoiding to invest, in companies of similar business because in the past we have experienced either a profit or loss of a company that operates in similar business
3. Investments made in technology stocks during the dotcom boom, and once made some profits, people went ahead and invested a lot in newer dotcom companies, as all those were similar and people expected similar returns as they got in the past.
4. Picking a restaurant of same cuisine based on our past experience of the same cuisine in some other restaurant

Overcoming Similarity Heuristic

1. Check if this heuristic is going to help solve your problem and make decision making easier. If yes, then go ahead – nothing wrong with this heuristic in this situation
2. Cross check with past facts and figures to make sure it would help in current situation. Only then plan to use those facts and figures in decision making in present situation

My Experience with Similarity Heuristic

During 2005-08, I made some investments in infrastructure stocks and during its initial run-up, I sold and made some profits. So, I thought of all infrastructure stocks are similar and again I invested in infrastructure stocks and MFs. Few of them did well, and many of them did not.

Self-Serving Bias – Don't Confuse Brains with Bull Markets

A self-serving bias, sometimes called a self-serving attributional bias, refers to individuals attributing their successes to internal or personal factors but attributing their failures to external or situational factors. This bias is a mechanism for individuals to protect or enhance their own self-esteem. Studies have shown that similar attributions are made in various situations, such as the workplace, interpersonal relationships, sports, and consumer decisions.

http://en.wikipedia.org/wiki/Self-serving_bias

Examples of Self-Serving Attributional Bias

1. A student may credit himself for better grades, and blame his health, or his classmate or even the teachers or school facilities for not getting better grades
2. We might have heard and read about sports coaches' interviews in the media as to how high their esteem were when their team has won a series of championships, and when they start losing the same coach would attribute failures to other factors. Rarely, few coaches attribute their team failures for themselves.
3. Investors who have made some money in a bull market usually think they are good at stock picking, and even provide tips to their friends. This leads to another bias – the overconfidence bias
4. Most of the Mutual Fund and Portfolio management Scheme managers get caught by this bias and they attribute the performance of their funds to their knowledge and skills during the bull market – but, when compared to benchmark or other schemes, their funds might have not performed better
5. CEO Interviews in the media when they have a series of good quarter – especially when the macro economic conditions are in their favour.

Overcoming Self-Serving Attributional Bias

1. Rational thinking and self-analysis during each success and failure
2. Accepting mistakes and willingness to learn from them
3. Treat both wins and losses objectively and analyse and record them to check again at a later date
4. When in doubt, discuss with a good friend, or guide who will provide you unbiased opinion on your successes and failures

My experience with Self-serving Attributional Bias

Like most investors, during 2006-07, I invested in infrastructure sector and the stocks in this and related sectors were moving up almost on a daily basis. I was extremely happy about my stock picking skills and even suggested some mutual funds and stocks to my friends. When tides turned starting Jan 2008, my portfolio suffered losses, but, fortunately I exited early booking some losses.

Normalcy Bias – Ostrich Style – Sticking Head in the Sand

The normalcy bias, or normality bias, refers to a mental state people enter when facing a disaster. It causes people to underestimate both the possibility of a disaster occurring and its possible effects. This often results in situations where people fail to adequately prepare for a disaster, and on a larger scale, the failure of governments to include the populace in its disaster preparations. The assumption that is made in the case of the normalcy bias is that since a disaster never has occurred then it never will occur. It also results in the inability of people to cope with a disaster once it occurs. People with a normalcy bias have difficulties reacting to something they have not experienced before. People also tend to interpret warnings in the most optimistic way possible, seizing on any ambiguities to infer a less serious situation.

http://en.wikipedia.org/wiki/Normalcy_bias

Watch a short video on YouTube here on Normalcy Bias – http://www.youtube.com/watch?v=1hdf675sUAc

Examples of Normalcy Bias

1. Jews in Germany were aware of what was happening to their friends and neighbours, but, they felt it will all be over soon and return back to normal
2. Ignoring the warning signs on the highways, warning announcements about hailstorm during a long drive
3. Working in a company where layoffs are happening, but, being optimistic about the job security
4. Smoking for years knowing it is injurious to health, just assuming you are a physically fit person
5. Economies going down under, but, hearing only the positive news spread by the analysts and assuming things will be back to normal
6. Driving for years gives us a feel that accidents can never happen

Overcoming Normalcy Bias

1. Read the facts and objectively analyse them
2. Don't hide from the facts – face them and plan
3. Trust your instincts more – read your gut feel
4. Be over-prepared than under-prepared
5. Reach out to others for expert advice
6. Do not procrastinate.

My experience with Normalcy Bias

During 2008 when the Indian stock markets started collapsing down, I was reading lots of reports on what is happening globally and was convinced that 'housing markets in US how it can impact Indian stock markets', this is just a big noise created by analysts, this is just a temporary dip, but, soon everything will be normal. I even went ahead and started buying some good companies. I was also under the impression that since I was holding a lot strong businesses, I was sure something happening somewhere will not impact those Indian businesses.

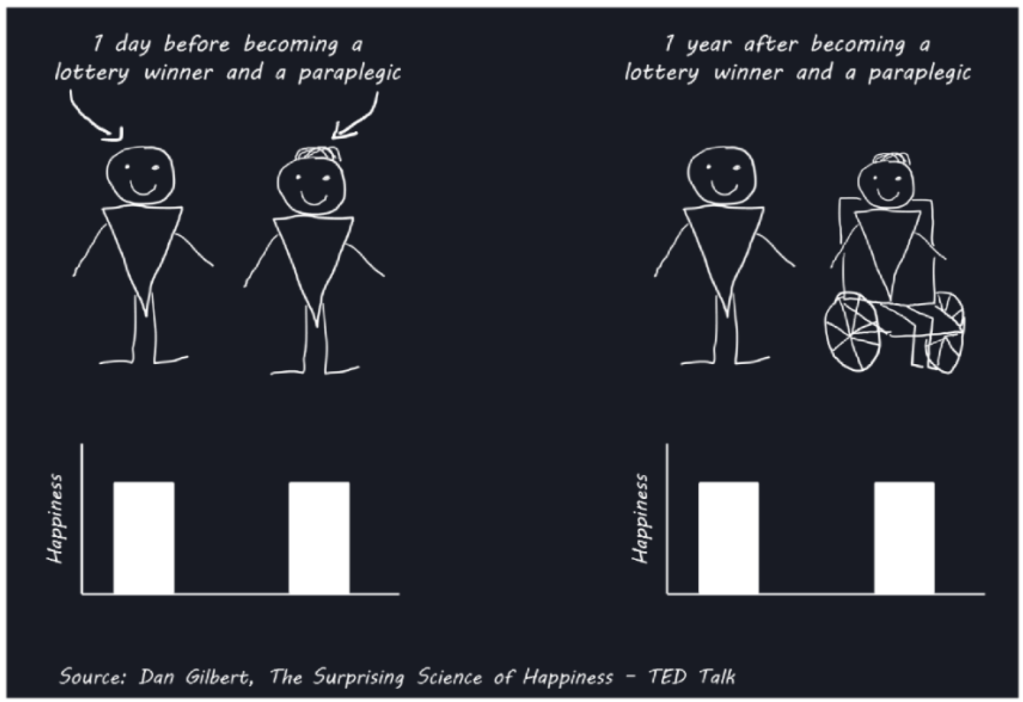
But, what happened was a total chaos – even the best fundamentally strong businesses' stock prices were pulled down. I had to clean up my portfolio – before I could incur lot more losses, and rebuilt the portfolio again, which I did.

Even though I was reading all the news, I was willfully ignoring what was happening.

Impact Bias – Overestimating Future Feelings

The impact bias, a form of which is the durability bias, in affective forecasting, is the tendency for people to overestimate the length or the intensity of future feeling states.

http://en.wikipedia.org/wiki/Impact_bias



Examples of Impact Bias

1. Lottery winners initially feel so excited and will expect that feeling will last forever. But, after a few months or years, that feeling fades off due to various other events in their life.
2. Sports fans are generally not as happy as they expect when their team wins.
3. A parent will feel very bad if something happens to their kids, they will have the impact too bad and will expect it to last for years to come. But, actually after few years, once they see their kid growing up like any other kids, they are back to normal.
4. Love failures – we have heard stories of how people were sad when their love fails, and situation forces them to marry someone else, but, after years, the feeling fades away.

Overcoming Impact Bias

1. Realise that 'Time' is the best long term medicine – as days, months, years pass by, time will heal everything
2. Always think any feeling – the level of joy or sorrow are only a temporary
3. Have faith in future – there are a lot more events in future that may change how you feel
4. You may quickly rationalise any event, thereby reducing the emotional impact

My experience with Impact Bias

During my early days of investing I had made a lot of mistakes and lost a decent sum, and was feeling very bad losing a hard saved money. I thought I would never enter stock markets again.

After a couple of years, I was interested again, but, this time I decided to read, discuss and understand about personal finance and then took the plunge. Now I do better than before. 🙂

Affect Heuristic – Gut Feel Decisions

The affect heuristic is a heuristic, a mental shortcut that allows people to make decisions and solve problems quickly and efficiently, in which current emotion—fear, pleasure, surprise, etc.—influences decisions. In other words, it is a type of heuristic in which emotional response, or "affect" in psychological terms, plays a lead role. It is a subconscious process that shortens the decision-making process and allows people to function without having to complete an extensive search for information. If their feelings towards an activity are positive, then people are more likely to judge the risks as low and the benefits high. On the other hand, if their feelings towards an activity are negative, they are more likely perceive the risks as high and benefits low. http://en.wikipedia.org/wiki/Affect_heuristic

Examples of Affect Heuristic

1. If someone has overtaken you on road, the emotion that drives you to immediately pick up speed and over take him, without thinking of the risks
2. If you come across a news in the media about a company, you may immediately make decisions regarding its financial instruments – like stocks, bonds etc., whether to buy or sell them
3. Similarly hearing some news about someone makes us to jump into conclusions about them or their character without analysing or finding facts
4. Immediately associating names with positivity or negativity – When we hear about names like Dettol, Horlicks, etc., we associate them with health.

Overcoming Affect Heuristic

1. It takes practice to start thinking rationally rather than emotionally before making decisions
2. Before making decisions make sure you have analysed properly, and decisions are taken only based on facts and figures

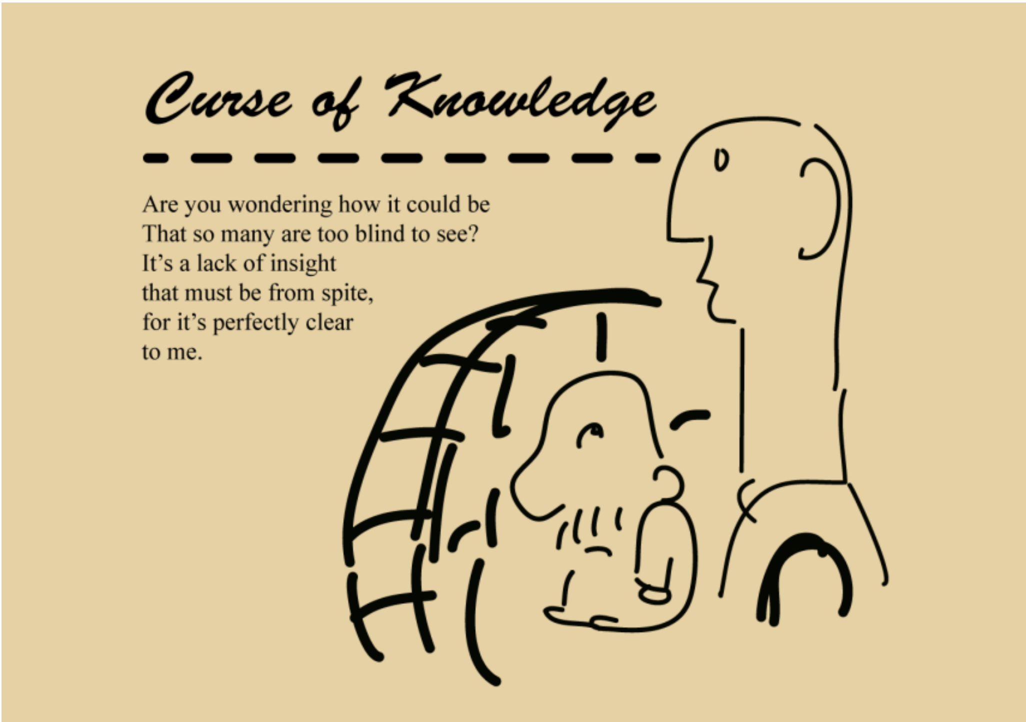
My experience with Affect Heuristic

During my early days, I used to just go with brand names like Tata, HDFC etc., and had invested in their companies – few of them gave good returns, and few did not. Then, I realized that I have been associating these brand names for their superior and transparent management.

Curse of Knowledge – How to Put Yourself in Others' Shoes

The curse of knowledge is a cognitive bias according to which better-informed people find it extremely difficult to think about problems from the perspective of lesser-informed people.
The term was coined by Robin Hogarth.

http://en.wikipedia.org/wiki/Curse_of_knowledge



Examples of Curse of Knowledge

1. We would have heard several statements thrown at us by our senior management folks at our workplace during meetings like ‘stakeholder satisfaction’, ‘innovation DNA’ etc., which may not be translated effectively by the lower level employees
2. Analysts in media throwing information and data at will – we won’t be able to correlate with current situation
3. Annual report of companies are mostly not clearly articulated with information and data for a common man to understand – an exception could be Berkshire Hathaway letters to shareholders
4. Someone who can cook a food item very well may not be able to explain properly to others
5. The doctor may be very skilled, but could not be in a position to explain in layman terms to patients.
6. Our knowledge about a financial product may lead us to jump into decision making before proper analysis

Overcoming Curse of Knowledge

1. First understand your audience and accordingly plan your speech or presentation.
2. Simply, follow the practice to explain everything to everyone in layman terms
3. Break complex things into smaller components and explain each of them in a simple manner and correlate all of them later to give a big picture
4. Cautiously unlearn and relearn what you already know – from a different perspective.
5. Make thorough analysis before making decisions – even if the area is much familiar to you.

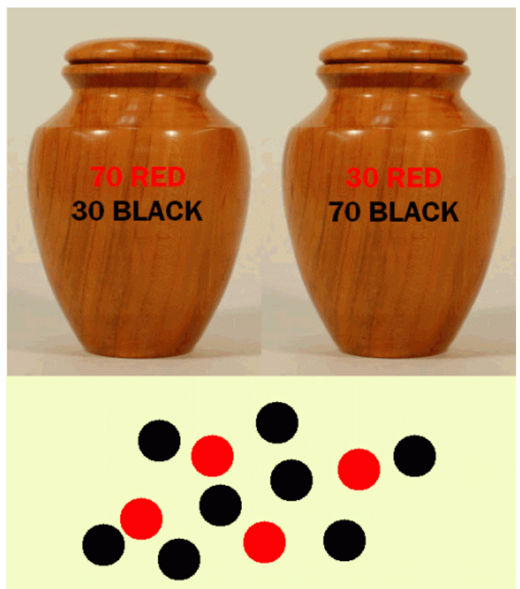
My experience with Curse of Knowledge

Many a times I have had problems explaining about personal finance concepts to my friends and relatives, especially when they are absolutely not aware of it. If they had some prior knowledge, I was comfortable explaining to them with examples.

During 2006-07 bull market, I invested in some BFSI stocks with my existing knowledge on analysing and valuing stocks/businesses. Then, I realised that I had overlooked the Price-To-Book value ratio because I was unconsciously assuming that I knew what parameters to look for in investing BFSI stocks.
I learnt that it is more of PBV ratio that matters than PE ratio when investing in Banking and Financial companies.

Ambiguity Aversion – Prefer Known Risks to Unknown Ones

In decision theory and economics, ambiguity aversion (also known as uncertainty aversion) describes an attitude of preference for known risks over unknown risks. People would rather choose an option with fewer unknown elements than with many unknown elements. It is demonstrated in the Ellsberg paradox (i.e. that people prefer to bet on an urn with 50 red and 50 blue balls, than in one with 100 total balls but where the number of blue or red balls is unknown). There are a number of choices involving uncertainty and normally they can be classified in two categories: risky and ambiguous events. Risky events have a certain probability for a given outcome. Ambiguous events have a much greater degree of uncertainty. http://en.wikipedia.org/wiki/Ambiguity_aversion



Examples of Ambiguity Aversion

1. We know as soon as we take any good out of a showroom, its value drops as it becomes second sale. This is a risk as we know, but, how much value will drop is ambiguous. We need to get lot of data to find that out.
2. When we are given a tough situation to choose an option, we prefer to look for prior examples, as what others have done in similar situation and would prefer to go by that
3. In TV shows, where the person who has won a certain amount is usually given a choice to choose to either exit from the show with the current price money, or continue to play and risk losing half of it or gain more in further rounds
4. What speculators do in stock markets is in my opinion making decisions in ambiguous situations and what investors do is risk taking based on their analysis of the business, and they may also use probability theories to assess the risk and accordingly shell out only a certain amount in a stock.
5. Insurance companies will always look for the word ‘risk’ when they underwrite any policy. They never even think of an ambiguous situation as they never cover those.

Overcoming Ambiguity Aversion

1. There is nothing in specific to do about this – other than trying to be rational and subjective in decision making based on facts and figures.
2. Check if the situation is risky or ambiguous – If risky, then you have a chance to work out something and come out successful. If ambiguous, try to avoid it, else if you have to make a decision, try to convert the ambiguous choice to at least a riskier choice, so that you have data points to make decisions.

My experience with Ambiguity Aversion

During 2008-09, I had invested in several stocks with proper analysis, or as much as I could, which covered the risk part better, but, I was counting on the future economic growth and GDP rates projected, which I did not realise was ambiguous. Hence, few bets I made in infrastructure sector went bad, and I had to exit them at a loss.

Denomination Effect – Penny or Pound?

The denomination effect is a theoretical form of cognitive bias relating to currency, whereby people are less likely to spend larger bills than their equivalent value in smaller bills. It was proposed by Priya Raghubir and Joydeep Srivastava in their 2009 paper “Denomination Effect”.

In an experiment conducted by Raghubir and Srivastava, university students were given a dollar, either in quarters or as a single dollar bill. The students were then given the option to either save the money they had been given or to spend it on candy. Consistent with the theory, the students given the quarters were more likely to spend the money they were given. http://en.wikipedia.org/wiki/Denomination_effect

Examples of Denomination Effect

1. Spending coins than higher denomination notes. We always want to keep Rs.100 or Rs.500 in our wallet and spend lower denominations first. We have heard people say, 'if I exchange it, I will spend soon'.
2. A product that is priced Rs.49.99 and Rs.49.00 and Rs.50.00 does not seem to have any difference.
3. When we get a tax return or bonus as Rs.25245.00 – we tend to spend Rs.245 and save Rs.25000
4. Thinking if the price is lower, the product may be cheaper – yes, it could be, but, is it value for money?

Overcoming Denomination Effect

1. Trying to be rational with money is the basic thing to practice
2. Look at the real value of the money however small it is
3. Remembering what our parents taught us – several drops together make a stream – Smaller denominations make one large denomination

My experience with Denomination Effect

During my early days of investing, I have considered stocks which are in two digits are cheaper and especially if it is associated with a brand name, I bought them without much deeper analysis. I preferred to buy 100 shares of Rs.15 rather than buying one Rs.1500 share.

As I learnt investing and stocks and valuations, I understood that the price does not signify anything, instead only the value underneath the business is.

Disaster Myopia – History Repeats?

The disaster myopia hypothesis is a theoretical argument that may explain why crises are a recurrent event. Under very optimistic circumstances, investors disregard any relevant information concerning the increasing degree of risk. Agents' propensity to underestimate the probability of adverse outcomes from the distant past increases the longer the period since that event occurred and at some point the subjective probability attached to this event reaches zero. This risky behaviour may contribute to the formation of a bubble that bursts into a crisis.

http://halshs.archives-ouvertes.fr/halshs-00617127/

Examples of Disaster Myopia

1. Any natural disaster when it occurs the authorities get on high alert and does all that is necessary to save people and assets. People plan and take all necessary precautions related to the threat to survive one such disaster in future. Once the disaster fades off from everyone's memory and long gone people are again laid back.
2. Once a disaster strikes people start taking all types of related insurances and after years pass by, the insurance policies may not get renewed or more people may not take new insurances.
3. When we drive on a highway and notice a drastic accident, we go in high alert mode and start driving slowly for next few days or even months. After a year or so, our old driving habits come back.
4. If you are a smoker, and you hear some of your close friend gets cancer because of smoking, you will reduce the number of smokes a day or even quit for a few weeks, then after few months, you may start smoking again
5. All Financial bubbles and crises are formed, ballooned and burst because of this. All past history of financial bubbles like Tulip mania, South Sea crisis, 1929 crisis etc., were forgotten and hence we landed up in 2008 financial fiasco. This time it is different?

Overcoming Disaster Myopia

1. Remembering the history of events is the most effective way before making key decisions in life
2. Making cautious and rational decisions can be brought in as a way of living and making decisions
3. In financial products, proper analysis, understanding biases, and purchasing with margin of safety
4. Discussing with your well-wishers before making key decisions will also help

My experience with Disaster Myopia

Even after reading and knowing my friends who lost heavily during the Tech bubble in 2000-01, I invested heavily during 2006-07 in infrastructure stocks. Starting Jan 2008, everything seems to break loose and started falling. Hence, I had to cut my losses earlier and get out with around 40% loss on few stocks. I think I was fortunate enough because those stocks went down further.

False Consensus Bias – On the Same Page with Me?

In psychology, the false-consensus effect or false-consensus bias is a cognitive bias whereby a person tends to overestimate how many people agree with him or her. There is a tendency for people to assume that their own opinions, beliefs, preferences, values and habits are 'normal' and that others also think the same way that they do. This cognitive bias tends to lead to the perception of a consensus that does not exist, a 'false consensus'. This false consensus is significant because it increases self-esteem. The need to be "normal" and fit in with other people is underlined by a desire to conform and be liked by others in a social environment. http://en.wikipedia.org/wiki/False-consensus_effect

Examples of False Consensus Bias

1. In workplace we may have a good performer, but, he/she may overestimate their skills and get to believe that all others in the organization also agree to them and behave accordingly.
2. In a love relationship, people think they are a right match and in a given situation they expect each other to behave the same way and also share similar views.
3. You watch a movie with your friends and after the show is over, you say that it was a horrible movie and why you thought so etc., but, one or more of your friends may say the movie was great and why he thinks so etc.,
4. When you go out for a purchase, your friend calls you and asks for a chocolate bar for him. You will buy the one that you like the most – assuming that your friends will also like it.
5. You believe that most people in this world want to save the environment, because you want it that way.
6. Even in an official meeting room discussion, when you raise some points, you may be surprised or taken aback but several people talking against your views
7. When a company fixes a price for a product launch, an employee may feel that price is too high – because he/she feels that is a high price – but, may not be for the market.
8. We watch few advertisements on TV which we may not understand for the first few times, that is because the advertising company thought all audiences will understand it because they understood it.

Overcoming False Consensus Bias

1. Being cautious when looking for consensus with others
2. Never jump into conclusions about what others think or believe.

3. Try to understand with others – either by talking to them or getting information on how they think before you make your decision

My experience with False Consensus Bias

During the 2008-09 market melt-down, when the stocks started falling off the cliff in early 2008, I thought the market has provided an opportunity to buy, and I assumed everyone would feel the same and go on a buying spree, which would pull up the market.

Based on this assumption I started buying heaving in early 2008, but, I was wrong because the market was trying to find is way down more and started falling further. I was trying to catch a falling knife assuming that others will also think the same way.

Mere-Exposure Effect – Familiarity Effect

The mere-exposure effect is a psychological phenomenon by which people tend to develop a preference for things merely because they are familiar with them. In social psychology, this effect is sometimes called the familiarity principle.

http://en.wikipedia.org/wiki/Mere-exposure_effect

Examples of Mere-exposure effect

1. You would have met someone and you might not have liked him/her much. But, as you continue meeting them or working with them you may start to like them and feel comfortable.
2. We may not like a song when we hear once or twice, but, if the same is repeatedly heard, we start liking it
3. We may not like an advertisement at the first shot, but, by viewing it again and again, we start liking.
4. Buying a particular brand of item – just because we are familiar to it either through advertisements, or we used already few times, or we know our friends and relatives use them.
5. Most of us may not want to try something new on the menu in the restaurant, and hence stick the ones we are already familiar with.
6. Given a situation when we have to trust someone, we prefer to choose someone who we might have already met once, even if we don't know what they do or where they live, etc., rather than choosing someone who we never met.
7. Most of the population in India stick to insurance products from LIC, buy footwear from Bata, etc.,

Overcoming Mere-exposure effect

1. Making decisions based on facts and figures and proper analysis.
2. Discussing with the right experts on the particular area will help make the right choice.

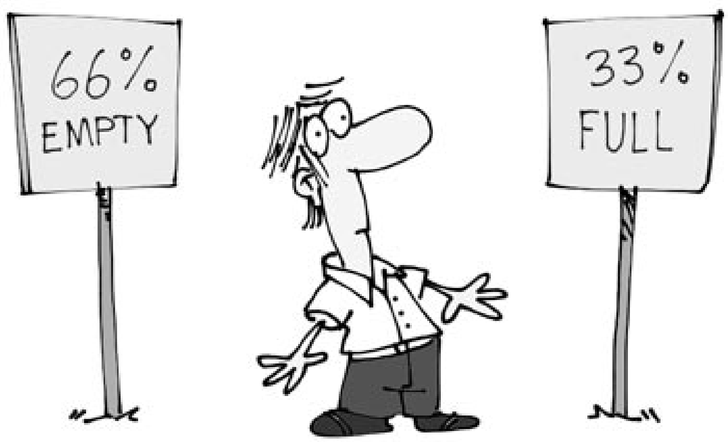
My experience with Mere-exposure effect

During my earlier days of investing, I always used to buy stocks of familiar names and companies. I bought stocks of Banks (SBI and HDFC), Auto (Tata Motors and Hero), FMCG (HUL and ITC), Oil & Gas (IOCL and Reliance), Technology (Infosys and TCS). Though these are great brand and fundamentally strong companies, I was able to make smaller profits because I forgot the aspect of margin of safety and hence was buying when their valuations were at their peaks.

Framing Effect – How Options are Presented

Framing effect is an example of cognitive bias, in which people react differently to a particular choice depending on whether it is presented as a loss or as a gain. People tend to avoid risk when a positive frame is presented but seek risks when a negative frame is presented. Gain and loss are defined in the scenario as descriptions of outcomes (e.g. lives lost or saved, disease patients treated and not treated, lives saved and lost during accidents, etc.).

http://en.wikipedia.org/wiki/Framing_effect_%28psychology%29



Examples of Framing Effect

1. Which one is heavier – a pound of sand or a pound of cotton buds? – Surprisingly, few times I have personally seen people instantly say ‘a pound of sand’. Try this out with your friends.
2. Which pack of chips is good for health? – 80% lean or 20% fat? – Looks like most people chose 80% lean, though both packs have same amount of fat.
3. We have watched in movies that in a courtroom scene, procedures do not allow lawyers to “lead” a witness when asking questions, in order to prevent the witness to fall prey to the framing effect.
4. Using the term ‘global warming’ causes a higher impact than the term ‘climate change’
5. Several instances of mis-selling of financial products like insurance policies, Ulips, teaser loans, 0% interest on retail products purchase loans etc.,

Overcoming Framing Effect

1. Properly analyse and calculate all the possibilities before making a decision
2. Like Charlie Munger referred, ‘Invert’, ‘Always Invert’ – Ask questions from all dimensions and even stand on the other side of the table and look at the options
3. If anything is too good to be true, take the cautions side and delay the decision
4. Learn probability and calculate the % of success and failure, before betting anything big.

My experience with Framing Effect

My early day insurance policies were Money Back or Endowment policies. My insurance agent explained all the types of policies his company had on offer, and clearly insisted on me buying these types of policies because I will get 'the premium + bonus' back after certain number of years. He also highlighted that I 'will not get any money from the company' if I choose the term plans. Neither he explained, nor did I analyse all the aspects of all types of policies.

Net net, he framed the options in such a way that…

- Option 1 = Pay premium, and get it back with bonus at the end of policy term
- Option 2 = Pay lower premium, and lose all of it at the end of policy term

So, now you know which option I had chosen.

Of course, after I started learning personal finance and investing, the first few things I did was to surrender all the above types of policies, and chose only one term plan.

Resources

Given below are some of the best books on the subject.

- Value Investing And Behavioral Finance by Parag Parikh
- Thinking, Fast and Slow by Daniel Kahneman
- The Art of Thinking Clearly by Rolf Dobelli
- Why Smart People Make Big Money Mistakes by Thomas Gilovich
- Think Twice: Harnessing the Power of Counterintuition by Michael Mauboussin
- Predictably Irrational: the Hidden Forces that Shape our Decisions by Dan Ariely
- Extraordinary Popular Delusions & the Madness of Crowds by Charles Mackay
- Irrational Exuberance by Robert J. Shiller
- Your Money and Your Brain by Jason Zweig

Youtube search will also provide you with some great videos on the subject.

About the Author

The author of this eBook is **Balaji Ganesan**, who lives in Chennai with his family. He has a Bachelor Degree in Economics, MBA in E-Business and Advanced Diploma in Systems Management. He is also a Certified Project Management Professional.

He is a Program, Project & Delivery Management professional in IT Industry.

Having a deep passion in Economics, Finance, Investments, and Stocks & valuation, he loves to read a lot on these subjects and also an avid blogger on his site - http://investing007.wordpress.com/

Facebook *– facebook.com/balaji.ganesan.583*

Linkedin *– in.linkedin.com/pub/balaji-ganesan/4/68b/536/*

Twitter *– @BalajiGanesan2*

About Safal Niveshak

Safal Niveshak is a movement to help you, the small investor, become intelligent, independent, and successful in your stock market investing decisions.

My name is Vishal Khandelwal, and I am the Founder and Chief Tribesman of *Safal Niveshak.*

Before starting work on the idea of *Safal Niveshak*, I was working as a stock market analyst for eight years.

During this period, I felt the pain of seeing small investors (like you) lose large amount of their hard earned money, for reasons ranging from:

- Scams…where companies simply vanished, to
- Speculation…to earn fast money, to
- Bad decisions…mostly backed by insensible and short-term advice from self-centered brokers and self-proclaimed stock market experts.

While the probability of a stock market analyst to work on a social cause is miniscule, here I am driving this movement called *Safal Niveshak* – to help you become intelligent, independent, and successful in your stock market investing decisions.

Through my experience in the stock markets, I have come to believe that:

- You alone are the most capable person alive to manage your money.
- Investing in the stock markets is not a rocket science. You just need to form the right habits, and behave yourself.
- Being smart about your money can be a lot of fun.
- You can create a lot of wealth for yourself doing it.

You can write to me at vishal@safalniveshak.com to know more about this initiative and how you can benefit from it and/or support it.

With respect,
Vishal Khandelwal
Chief Tribesman, Safal Niveshak