CHAPTER 7

IMPLICATIONS AND FUTURE AREA OF RESEARCH

7.1 IMPLICATIONS

In recent times, the interest in behavioral finance has not just emerged; it has exploded into the scene as it has significant implications in the stock markets. This is because, what registers in the stock market fluctuations, are not the event themselves, but the human reaction to these events and how they may impact the future. These reactions are the progeny of behavioral biases that can have lasting consequences. However, if detected timely, they can be avoided. We focus on the implications of four such behavioral biases. These are herd behavior, optimism (pessimism), overconfidence, and the disposition effect. The results of this study show that all the four biases prevail and have significant implications in the Indian equity market. Moreover, the investor sophistication factors like trading experience and trading frequency do not curtail these biases in Indian investors, unlike their foreign counterparts. In this case, awareness about these biases and their early detection can be a possible remedy to control them. This study enables the portfolio managers in identifying various indicators that predict the presence of these biases in Indian context. Table 7.1 summarizes the implications of the present study by providing the behavioral and market indicators corresponding to each bias and their subsequent impact, if they remain undetected.

Table 7.1: Implications of four behavioral biases

<table>
<thead>
<tr>
<th>Bias Name</th>
<th>Behavioral Indicator</th>
<th>Market Indicator</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Herd Behavior</td>
<td>Mimicking others actions</td>
<td>Low or negative security return dispersion</td>
<td>Speculative bubbles and busts</td>
</tr>
<tr>
<td>Optimism</td>
<td>Overestimating the probability of a favorable outcome</td>
<td>Low past volatility</td>
<td>Negative relationship between risk and return</td>
</tr>
<tr>
<td>Overconfidence</td>
<td>Excessive trading, high risk takers</td>
<td>A positive relation between past market returns and present trading volume</td>
<td>High brokerage costs, Chances of high losses.</td>
</tr>
<tr>
<td>Disposition Effect</td>
<td>Selling winners too soon and holding on to losers, failure to diversify</td>
<td>Positive relation between past security returns and present security trading volume</td>
<td>Suboptimal portfolio performance, reduced returns</td>
</tr>
</tbody>
</table>
To elaborate further, herding can be detected in the behavior of individuals who tend to mimic others, rather than relying on their own judgment. This behavior gets reflected in the stock market in the form of speculative bubbles and bursts. However, its presence in the market can be detected if the security return dispersion becomes very low or negative. In this study, herding is detected in the bull phase for the period 2006-2013. It implies that in the periods of market extremes (i.e. bull or bear phase) individuals tend to herd more.

Figure 7.1: Annual returns of Nifty 50 during the period of 2006-2013.

The second behavioral bias is one of the most potent biases that drive the market sentiment. This is optimism. It is seen that this bias makes Indian investors to over expect their mean portfolio returns and reverse is true for pessimism. It can give rise to negative risk and return relationship in individuals. This implies that biased investors ask for lower returns in pessimistic (high risk) conditions while higher return in optimistic (low risk) conditions. Nevertheless, our study shows that this bias can be investigated with the help of past volatility. Optimism prevails after a period of low volatility while pessimism generally occurs after a period of high volatility.

Overconfidence is another highly prevalent and significant bias amongst practitioners. It can be detected in investors who trade excessively and are high risk takers which can result in
high brokerage costs and heavy losses. The study reveals that Indian investors are prone to overconfidence and its presence in the stock market can be expected if there is a positive relationship between past returns and present trading volume.

Further, the disposition effect also exists in the Indian investors. Like overconfidence, this bias can lead to suboptimal portfolio performance and reduced returns. However, its symptoms can be seen in individuals who have a tendency to hold their losing stocks for too long and sell their profiting stocks too early. It is seen from the study that these investors have biasness towards their favourite stocks and are not willing to diversify. The study suggests that this bias can be observed by positive relationship between past security returns and present trading volume.

Once the behavioral and market indicators of biases are identified, the role of financial advisors comes into play. The knowledge of behavioral biases can help them in understanding their clients’ decision making process, so that they can assess whether their clients’ behavior needs to be modified or adapted. [122] advises the portfolio managers to take diagnostic tests of their clients. Just like a doctor, these tests can help them to identify the biases and provide appropriate financial cure. For instance, psychometric tests for overconfidence involve guess estimates or the degree of control that the respondents think they have over a situation. The overconfident respondents will give a narrow and restrictive range of their guess estimate. They will also profess to have a greater degree of control over situations like picking up better stocks. These investors can be advised to keep a track of their each investment in the past and then calculate returns. This will show them the detrimental effects of overconfidence like excessive trading and under estimating downside risk. Such updated information can often help investors to correct the error of their ways [122]. In this manner, the financial advisors can gain a better grasp of their clients’ psychology while structuring their portfolios. If the advisors achieve this, their relationships with their clients will strengthen considerably.

Furthermore, the awareness of these biases is not just limited to, financial advisors and their clients. It is equally applicable for investment bankers and financial strategists so that they can understand the market sentiments and market trends before making their public issues and forecasts respectively. Finally, the self awareness of these biases is also important so that
individuals can make sensible and effective financial decisions, as knowing what to do is important but knowing when to do what is priceless.

7.2 FUTURE AREA OF RESEARCH

Behavioral finance is a rapidly growing field, but it is still at a nascent stage in the developing countries, like India. Thus, this area offers tremendous possibilities for the researchers in terms of exploring behavioral biases, interpreting investor behavior and developing behaviorally adjusted market models. The present study captures the presence and impact of four select behavioral biases using both primary and secondary data. However, there is still a wide scope for further investigation. This involves research in other equally important biases like loss aversion, representativeness, anchoring, availability bias, framing and mental accounting. The importance of these biases has been highlighted in the past by various Indian and foreign researchers [40], [121], [122], [161], [32]. Moreover, in India the behavioral biases are mostly studied using survey based techniques, leaving a huge opportunity for researchers to use secondary data. Therefore, efforts can be made to detect the possible market indicators that can predict the presence and impact of these biases with the help of secondary data. Another method which can provide unique insight about the research issue under consideration can be experimental researches. For instance, an experiment can be conducted on two investor groups where one group is informed about the behavioral biases and the other remains ignorant. Thereafter, both the groups can be presented with same investment scenario. Their responses can be compared to check whether prior information has helped the investors in curtailing the biases or not. Such experiments can unveil the pre and post behavioral transition of investors. There is an immense potential to expand survey based research. This can be extended with a larger sample and over a longer duration and with respondents from other parts of India where trading activity is high, for instance Mumbai which is considered to be the financial capital of the country. Insights on the behavioral biases can also come from specific respondent sets like institutional investors, foreign institutional investors (FII) and high net worth investors who have tremendous influence over Indian stock markets.

Investor behavior involves a lot of complexities and researchers still have a long way to go before they understand its intricacies. This research work is a humble attempt to provide
unique insights into the existing body of knowledge. If this work can make a contribution in understanding the complex investor behavior and its implications on the stock market, the untold number of trees that were required to print this thesis were not cut down in vain.