ASSET MANAGEMENT

Behavioral Finance

Module **2**

Let us understand Ourselves

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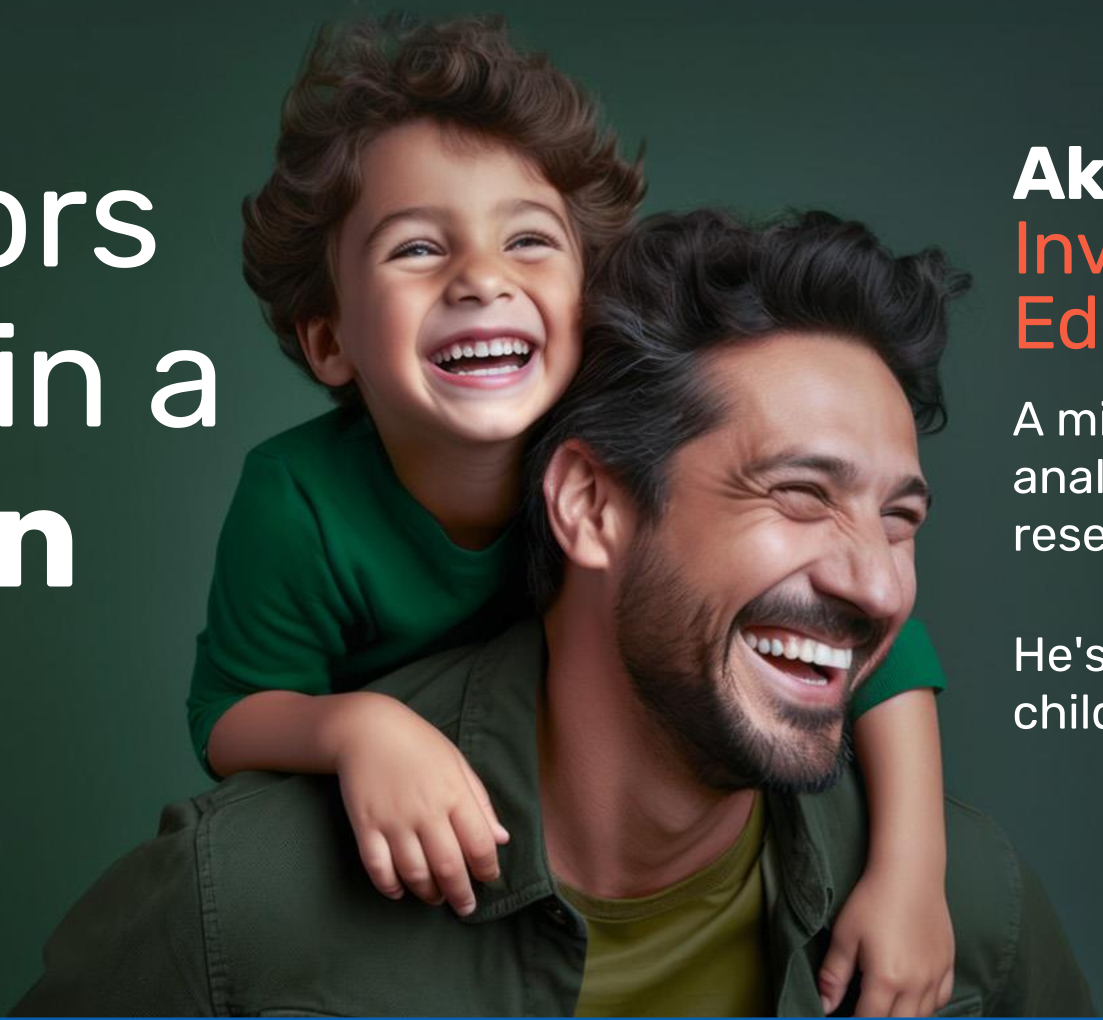
Investors meets in a **session**



Akash-
Investing for Child’s Education

A middle-aged engineer who loves analyzing data and believes in his research skills

He's investing his savings for his children's education

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Investors meets in a **session**

Madhu-
Investing for Retirement

A cautious accountant who seeks stability. She's close to retirement and is looking for a secure investment option.

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Sid-
New Investor

A young artist who is new to investing. He follows trends and goes with his gut feeling when making decisions.

Believes

I've studied the market thoroughly. This new technology seems promising

I'll stick to what I know, even if it's not giving great returns

I heard my friend talking about this new startup.
I think I'll invest

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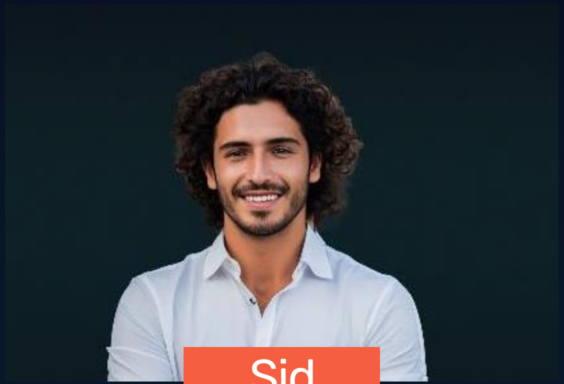


	Akash	Madhu	Sid
Market **Rise**	“See, I knew it! My research was right!"	“The market is volatile, maybe I should move everything to Fixed Deposit“	“This startup is soaring; my instincts were spot on“
Market **Dips**	“But my research said it would rise!"	“See I was right about going with safer options“	“I can't believe I lost so much; my friend's advice was terrible“

Reflections

Overconfidence Bias

Maybe I was too confident in my research.

Anchor Bias

Awareness matters more than blindly following my familiar options

Confirmation Bias

I need a more informed approach. Trends alone aren't enough

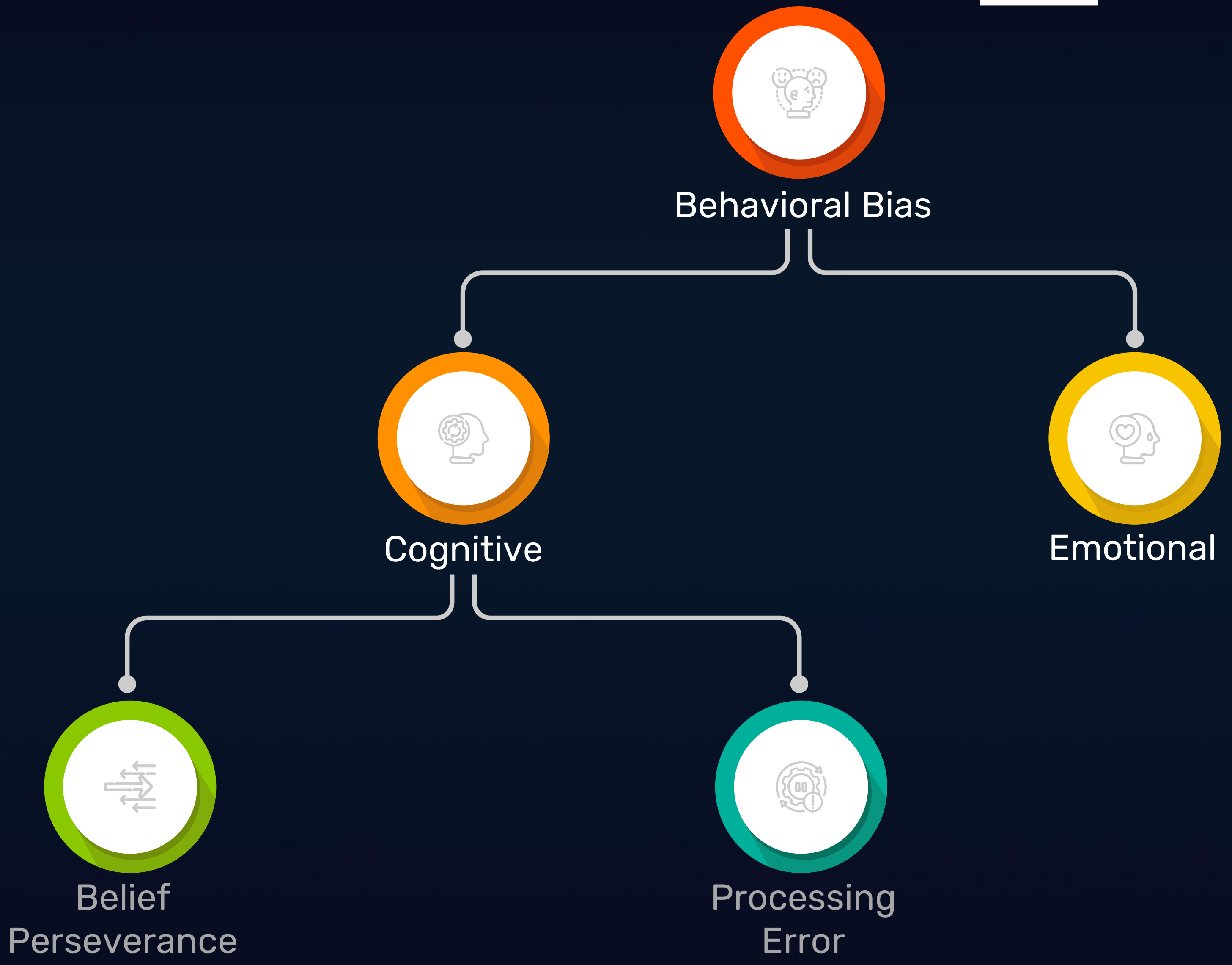
The Biases

Cognitive **Bias**

Cognitive errors arise from a lack of understanding proper analysis techniques, information processing mistakes, faulty reasoning, or memory errors. Such errors can often be minimized or mitigated with better training or information.

Emotional **Bias**

Emotional biases are not related to conscious thought and stem from feelings or impulses or intuition.



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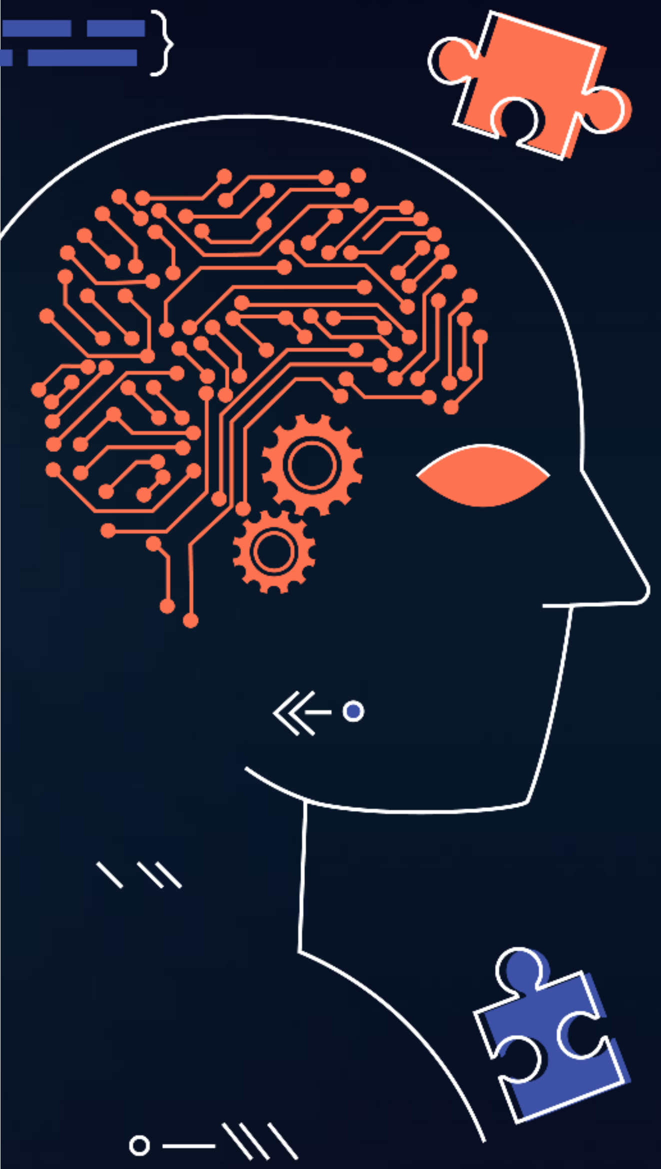

Cognitive **Bias**

Belief Perseverance

Belief Perseverance biases that reflect a desire to stick with a previous decision

Belief Perseverance

Confirmation Bias

Investors seek out information that confirms their existing beliefs, instead of considering alternative opinions or data.

Conservative Bias

Conservatism bias happens when people in the market initially think one way but don't update their thinking when they get new information.

Hindsight Bias

Hindsight bias is when people remember past events, actions that makes things seem more predictable than they actually were.

Illusion of Control

Illusion of control is a cognitive bias where individuals believe they have control over outcomes when they actually don't.

Representative Bias

Representativeness bias occurs when people mix up the likelihood of an outcome because they see similarities between objects or events.

Understanding Biases

Let us understand the biases from Rahul's behavior and how it impacted his decision.

Confirmation Bias

The Bias Discussed

Confirmation bias happens when people in the market search for or twist new information to align with their current views.

This is a type of bias where information that goes against their beliefs is often overlooked or underestimated.

The Way Out

Investors can refrain this bias to impact their investment decisions by surrounding themselves by investors with different perspective, someone who could play devil's advocate.

Rahul often reads financial news to stay informed. However, he tends to pay more attention to news that aligns with his preconceived notions about a *particular* stock.

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Conservative Bias

The Bias Explained

Conservatism bias happens when people in the market initially think one way but don't update their thinking when they get new information.

This bias can hinder potential gains and limit diversification.

The Way Out

Investors should regularly reassess their portfolio and consider new opportunities.

Gradually introducing new, well-researched investments can help expand the portfolio without taking unnecessary risks.

Rahul believes in the safety of *fixed deposits* and is apprehensive about the *volatility of the stock market*. Even when equities are experiencing substantial gains, Rahul sticks with low-interest fixed deposits.

Representative Bias

The Bias Explained

Representativeness bias occurs when people mix up the likelihood of an outcome because they see similarities between objects or events.

This happens because they tend to believe that past patterns will continue, and they treat new information as if it fits a specific category.

The Way Out

Investors should consciously seek out diverse information and avoid relying solely on past patterns.

Rahul is investing in a stock just because it recently performed well, *without considering* other factors.

Illusion of Control

The Bias Explained

Illusion of control is a cognitive bias where individuals believe they have control over outcomes when they actually don't.

This bias can lead to overconfidence and poor decision-making.

The Way Out

Investors should recognize that some factors in the market are beyond their control and cannot be accurately predicted

Rahul believes that he has more control over outcomes than he actually does. He is excessively trading his portfolio due to the belief that he can *time the market* perfectly.

Hindsight Bias

The Bias Explained

Hindsight bias is when people remember past events, actions, or what they could have known in the past in a way that makes things seem more predictable than they actually were.

This bias can lead to overconfidence and poor decision-making.

The Way Out

To combat hindsight bias, individuals should ask themselves if they truly remember their past predictions and recommendations accurately

This bias made Rahul believe that he knew a stock would rise sharply after seeing the positive news, even though he *didn't anticipate it beforehand*.

Process Error

Process error in psychology refers to mistakes or inaccuracies that occur during mental processes, like memory, attention, or decision-making.

Process errors highlight how our minds can misinterpret information, leading to faulty conclusions or actions that deviate from rationality.

Process Errors

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Anchor Bias

People in the market rely on their past experiences and quick decision-making rules to influence probabilities too much.

Availability Bias

Investors give too much importance to information that's easily accessible.

Mental Account Bias

It happens when people treat money differently based on how they label it.

Framing Bias

The decisions are influenced by how a question or data is presented.

Anchor Bias

The Bias Explained

This bias occurs when market participants use psychological heuristic experience based trial and error rules to unduly affect probabilities. Changes are made but in relation to the initial view and therefore the changes are inadequate.

The Way Out

It's important to keep in mind that looking at past performance and market data isn't a reliable way to predict the future.

When making forecasts, they should update them to account for changes in a company's fundamentals and not stick too closely to past estimates

Rahul considers a stock a good deal simply because it's priced higher initially, overlooking its actual value.

Availability Bias

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The Bias Explained

Availability bias occurs when people give too much importance to information that's easily accessible.

This bias occurs when individuals estimate the likelihood of an event based on how easily they can recall examples and instances related to it.

The Way Out

Investors should consciously seek out a wide range of information and consider different perspectives.

Consulting peers and experts can offer valuable insights that counter the bias.

Rahul rely on readily available information to invest in a sector he recently read about, neglecting to consider other potentially profitable options.

Mental Accounting Bias

The Bias Explained

Mental accounting bias happens when people treat money differently based on how they label it.

This bias comes from the fact that individuals put their spending into different categories, like food, rent, or investments, and think of each category separately.

The Way Out

See the holistic picture of their investments rather than segregating them into separate mental categories.

Regularly reviewing and rebalancing the entire portfolio can help ensure a well-rounded approach.

Rahul mentally segregates return into arbitrary categories of income, realized gains and losses, or unrealized gains and losses.

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Framing Bias

The Bias Explained

Framing bias happens when decisions are influenced by how a question or data is presented.

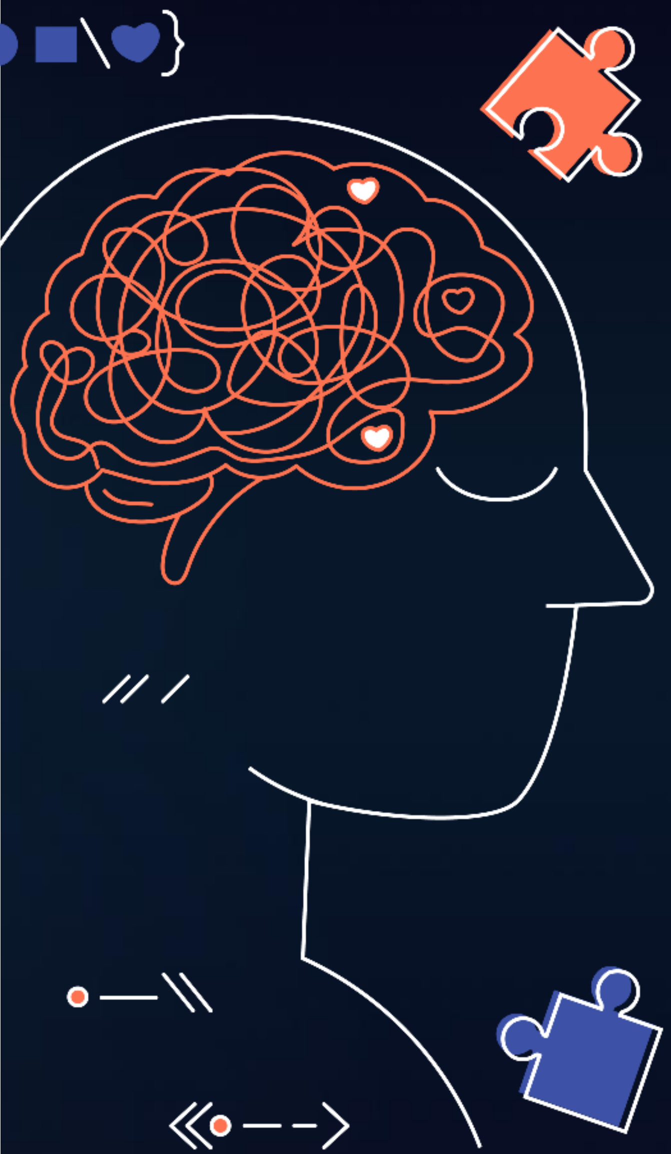
It can lead to different choices based on how options are framed, even if the underlying information is the same.

The Way Out

They should consciously recognize how information is being presented and consider its potential impact on decisions.

Comparing options from multiple angles and seeking objective data can help mitigate the bias.

Rahul prefer stocks labeled as "low-risk" instead of the same ones framed as "high-risk," regardless of actual risk assessment.



Emotional **Bias**

Emotional Behavioral Biases

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Loss Aversion Bias

The investors feel the pain of losses more intensely than the joy of gains.

Endowment Bias

Investors assign more value to the investments they own, simply because they own them.

Regret Aversion Bias

Investors avoid taking action because they're afraid of making a mistake.

Status Quo Bias

A preference for sticking to current decisions or maintaining the existing situation, even if better alternatives exist.

Overconfidence Bias

Investors have too much confidence in their own intuition and thinking abilities

Self-Control Bias

This bias involves making choices that prioritize short-term desires over long-term goals, often leading to suboptimal investment decisions.

Loss Aversion

The Bias Discussed

The investors feel the pain of losses more intensely than the joy of gains.

This bias can lead them to make irrational decisions, like holding onto losing investments for too long or selling winners too early.

The Way Out

To overcome this bias investor should set objective and focus on the bigger picture.

They could set clear criteria for when to sell an investment, based on facts and analysis, rather than letting emotions drive the decision.

Rahul holds a stock when it's value declines, without carefully assessing its potential for recovery, and not selling if needed to cut losses early.

Overconfidence Bias

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The Bias Discussed

Overconfidence bias happens when people in the market have too much confidence in their own intuition and thinking abilities

It can lead to a false sense of knowing things better than they actually do, which is called the "illusion of knowledge."

The Way Out

They could seek advice from other experienced investors, conduct thorough research, and be open to the possibility of being wrong.

Rahul often changes his investment strategy believing that he can outsmart the market.

Endowment Effect

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The Bias Discussed

Investors assign *more value to the investments* they own, simply because they own them.

They might be unwilling to sell an investment even if it's not performing well, just because they feel attached to it.

The Way Out

Investors can question themselves if they would still buy the investment at its current price if they didn't already own it.

This can help investors make more rational decisions and avoid holding onto underperforming investments out of sentimental attachment.

Rahul holds onto a declining stock because he overvalue it due to his emotional attachment towards it.

Regret Aversion Bias

The Bias Explained

Regret Aversion bias occurs when people in the market avoid taking action because they're afraid of making a mistake.

They give too much importance to doing something and don't think enough about the consequences of doing nothing.

The Way Out

Regret Aversion can be reduced by talking about the advantages of diversification, the results that match the balance between risk and reward , and what happens if we don't reach important long-term investment goals.

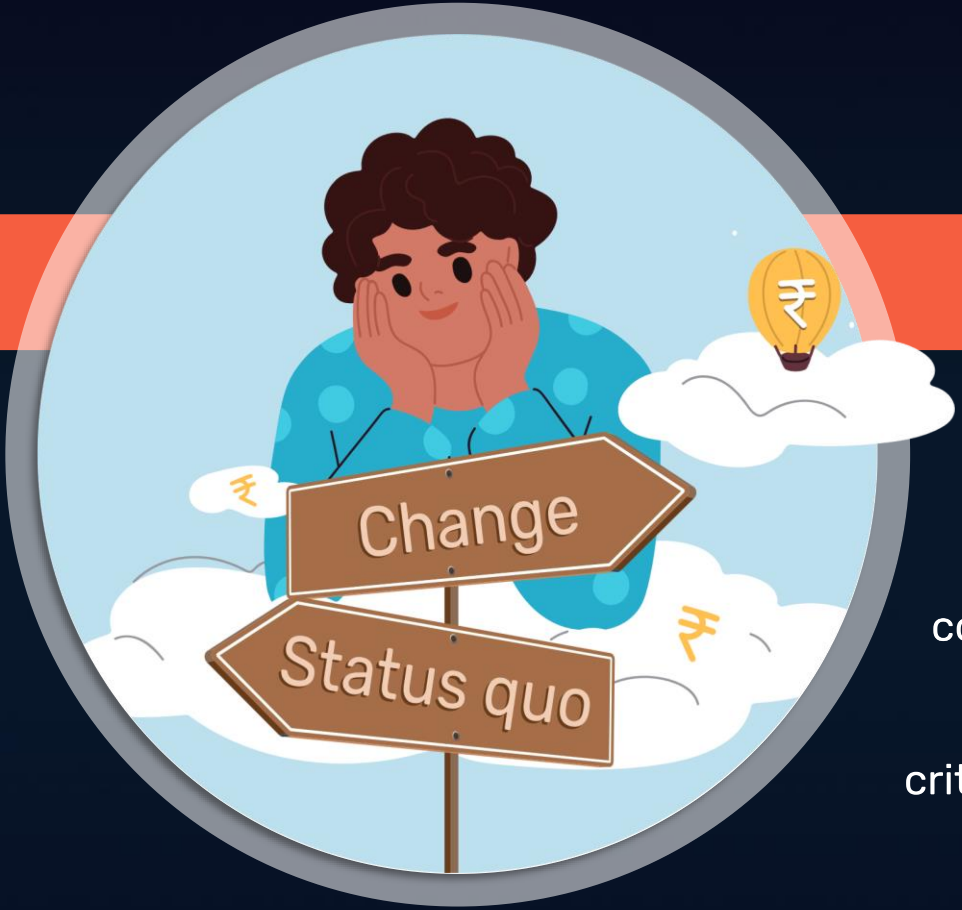
Rahul decide not to invest in a potentially profitable stock to avoid regret if it goes bad but regret missing out on big profits when that stock soars in value.

Status Quo Bias

The Bias Explained

This bias is a preference for sticking to current decisions or maintaining the existing situation, even if better alternatives exist.

It can hinder progress and limit opportunities for portfolio growth.



The Way Out

Investors should regularly review and assess their investment choices, considering if changes could lead to better outcomes.

Setting specific goals and criteria for decision-making can help counteract the pull of inertia.

Rahul hesitates to rebalance his portfolio, favoring existing holdings despite changing market conditions.

Self Control Bias

The Bias Explained

This bias involves making choices that prioritize *short-term desires over long-term goals,* often leading to suboptimal investment decisions.

Investors struggle with self-control and may make impulsive decisions without considering the long-term consequences.

The Way Out

Setting clear and realistic financial goals can help maintain focus on the bigger picture.

Creating a structured investment plan with gradual steps can curb impulsive decisions.

Rahul gets affected by market fluctuations and makes impulsive decisions driven by short-term emotions.

"To find real solutions, first recognize your biases, clarity follows understanding."

In module 3, you will learn how Behavior Finance will help you overcome these biases to become better investors.

Thank You

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