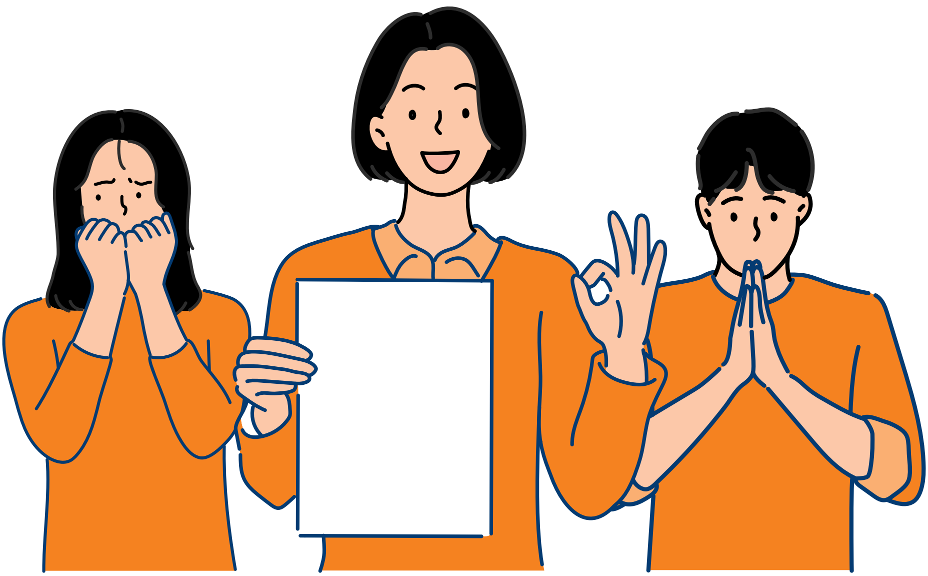
An Investor Education Initiative

MIRAE ASSET
Mutual Fund

INVESTOR BEHAVIOUR



Introduction

Any financial investment can be said to give two kinds of returns: Investment Returns and Investor Returns. At first, they may seem more or less similar, however, they are quite different.

The Investment Return is a scale that measures the returns on a portfolio over a period of time. Investor return is the value of the total purchases minus the total sales of the investor's portfolio. Investor return also measures that how an average investor has fared in the markets.

Most often, investor returns are quite low compared to investment returns because of what Carl Richards, a certified financial planner and a best-selling author, calls **"Behavior Gap."**

Investor (mis)behaviour

- Investment returns are more dependent on investor behaviour than on fund performance.

In this book we will discuss on what are the causes of investor behaviour, why it is important and how we can overcome behaviour gaps.

Topic 1:

Importance of investor behaviour in market correction, Greed and Fear cycle

There is an old saying in Wall Street, "Financial markets are driven by two powerful emotions – Greed and Fear".

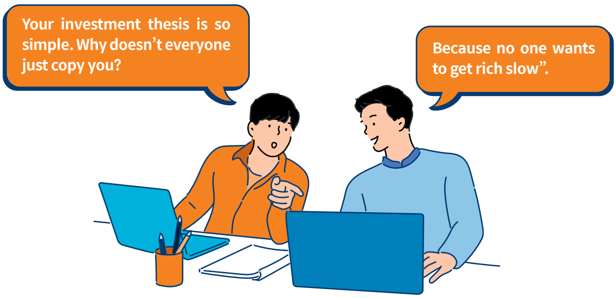
Legendary investor, Warren Buffet in his 1986 letter to Berkshire Hathaway shareholders once wrote that -

> **Occasional outbreaks of those two super-contagious diseases, Fear and Greed, will forever occur in the investment community.**

Greed

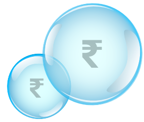
Investor behaviour driven primarily by Greed and Fear is responsible for the dizzying highs in bull markets and subsequent crash in bear markets.

How Greed affects asset prices and returns



What Warren Buffet said to Jeff Bezos is the essence of Greed in investment behaviour. Investors want to make profits quickly and bull markets provide a great opportunity to make profits in a short period of time. When price keeps rising, more and more people invest more and more money in stocks. Stock prices follow the law of demand and supply. With higher demand (more money), prices keep rising further and profits grow. Growing profits fuel more greed and more money get invested raising prices to excessive levels.

At very high prices, asset bubbles are created i.e. prices are much more than intrinsic or fundamental value of assets. Like all bubbles, asset bubbles eventually burst and prices crash. Investors who had bought stocks at very high prices face big losses when market corrects.



How Fear affects asset prices and returns

Fear

When asset prices get overheated it eventually corrects. Bear markets (falling markets) can be triggered by a number of factors but the most common factor is slowing or sluggish economy. It has generally been seen that a stock price fall faster than it rises. 2–3 years of gains in stock price can be wiped out in just 2–3 months during bear markets. A number of reasons can be ascribed to severe crashes seen in bear markets e.g. high leverage through derivatives near bull market peaks, margin calls getting triggered etc, but the fundamental reason is Fear. When prices fall sharply, investors fear that it will fall more and sell in panic. As mentioned earlier, stock prices follow the law of demand and supply. In a bear market, supply of stocks is high since most investors want to sell in panic. Panic selling causes stock prices to fall sharply. Ultimately, prices fall to such low levels that stock valuations become attractive (cheap) and the market eventually bottoms out.

Effect of investor behaviour in market corrections

You cannot control the market but you have control over your actions. Your actions will determine whether you make a profit or loss in stocks or mutual funds.

Let us assume-

Invested Rs. 100,000

NAV: Rs. 100

In a Equity Mutual Fund Scheme

During such instances as shown in the above illustration, even though the market value of your fund is now less than your purchase price, this is only a notional loss – not an actual loss. Over time, market value of your investment may go up when the stock market recovers. Whether you make a profit or loss ultimately will depend on your actions. You may do one of the following :-

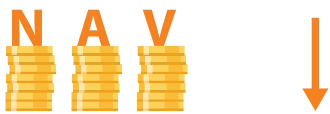
Fear that market value of your fund will fall even further and redeem. By redeeming you will convert the notional loss of 100 X (100 – 90) = Rs 10,000 into an actual loss of Rs 10,000.

NAV: Rs. 100 Rs. 90

Loss of Rs. 10,000

Think the market value of your fund will fall even further and you will have the opportunity to buy it again at a lower cost.

Let us assume that you were right and -



NAV: Rs. 100

NAV falls to Rs. 80

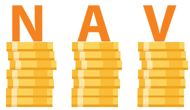
Even if Rs 80 is the lowest price you are unlikely to invest at that price because you will fear that price will fall even further. In almost all bear markets, the more the market fell, the greater was the fear among investors. Most investment experts have conceded that it is almost impossible to time a bear market bottom. Most investors who have made a loss want to feel confident about recovery before investing again. However, turnaround from market bottoms is usually very rapid. Therefore, by the time you invest again prices would have risen considerably above the market bottom.

Let us assume-

Invested Rs. 100,000

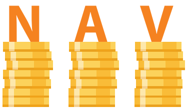
Bought 947.4 units

In a Equity Mutual Fund Scheme



At an NAV of : Rs.95
Which is above market bottom

In 1–2 years, the fund NAV becomes Rs 110. The market value of your investment will be Rs 104,210. So your profit is Rs 4,210.



NAV: Rs. 110

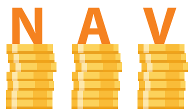
Market value Rs. 104,210

Profit Rs. 4,210

You do nothing – simply, stick to your investment plan despite the fall in prices. The market value of your investment may rise, fall and rise again. When your fund NAV is Rs 110, your profit will be = 100 X (110 – 100) = Rs 10,000. Doing nothing and remaining disciplined was the best course of action in this example.

Original Investment
of Rs.100,000 for 1,000 units

In a Equity Mutual Fund Scheme



Results in a profit of Rs. 10,000
At current NAV of Rs.110

Conclusion

It is said that even Sir Isaac Newton lost a lot of money in a speculative investment in shares. Reflecting on his losses, the great scientist said, "I could calculate the motions of the heavenly bodies, but not the madness of people". **Stock market prices reflect the collective investment behaviour of all investors. Greed and fear are base instincts driving investment behaviour but they are greatly detrimental to your financial interests. It is not easy to remain calm in highly volatile markets. But if you do not let greed and fear affect your investment behaviour then you may be in a much stronger position to meet your financial goals.**

Topic 2:

Investor biases - Herd Mentality

Herd mentality in investing is following what other investors are perceived to be doing rather than taking decisions based on your own objective analysis.

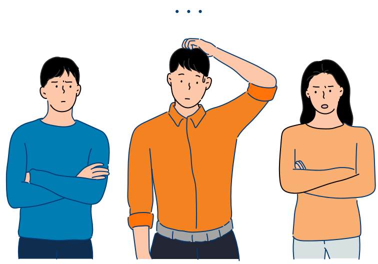
For example, many of your friends are buying shares of ABC Company Ltd and not wanting to be left out, you also buy shares of that company – this is herd mentality in action. Another example of herd mentality will be your friends, relatives or acquaintances selling shares or mutual funds and shifting to FDs because "market may crash further" and you are also following the same.

Herd mentality is characterized by lack of rational decision making based on knowledge and logic. Examples of herd mentality in action in the stock markets over the past 20 – 25 years include the dotcom bubble in late 90s, the craze for infra stocks and funds in 2007, redemptions at very low NAVs in 2008, excessive retail investor inflows in small / midcap stocks of mutual funds in 2015 – 2018 and subsequent redemptions at low prices etc. At a market level, herd mentality invariably leads to asset prices getting overheated leading to their eventual crash. As an individual investor, this may cause you to suffer big financial losses.

Herd mentality is bad in both bull and bear markets. Buy low and sell high is the mantra of success in financial markets. However, the opposite happens when you make investment decisions based on herd mentality.

In bull market, you end up buying / investing at very high prices because you don't want to be left behind. In bear market, you sell / redeem at very low prices because you feel what others are doing is right and you don't want to make more losses.

Often information sources that many investors depend on to make investment decisions are not verifiable or credible sources. Your friend may tell you something about a stock, fund or the market, but if you ask him the source of his information, your friend will say that he / she heard it from someone else. Often market grapevine appears to come from a credible source but if you dig deeper, there may not be much substance. What is touted as "information" is often someone's "opinion" which herd mentality leads you to believe as "facts".



Warren Buffet said -

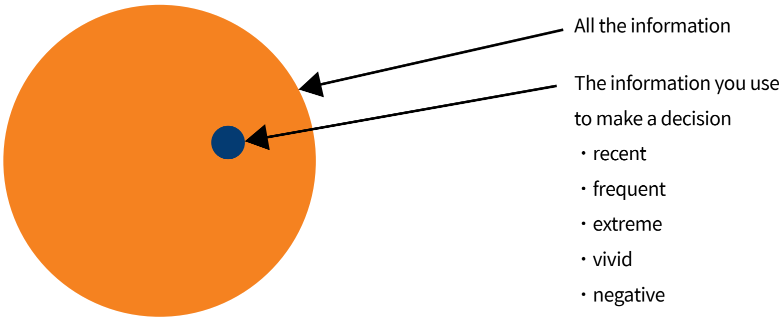
> **"Be fearful when others are greedy and greedy when others are fearful".**

Value investing and Contrarian investing are investment styles which act exactly the opposite of herd mentality. Value and Contrarian investing styles are followed by fund managers, but retail investors can avoid falling prey to herd mentality by following a disciplined approach to investing i.e. making a financial plan and sticking to it irrespective of market movements. Proper financial planning and asset allocation are much more important attributes of investment returns than investing in specific stocks. Having a good financial advisor can also protect you from the harmful effects of herd mentality. You should seek the guidance of your financial advisor when making investment decisions.

Topic 3:

Availability bias

The availability heuristic



Availability bias is making investment decisions based on information which investors have received recently or examples they can recall easily, instead of taking all relevant factors into consideration.

In simple terms, you exhibit availability bias when you made decisions or form opinions based on the first thing that comes to your mind. The world is rife with examples of availability biases.

A leading global financial publication did an investor survey asking investors to recall how the stock market performed in 2009 to 2011. Large numbers of investors indicated that they thought the market performed badly. In recalling that period, the memory of stock market crash in 2008 and it coloured the perception of the investor, even though question was about the 2009 – 2011 period. In reality the market did very well during that period with Nifty grew at a CAGR of 18% from 2009 to 2011 end.

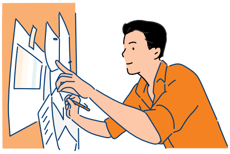
Availability bias causes you to lose objectivity and make wrong investment decisions, which harm your financial interests.

Source : Advisorkhoj Research

Examples of availability biases in finance

- The market crash due to Satyam scam is an example of availability bias. Satyam share price fell by 78% in a single day and Nifty (of which Satyam was a part of before the crash) fell by more than 6%. Even the broader market (midcap and small cap) fell 6 – 7%, even though Satyam was purely a case of financial mismanagement and not a systemic failure of the market. The Satyam scam should have affected only Satyam shareholders but it ended affecting all equity investors. It is an example of availability bias. Satyam was the headline on TV channels and investors were biased by it even though most investors had nothing to do with Satyam.

  Source : Advisorkhoj Research



- Buying a mutual fund whose advertisement you recently saw online or on print or electronic media. The advertised fund may be a good one but you need to do your own research and select a fund that is right for your investment needs.

- A family where one of the earning members has been unemployed for a period of time is more likely to feel pessimistic about the economy and stock market compared to a family which has been doing well financially.

- Buying life and health insurance in a pandemic outbreak. It is good that you buy more life and health insurance but you should not wait for a pandemic to get adequate insurance cover.

How to avoid availability bias

Cognitive biases like Availability Bias is one of the errors which humans are prone to. It affects not just our investment decisions but also clouds our judgment / opinions in other facets of life. Developing faculties of critical thinking and objective analysis is the best way to counter this bias. From an investing perspective, instead of denying the existence of Availability Bias, investor awareness and education is best way to overcome Availability Bias.

You should be open to educating yourself more about investments, about different asset classes, characteristics of asset classes, how different each asset class work, risk and return profiles of different asset classes, historical performance at different points of time, broad understanding of the economy, risks, opportunities and benefits in investing. You should also try to seek knowledge from different sources, not just one source because it can be biased. Acquiring knowledge should not be a one-time effort; you should be open to learning all your life. What is more important than acquiring knowledge, is applying it in important decisions, especially financial and investment decisions.

Topic 4:

Loss Aversion Bias

Loss aversion is a trait of investor behaviour wherein investors prefer to avoid a loss than to make an equivalent profit. Loss aversion is also known as Regret Aversion.

When faced with a choice of avoiding a loss of Rs 1,000 or making a profit of Rs 1,000, investors with loss aversion bias will prefer not making a loss to making a profit. Investors with loss aversion make often sub-optimal investment decision.

Loss Aversion versus Risk Aversion

It is easy to confuse between risk aversion and loss aversion because on the surface they appear to be the same. However, there is a difference between the two. Risk aversion is avoiding risks or the possibility of a loss; it gets reflected in their choice of investments. Risk-averse investors will prefer less risky investments e.g. fixed income over equity, large cap over midcap etc. Investors with loss aversion bias may not be necessarily risk averse; they often invest in risky assets. Loss aversion comes into play when investors are faced with uncertainties. The regret of a loss is far more than the satisfaction from an equivalent. According to behavioural economists, the psychological impact of a loss is twice that of same amount of profit.

Harmful effects of loss aversion

- Loss aversion causes investors to hold on to loss making stocks or funds for very long period. They refuse to sell a stock or fund at a loss and can hold on it for long periods of time even if there are better alternative investment options available.

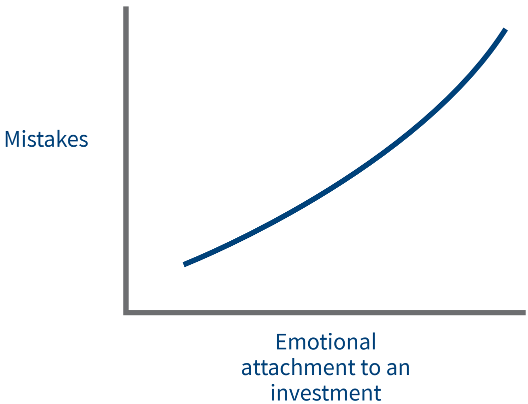
- Aversion for losses makes investors hold on to loss making stocks or funds till the loss is recovered. Ultimately, when the investor sells the stock or fund, a long time may have elapsed and the return on the investment is very low.

- There are also instances of investors holding on to loss making stocks/funds and then finally selling them at a much bigger loss than what they would have incurred if they sold earlier.

- Loss aversion is commonly seen in property/real estate investments. Investors refuse to sell their property at a loss and hold on to it hoping the investment will turn profitable someday. Throughout the holding period of the investment, they pay interest on their loans which could have been avoided if they sold earlier.

How to avoid loss aversion and conclusion

No one likes to make a loss, but loss aversion can cause you to lose more money or make less money than what you feared to lose. You can avoid loss aversion by not getting too emotionally involved in your investments. There are risks involved in investments, many of these risks are beyond your control and you cannot be right all the time. Sometimes, it is better to book a loss and move on to alternative investment options. It is difficult to separate emotions from investing, but successful investors are able to do it. A good financial advisor can help you overcome this behavioural bias. You should have a rational and objective portfolio performance evaluation process; take the help of a financial advisor if required. You should do what is right to meet your financial goals including selling funds that are underperforming consistently and switching to better funds.



Topic 5:

Information Bias

Information bias is the tendency to seek and evaluate information, even if it may not be irrelevant from the perspective of the investor's needs.

The traditional view on information related to investments and finance was that investors did not have sufficient information. Regulators tried to address this issue by asking AMCs to disclose all the relevant fund related information in the monthly fund factsheets. In addition to the AMCs, there are a number of third party research firms/analysts who provide information related to fund and stock performance to investors. The advent of internet and spread of broadband heralded the information age. Today, investors had much more information than before and this fuelled their thirst for more information.

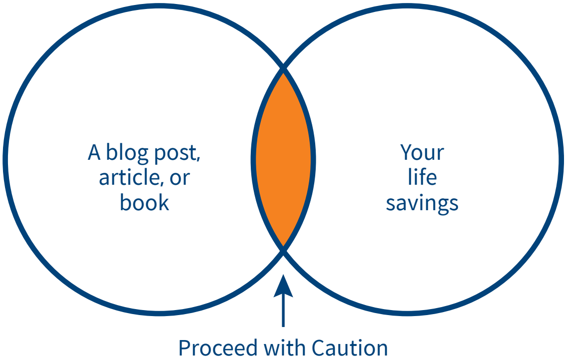
Through social media we are now being bombarded with new information almost every hour and sometimes every few minutes. Too much information can cause bias if you take all information which you receive very seriously without checking their veracity or even if it is relevant at all. If you have information bias in investing, you may get confused or even worse; make wrong investment decisions based on irrelevant information which harm your financial investments.

Information bias in investing

You should ask yourself, if some of the information you are getting is relevant at all. Information like daily NAV movement, 52 weeks high or low NAVs, best performing funds of the month etc. are useless in our view. Should you buy or sell a fund based on its last 7 days or 30 days performance? However, with interesting captions they are made to look as if it is very important information that you should pay attention. But mostly they are irrelevant or cause you to make wrong investment decisions.

Likewise, for mutual fund investors, top stocks bought or sold by fund managers every month is mostly not relevant. When you are investing in mutual funds, you rely on professional fund managers to do the stock selection because you do not have their expertise or experience. Top stocks bought or sold by fund managers can be an interesting article on the internet but is it really useful for you as a mutual fund investor in making investment decisions?

Another danger of information bias is investing in wrong product. There is a lot of content online almost on any topic. Let us suppose you want to buy life insurance. You will find a lot of information on insurance products which will also say "grow your investments". Though your objective was life insurance, because of the information overload, you can be distracted from your primary objective of getting adequate life insurance and lead you to a product which addresses neither your insurance nor investment needs optimally.



How to avoid information bias

- **Financial planning:** Financial planning with clearly defined financial goals and investment plans to achieve different goals can help you avoid information bias. Make sure that you are committed to your financial plan.

- **Know the fundamentals of investing:** Know what is important and what is not. You need to understand what will make your financial goals successful and filter out the unimportant information.

- **Do not track your portfolio on a daily basis:** It is important to monitor your portfolio regularly, but you not need to track it on a daily basis. Short term price movements have no impact on long term portfolio returns. If you track your portfolio on a daily basis, then you are likely to be prone to information biases.

- **Seek counsel before you react to information:** Information that you get every day or every hour usually has no bearing on longer term portfolio performance. If you want, you can seek more information about investments, but seek the guidance of a financial advisor before you act on the information you have. A lot of information you get daily may be totally irrelevant and can harm your financial interests, if you act on it without considering other factors.

Topic 6:

Confirmation Bias

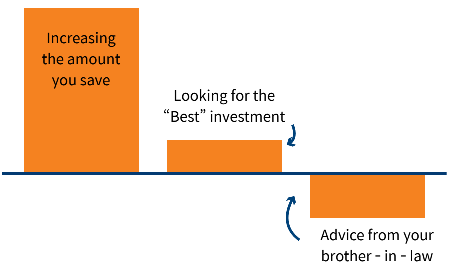
Investors have their own opinions or pre-conceived notions. Seeking information or opinions that supports their ideas or pre-conceived notions and ignoring information that is contrary to their pre-conceived notions is confirmation bias.

Confirmation bias is tested by a simple experiment. Investors are given 4 cards like the ones shown below. They are told that there is a letter or number on back of each card. Then they are asked to pick maximum 2 cards to test the hypothesis that “there will always be an even number of the back a card with a vowel”. Which 2 cards will you pick?

A	K	4	7

Most people pick up “A” and “4”. Having vowel behind “4” does not conclusively prove the hypothesis is right or wrong. At best you can say that hypothesis may be true. Instead if you picked 7 and found a vowel behind it, you would have conclusively said the hypothesis is wrong. Please remember this is not an intelligence test. It is a psychology test. When you were told that “there will always be an even number of the back a card with a vowel” you believed it to be true and try to confirm that it is true. This is confirmation bias.

This is like if a friend told you that Gold is always better than Equity and you look at last two-year asset class returns and feel confident about your friend’s opinion. You would ignore the period where Gold underperformed Equity.



Confirmation bias is seen in many aspects of life. For example, if you have a certain set of political beliefs, you would like to associate with friends you share your beliefs or like to follow political commentators, journalists or publications that affirm your belie . Similarly, if you like one sports team you will like to discuss about it with friends who support your team. People with confirmation biases are highly subjective and do not apply objectivity. This is harmful in investments.

How confirmation bias affects investment behaviour?

Confirmation bias is affirmation seeking behaviour. If you believe equity is risky then every time the market corrects 10% will be an affirmation while you ignore the periods when market was rising. Similarly, if you think FDs are better than debt funds, every time a bond gets downgraded or when yields rise and fund returns are impacted, you will seek to confirm your bias for FDs often ignoring other relevant information like returns of high credit quality funds, debt fund returns in favourable interest rate environments or tax efficiency of debt funds.

Another example of confirmation bias may be a personal preference for a particular fund manager or fund house. You will tend to compare the performance of the fund manager with peers who would have underperformed him/her and not compare performance with peers who would have outperformed.

Confirmation bias leads to overconfidence about your investment strategy. Confirmation bias cause bulls to remain bullish or bears to remain bearish even when the market is too high or too low. Confirmation bias can provide explanations as to why some stocks trade at completely unreasonable valuations relative to their intrinsic value or why it may sometimes trade even below book value. More often than not, confirmation bias leads to sub-optimal investment decisions or even wrong investment decisions.

How to avoid confirmation bias?

- Seek contrary opinions, even if those opinions may seem uncomfortable to you at first. Try to understand the rationale behind the contrarian opinions.

- Do not rely on just one source of information to form opinions about a product. Look at multiple sources of information.

- Knowledge is your biggest friend in overcoming investor biases. Increase your investment knowledge about different investment concepts, financial markets and the economy to make better investment decisions.

Confirmation bias is a psychological phenomenon which affects how we perceive things and make investment decisions. You should always be open to learning irrespective of what stage of life you are in.

Topic 7:

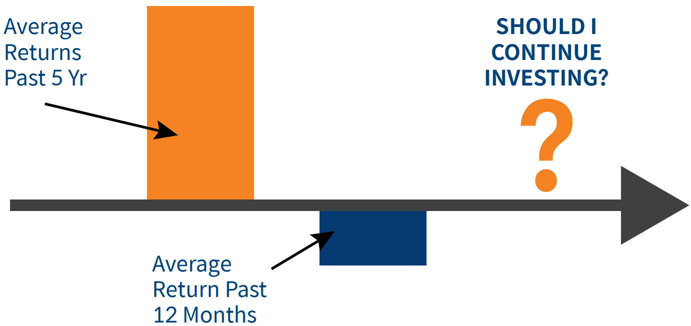
Recency Bias

Recency bias is a psychological phenomenon where we give more importance to recent events compared to what happened a while back.

For example, if you are asked to name 30 movies that you have seen there is likely to be a tendency of recalling movies you have seen in the recent 1 or 2 years more than movies you saw 10–15 years back. Recency bias is seen in many aspects of our lives. For example, it has been noted that in performance evaluations, managers tend to give more importance to last 3–4 months of work done by their employees rather than the performance over the entire year. Similarly cricket fans often judge a batsman or bowler based on his performance in the last series or the last ODI / T20 championship and not based on their long-term career statistics. Recency bias is also extremely common in investing.

Recency bias in investing

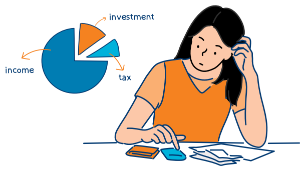
Recency bias is very common in investing; investors tend to give more importance to short term performance compared to long term performance. For example, an investor invests Rs 100,000 in a mutual fund. Over 5 years the market value of his investment grows to Rs 175,000. Then in the last three months, the value falls to Rs 150,000. The investor may look at his investment performance of as a loss of Rs 25,000 in 2 months and not an overall profit of Rs 50,000 in 5 years. This is recency bias. Investors often stay away from equities when market has fallen sharply when on the contrary, they should be investing because they can buy further at attractive prices. Recency bias clouds our judgment and is detrimental to our financial interests in the long term.



How to avoid recency bias

- **Understand how market works:** Equity markets always work in cycles. There are periods when prices go up (bull market) and there are periods when prices fall (bear market). Markets eventually recover from the lows and goes on to make a new peak, higher than the previous one. Rs 100,000 invested in the Sensex 20 years back, despite several bear markets, would have grown to Rs 881,000 (as on 30th July 2020).

  Source : Advisorkhoj Research



- **Invest according to your financial goals:** You should clearly define your financial goals and invest accordingly. You should have a financial plan to meet your different goals – short term, medium term and long term. You should always stick to your financial plan. Goal based investing will keep you disciplined and not get affected by recent events in the market.

- **Portfolio approach and asset allocation:** You should focus on the performance of your overall portfolio and not get too riled up by the short-term performance of one or two funds. Asset allocation is the most important factor in the performance of your portfolio. You should maintain your asset allocation and rebalance regularly to get the best portfolio performance according to your needs.

- **Consult a financial advisor in making investment decisions:** In turbulent times, often talking to a person who is knowledgeable and experienced about how market works can help you avoid recency bias. Financial advisors can be of great help in volatile markets. Talk to your advisor about concerns regarding your investments and seek his/her guidance.

Think of funds in your portfolio as players in your team and you as the captain. If you are the captain of a team will you drop players, who may have scored lots of runs or taken many wickets in the past or have great potential, but may have performed badly in one match or one series? There can be a number of reasons why your batsman or bowler underperformed. A good captain will try to understand the reasons for underperformance but he will never act impulsively based on short term performance.

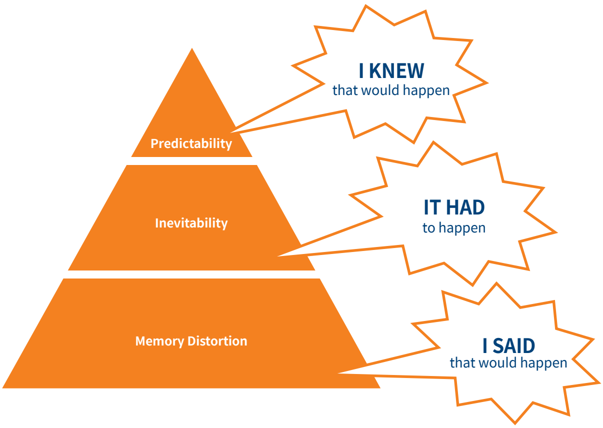
Topic 8:

Hindsight Bias

Hindsight bias is a psychological trait which leads to investors overestimating their predictive abilities.

Many pundits have claimed that stock market meltdowns like the dotcom bubble and global financial crisis of 2008 could have been predicated based on stock valuations. But the magnitude of these corrections was largely unexpected; if many people knew beforehand that stock prices would crash, then crash would not have been so severe, which means that the explanation of these crisis had the benefit of hindsight.

Three Levels of Hindsight Bias



Examples of benefits of hindsight

- Your favourite team is playing in the IPL final, needing 20 runs to win in the final over. Your team scores the required runs and wins the match. If you always knew that your team will win the match then you may be exhibiting hindsight bias. People who have played cricket know that scoring 20 runs in one over against a top bowler is a very difficult task. The batsmen would have simply taken their chances and got lucky. You are misinterpreting chance or luck with your predictive powers.

- Elections have taken place and opinion polls suggest a close contest. When the results are declared and the party you supported wins by a big margin. If you say that, you always knew that this party would win by a big margin then it is a case of hindsight. What if the party lost by a close margin?

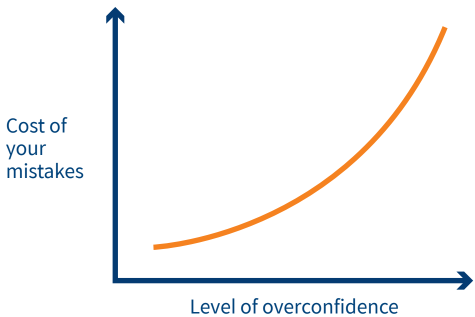
- You buy a stock. According to random walk theory of stock prices, the price can either rise or fall in the short term. The stock price rose and you made a handsome profit. Your profit was simply due to luck, not due to your ability to make great investment decisions.

In all the three examples, the results were favourable for you. But just because the results were what you wanted does not make you a cricket, political or investment expert. It was a matter of chance and you were lucky. Restricting ourselves to the domain of investments, you must realize that there is an element of unpredictability or randomness in price movements in general and price outcomes of different events. Beware of people you always claim that they knew what would happen. We are not saying that they are consciously lying or they are frauds; they have the behavioural trait of hindsight bias.

Negative effects of hindsight bias

People explain events post facto using the benefits of hindsight, but this bias leads people to believe that such events are more predictable than they really are. It can lead to the following negative consequences:-

- **Over-confidence:** Over-confidence in our investment knowledge or abilities can lead us to make risky investments or investments without doing the necessary homework.



- **Not be ready for unexpected outcomes:** Investors with hindsight bias tend to base their decisions on major events they have experienced. However, they may not be prepared for smaller events which also have an effect on investment returns. In investments you should be prepared for unexpected outcomes and plan accordingly.

- **Relying on memory instead of logical analysis:** People with hindsight bias rely on their judgement based on past experience. They rely more on their memory than rational, systematic and thorough analysis. This leads to wrong investment decision.

How to avoid hindsight bias

- **Be prepared for all outcomes including unpleasant ones:** There is an old saying, "Hope for the best, but plan for the worst". Do not expect that things will always go according to plan. Know your risk appetite and always invest according to it.

- **Asset Allocation:** People with hindsight bias are likely not to give importance to asset allocation because they believe that they are always right. Asset allocation on the other hand, helps you plan for risks and reduces the impact of risk events on your portfolio returns.

- **Increase your investment knowledge and apply it:** Understand risk profiles of different asset classes / sub classes, make a financial plan and investment according to your financial goals, instead basing your investment decisions on past events.

Topic 9:

Mental Accounting

Mental accounting is a behavioural trait which causes investors to ascribe different values to money coming from different sources or put in different uses using entirely subjective criteria.

For example - many investors save money to buy an expensive gadget or take an expensive vacation when they also have credit card debts. This is an example of mental accounting. Mental accounting is irrational and often detrimental to your financial interests. Money is money and cannot be categorized in mental buckets. By saving money to buy a gadget you are delaying your credit card debt repayment and incurring interest costs.

Examples of mental accounting

- **Treating bonus and salary differently:** Some people treat bonus and salary differently from a savings and investment standpoint due to mental accounting. Fundamentally, both bonus and salary are compensations for your work, but some people think of bonus as a gift to be spent on discretionary expenses like vacation, one-time purchases, discretionary items etc. If you are using your monthly savings to achieve your financial goals, the same principle should be applied for bonuses also.

- **Maturity proceeds from life insurance policies or PPF:** Some investors treat these as windfall gains, whereas these should also be investments made with a specific purpose. Do not have arbitrary parameters for different investments. Money is fungible – all the money you invest, whether through mutual fund SIP, insurance premiums, PPF deposits should have a specific purpose.

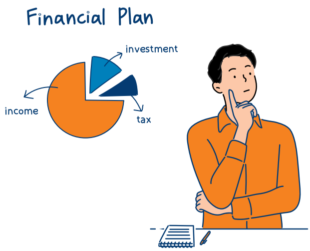
- **Notion of safety capital:** For some investors, there is money they cannot afford to lose, also known as safety capital and the money they can afford to lose, known as risk capital. Safety capital is usually deployed in risk free assets like FDs and risk capital is deployed. Segregating capital into safety capital and risk capital is pure mental accounting because you should never put money in an investment where you are likely to lose. There are assets with different risk / return profiles and you should

in assets of different risk categories according to your investment needs and risk appetites. If you treat a part of your assets as risk capital you may have tendency to speculate to get high returns or may be undisciplined about investing, both of which may be harmful for your financial interests. This mental segregation can also cause you to invest most of your money in very safe assets which will be detrimental to long your long term financial interests because you will get sub-optimal returns on your investments.

- **Sunk cost fallacy:** This is another form of mental accounting. You have paid the annual subscription fees of a stock advisory service. After sometime you realize that trading stocks is not right for you and that you should invest in mutual funds. However, since you have already paid for the service and they will not refund your money, you continue to trade based on their stock recommendations. In sunk cost fallacy, you somehow want to recover the money you have already spent and in the process risk losing more money. The best course of action in the example we discussed would have been write off the subscription fees as a loss and invest in the right instruments.

How to avoid mental accounting

- **Be more diligent about your finances:** Do not try to do mental calculations based on what you remember. Go through your bank statements, credit card statements carefully and list all your expenses on a spread sheet. Similarly, get statements of all the investments you have and insurance policies you have bought. Once you go through these you will have much clearer picture of your finances and get more organized.



- **Have a financial plan:** Define and quantify your short term, medium term and long term financial goals. List all your expenses - discretionary and non-discretionary, and incomes - monthly (salaries, rent etc.) and one-time (bonus, interest etc.). Build a savings and investment plan to meet each of your financial goals. It will help you avoid many mistakes that are caused by mental accounting.

- **Consult a financial advisor:** A financial advisor can help you build a financial plan and help you remain committed to it for the success of your goals. He can also provide objective opinions in case you need help in making decisions.

Conclusion

In this series of articles we have discussed some common behavioural biases which investors have. These biases are caused by our emotional reactions in different situations. Each investor is different and you may have different biases. In investments, it is in your interest to keep emotions under control. Even if you think that, you may not have these behavioural biases, it is important to recognize that they are fairly common among investors and try to introspect. We are humans and it is natural to have emotions.

You should remember that pre-conceived notions you have about investments is your enemy and knowledge is your friend. Keep emotions out of investing to the maximum extent possible. Remember what legendary Warren Buffet said about investment success – keeping emotions in control is far more important than Intelligence Quotient as far as investments are concerned.

An Investor Education Initiative

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