ABSTRACT

This research work falls under the broad category of behavioral finance that deals with the influence of psychology on the behavior of financial practitioners and its subsequent impact on stock markets [131]. This study is an attempt to investigate the presence and impact of four behavioral biases in the Indian context for the period 2006-2013. These are overconfidence, optimism, the disposition effect and herd behavior. The interest in this field is rapidly gaining pace as it tries to replace some of the ideal assumptions of traditional finance theories like, rational agents and efficient markets. This area proposes a more realistic behavioral agent who is ruled by sentiments and is prone to make biased decisions. It signifies the role of psychological biases and their specific behavioral outcome in decision making. These biases can be heuristic driven, like overconfidence and optimism or frame dependent like the disposition effect and the herd behavior [134]. These biases can prove to be extremely potent in financial markets as they can result in market anomalies like speculative bubbles and busts.

Research in behavioral finance has been addressed mostly in developed countries like U.S. However, in Indian context, this area is still at a nascent stage. The Indian stock market has seen turbulent times in the recent past. It has experienced a sharp dip in 2008 from the heights of 2006, followed by a series of ups and downs in the subsequent years, till 2013. This was the period when markets observed sharp swings in sentiments in a very short span of time [161]. Thus, a research based on investor behavior becomes relevant and interesting. This research work is an attempt in this direction. It tries to unveil the influence of behavioral biases in investment decisions with the help of market trends and indicators. Moreover, it also identifies the situations and characteristics that make the Indian investors susceptible to certain biases. The methodology makes use of both primary and secondary data that provide real time and historical insights of investor behavior. The impact of these biases on market indicators like return dispersion, risk premium, volatility and transaction volume is detected with the help of secondary data. Herding is detected by the measure suggested by [36] and [33] which is cross sectional standard deviation (CSSD) and cross sectional absolute deviation (CSAD). The presence and impact of optimism are investigated with the help of the pricing kernel technique.
and time series regression, as suggested by [11]. Overconfidence and the disposition effect are jointly analyzed by time series techniques as proposed by [160]. The behavioral aspects of these biases have been studied with the help of primary data using a questionnaire administered on investors in the Delhi/NCR area. It provides a comprehension into investors’ psychology and the role of demographics and investor sophistication in the existence of biases. It signifies the role of age, gender, annual income and education in influencing the mindset of investors. It also captures the effect of trading frequency and experience in curtailing the biases. The responses of this survey are analyzed with the help of parametric and non-parametric techniques.

The results reveal that herd behavior is not seen in the overall market, although, it persists in a bull phase. This bias can lower the security return dispersion. Moreover, in the presence of severe herding, the dispersion might become negative. Further, the Indian equity market has been predominantly pessimistic for the period 2006-2013. It is found that past volatility is one of the factors behind pessimism. This bias is responsible for creating a negative risk-return relationship with investors. Additionally, overconfidence and the disposition effect also prevail in the Indian equity market. These biases increase the market and individual security transaction volume respectively. On segregating the impact of these biases, it is seen that overconfidence predominates the disposition effect. Finally, the survey results capture the current state of behavioral biases of Indian investors. It presents the investor characteristics specific to each bias. On ranking these biases in their order of prevalence, it is observed that overconfidence is the most important bias in the Indian equity market followed by optimism and herd behavior. The disposition effect gets the lowest rank.

The findings of the study have significant implications for fund managers and asset management companies as it facilitates them in gaining a better understanding of their clients’ psychology. It can aid them in developing behaviorally modified portfolio, which best suit their clients’ predisposition.