Heuristics Psychology and Investment Behaviour

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ABSTRACT: : *Investment decisions are of great relevance as it influences the results of investment and are often based on biases and heuristics. Based on the type and needs of investors their investment decisions will also vary. Heuristics as the common set of rules or principles usually followed by investors in their investment decisions to choose upon the suitable alternatives. Being considered as rule of thumb it does not provide optimal investment decisions but assists investors in making decisions based on the potential of problem solving. The present study mainly focuses on obtaining an understanding regarding heuristics psychology and investment behaviour, identifying the major types of heuristics. The study is theoretical in nature and the data for this study is mainly obtained from secondary source such as books, journals and articles.*

Key Words: *Heuristics, representativeness, availability, anchoring and overconfidence.*

Introduction

Heuristics theory are defined as the rule of thumb, which individual used in uncertainty situation to make decision simple and efficient (Tversky & Kahneman, 1974; Ritter, 2003). Heuristics is gaining momentum in investment decision making. The concept was popularised by the Nobel laureate Herbert A. Simon. Investors usually take decisions which are satisfying i.e. decisions which are good enough rather than optimal decisions. Decisions based on various types of heuristics represent the mental shortcuts used by investors in making decisions rather than following logic, probability and rationality. Heuristics psychology based decisions are almost irrational in nature. Heuristics based decisions may lead to errors as they are made on the basis of intuitions. Investors usually prefer heuristics for the purpose of making complex decisions. The problems are made less complex either by looking at only a single aspect of a problem or by ignoring the information related to the problem consciously or unconsciously.

Literature Review

(Venkatapathy & Sultana, 2016) made a study on the topic behavioural finance: heuristics in investment decisions. The major discussion in that study is about the influence of heuristics on investment decision of investors. A detailed discussion regarding different decision making models namely rational - economic model, administrative model, image theory and the various types of heuristics including representative heuristics, overconfidence heuristics and availability heuristics were made. The evolution of behavioural science from psychology and sociology is also discussed in this paper. (Gigerenzer, 2008) made a study on the topic why heuristics works and rejected the assumption that heuristics works mainly because of our cognitive limitations. This research paper discusses in detail about the various models of heuristics and examples of heuristics. From the examples stated in the study it is evident that majority of the investors are using 1/N rule of heuristics i.e. allocate your money equally to each of N funds than the models ensuring optimum return and minimum risk. The application of models of optimization along with heuristics will ensure an optimum outcome. People always follow ecological rationality while selecting heuristics and through this it is possible to know whether a specific heuristics will fail or succeed. Representativeness heuristics is the major type of heuristics and this may lead to irrational decision among investors. (Boussaidi, 2013) made an empirical study regarding representativeness heuristics and investors behaviour by obtaining data from Tunisian stock market for the period 1990 - 2010. Investors who are following representativeness heuristics in stock markets estimate that a particular stock will perform better on the basis of its past performance. This study mainly aims to identify whether there exist any relationship between past earnings surprises and future abnormal returns. The primary objective of this study is to know whether representativeness heuristics causes overreaction of the Tunisian stock market to the informational content of earnings. Variables used include unexpected earnings, investor sentiments and abnormal returns. The important statistical tools used in the study includes descriptive statistics, stationarity test, Granger Causality test for identifying whether representativeness affect investor sentiments, Cumulative Abnormal Returns(CAR) were calculated to evaluate the impact of past surprise on

the market reaction and autocorrelation among the values were also checked. The result of analysis indicates that there is only a partial association exists between past earnings surprises and future abnormal returns. Investors who are following representativeness heuristics may overreact on the basis of past information and which may represent an irrational behaviour. Behavioural finance explains the relationship between heuristics and the investment performance of individuals. Availability and representativeness is the strongest predictor of investment performance, followed by fundamental anomalies. Overconfidence is also a positive predictor of investment performance of individuals followed by fundamental anomalies (Farooq, 2017). (Sarin, 2017) made a comprehensive study on an understanding of role of heuristic on investment decisions and found that Kahneman and Tversky seem to be ones of the first writers studying the factors belonging to heuristics when introducing three factors namely representativeness, availability bias, and anchoring (Kahneman & Tversky, 1974, p.1124-1131).The study was based on secondary information and it stated that at some decision points, the gathering of information by decision model could result in long time delays and high costs, and, if decision errors are "cheap", it is acceptable to sacrifice decision quality and choose a simpler, fast, and less expensive evaluation method. (Iqbal, Hussain, Latif, & Aslam, 2013) tried to identify the relationship and link between investor behaviour and financial market anomalies. The study also revealed that the most compelling factors behind stock market anomalies are investor overconfidence, overreaction, overestimation, investors biased behaviour and investor's less sophistication level. Therefore, it may be inferred that investor behaviour forms stork market anomalies.

Objectives of the study

- To obtain an understanding regarding heuristics psychology and investment behaviour.
- To identify the different types of heuristics behaviour adopted by investors.

Data and Methodology

The study is theoretical in nature and the information is collected from secondary source such as books, journals and articles.

History of Heuristics

The concept of heuristics was initially suggested by the Nobel Prize winning psychologist Herbert A. Simon in 1950's. The real or practical applications of heuristics by investors are classified under three and were popularised by Amos Tversky and Daniel Kahneman. Investors will make investment decisions based their past experience, perceptions etc. due to lack of availability of time and information. And such decisions enable them to avoid constantly thinking about the next course of action to be undertaken by them. As a result majority of the investors apply heuristics in investment decision making. Later on various behavioural scientists argued that the application of heuristics in investment decisions may lead to irrationality and errors. Eventhough investors are practising heuristics for finding solution for complex problems.

Role of Heuristics in Investment Decision Making

Heuristics represent the mental short cuts used by investors in making complex decisions. The solutions obtained through applying heuristics may not be optimal or it may lead to some biases or errors. It is automatically used by the investors due the insufficiency of time and information. It can be applied for solving problems systematically and may provide exact solutions. Heuristics is applied carefully by the investors on the basis of intuition, past experience and preconception. Exactly speaking a trial and error method is applied by irrational investors while making decisions using heuristics. This irrational investment decision making method enables investors to make timely decisions. But can be considered as an intelligent guess work and sometimes may be prone to errors, biases, irrationality and loss to the investors.

Findings of the study

Types of heuristics on investment decisions are as follows:

- **Representativeness**

Representativeness refers to the likeness of an event with its population. In case of investment it refers to the decisions taken by investors on the basis of certain stereotypes. In such case investors may consider past earnings of the stock as a trigger to future growth. Past events or traits are used as the base for decision making instead of complex calculations. Here the past events are used as the representatives of the present scenario. There are four variant of representative heuristics and they are ignorance of sample size, base rate neglect, conjunction fallacy, innumeracy (Bhatia Sarin, 2017).

For example an investor identified that the stock price of XYZ Steel is increasing at a random pace and recently XYZ moved to FMCG section. Then the investor decides to invest in XYZ FMCG on the expectation that the company will outperform in the future on the basis of past performance history of XYZ Steel. Here the investor is not applying any calculations. He simply relies on the past performance shown.

- **Availability**

It refers to the investment pattern of investors to invest in securities which are familiar to them or they can easily recollect or obtain information which inspires them to put their money in local securities or stocks instead of following specific principles or rule of thumb.

- **Anchoring and Adjustment**

Anchoring and adjustment refers to the investments which are based on certain initial estimates. People follow this practise may be due to the uncertainty of true value or due to cognitive laziness.

- **Overconfidence**

Overconfidence heuristics is applied by persons who are highly confident about their subjective judgement capability than that of others. Investors who are highly confident about their precision in knowledge and judgement capacity will adopt this for investment decision making and for predicting the future of investment avenues. Overconfidence has been defined in three distinct ways: overestimation of one's actual performance, over placement of one's performance relative to others and over precision in expressing unwarranted certainty in the accuracy of one's beliefs.

Conclusion

Investment decisions are most often depends on heuristics psychology and biases rather than complex investment models. The present study has made an enquiry into the history of heuristics psychology and investment behaviour and has identified the major types of heuristics on investment decisions based on the secondary information collected from secondary information sources. Through the study it has been found that representativeness, anchoring, availability and overconfidence are the major factors influencing investment decisions among the other factors such as overreaction, overestimation, investors biased behaviour and investor's less sophistication level.

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