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INDIVIDUAL INVESTORS PREFERENCES AND BIASES IN CAPITAL MARKET INVESTMENT

by

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ABSTRACT

Savings and investments play a key role in achieving economic growth and overall development of a nation. India in its march towards development has a healthy household savings, a robust developing economy and strong and developed financial markets. But, it has been noted that majority of the investors, especially those in Kerala are reluctant in using capital markets for their investments. In this regard, it is essential to generate a profile of these individual investors, the structure of their savings and investment and their preferences and motivations. In this direction, a study with the objective of understanding the preferences of individual investors and the factors that are influencing their investment decision in capital market was carried out. A structured questionnaire was distributed among investors of two districts in Kerala state and the data thus collected was analysed. From the data it is inferred that investment community is dominated by people who are male, middle aged, graduates or above and private or self employed. It is seen that while factors like, past performance of the share, Government/Political decisions and affordable share price significantly influence decision making of investors, factors such as recommendations of brokers, friends and family, coverage in press were considered to be least influencing. It is also seen that behavioural biases like overconfidence, conservatism bias and self-attribution influence the investors while making their investment decisions.

KEYWORDS: Investor perceptions, preferences, behavioural finance.

INTRODUCTION

It is considered that the need for greater understanding and careful monitoring of the financial sector is essential for designing policies for sustaining high rate of economic growth and stability. Savings rate of a country is very important for economic growth as it a catalyst for growth. India's savings performance has been quite impressive in a cross-country context (Table 1). India's gross domestic savings rate in the recent period is comparable to Indonesia, Thailand and Korea, much lower than that of China, Malaysia and Singapore but much higher than that of many other emerging and advanced economies. Households and individual investors supply a pool of capital that creates liquidity in the market and make it dynamic.

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Country	Rate (percentage of GDP)
India	32
China	46
Korea	35
Pakistan	14
Brazil	16
Mexico	19
Russia	23
Japan	25
Unites States	18
United Kingdom	12
World	25
Source: World Bank Report	

Thus, household income, its consumption and its distribution are fundamental to any economic analysis. These determine the nature and rate of saving in an economy which, in turn, implies the rate of economic growth.

CAPITAL MARKET INVESTMENT

In India, since the 1970s, the allocation of household savings between financial assets and physical assets had been progressively moving in favour of the former, with the notable exception of the first half of the 2000s. The allocation became almost evenly balanced during the second half of the 2000s. The composition of (changes in) the gross financial assets of households has also changed substantially over the years (Table 2).

Period	Currency	Bank Deposits	Non-banking deposits	Life insurance funds	Provident fund and pension fund	Claims on Govt.	Shares and debentures	Units of UTI	Trade debt (Net)	Gross Financial Assets
1970s	13.9	45.6	3.0	9.0	19.6	4.2	1.5	0.5	2.7	100
1980s	11.9	40.3	4.6	7.5	17.5	11.1	3.9	2.2	0.9	100
1990s	10.3	34.7	6.8	10.1	18.8	9.5	7.0	3.8	-1.0	100
2000s	9.6	44.7	1.3	17.4	12.4	11.1	4.1	-0.5	0	100
Source: RBI Report										

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The capital market plays an important role in the development of the country for mobilizing and allocation of domestic and foreign savings. It plays crucial role to channelize the savings from household sector of the country, which in turn enhance the capacity of the economy to produce goods and services to society. Therefore capital market plays a very crucial role in stimulating industrial growth as well as economic growth and development. This market consists of primary and secondary segments, segments that deal with new issues of securities and that which trade in the existing securities, respectively. As seen from Table 2, in India, while bank deposits continue to dominate the savings pie, life insurance funds and provident and pension funds follow with minor shares. It can be seen that shares and debentures as an asset class has not been able to attract enough of the household saving as per its capability. This is an aspect that needs further analysis as it has an untapped potential to attract investments from household which in fact will be instrumental for increasing the gross domestic savings of India. In this regard it is considered essential to study the investment behavior of individual investors in order to understand their characteristics and preferences, which will help in formulating strategies that would attract new investors into capital market.

The global economy is on a recovery path after the shocks of the severe financial and economic crises of 2008 and 2009. The Indian financial sector was also struck by these global shocks, but had been able to withstand these shocks to an extent. It has to be noted that unlike past, during recent times shocks originating from a single markets is not only impacting the domestic market but also all global markets. This is due to the reason that the financial markets are getting globally integrated; they are increasingly exposed to macroeconomic shocks that affect markets on global scale. The equity markets have been characterized by increasing volatility and fluctuations. The market is so volatile that its behavior is unpredictable. It has been seen in the past couple of years, that the movement of share prices has exceeded all the limits and had gone remarkably low and high. This has been a concern and has affected all the participants in this market including individual investors and institutional investors.

Individual investors are those who trade in stocks and other securities for their personal portfolios, as opposed to institutional investors, such as mutual funds, insurance companies etc...who trade through their corporate portfolios. In all the stock markets in the world individual investors as a category exhibit certain strong patterns in their trading activities (Sankar, 2010). First, they are typically the biggest players in the market, and second, they almost consistently lose to other categories of investors, especially the institutional investors. With respect to Indian market Sankar(2010) finds that individual investors account for not only a larger number of investors (account holders) and a larger number of trades, but also a larger volume of trades in rupees than all other categories of investors, including institutional investors. He also finds that individual investors as a category have been the biggest loser in the market. This being the case it is necessary to understand the trading behavior of these individual investors who constitute the majority of the participants in the market.

Similarly, even when they are making losses, why do individual investors not learn from their poor records and slow down their trading activities, if not stop them altogether? “Rational” reasons cannot explain their trading behaviour. However, this behaviour has tremendous implications for the brokerage houses who execute the trades placed by individual investors,

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the stock exchanges where the trades happen and which are, consequently, responsible for keeping the markets smooth and orderly, and the regulatory authorities who are charged with the task of protecting the investors from stock price manipulations and frauds. Despite the importance of individuals' trading behaviour, however, we know little about the factors that influence them. Thus understanding the behavior of individual investors is important for all involved with these markets from participants to the regulators. Taking this into consideration, this article is based on a study of individual investors, intends to understand the preferences and behavior of individual investors. This study was conducted among individual investors of Malappuram and Calicut districts of Kerala state.

LITERATURE REVIEW

Investors employ a range of practices in different markets and use various techniques for market forecasting while making investment decisions. In conventional financial theory, investors are assumed to be rational wealth maximisers, following basic financial rules and basing their investment strategies purely on the risk-return consideration. During the second half of the 20th century exploiting the full potential of mathematical probabilistic and optimisation models and techniques the field of finance changed from a descriptive discipline to a modern science. This led the academic community to the construction of theories and models such as portfolio optimization theory, the Capital Asset Pricing Model(CAPM) and the Efficient Markets Hypothesis(EMH) (Andrikopoulos, 2007). Throughout history, theoretical and empirical evidence explaining market movements have been almost entirely influenced by the CAPM and EMH. The standard equilibrium models of asset pricing (CAPM) assume investors only care about asset risks if they affect marginal utility of consumption and incorporate publicly available information to forecast stock returns as accurately as possible (EMH) (Camerer & Loewenstein, 2002).

Latter on it was found that the traditional finance theories which assume that investors are rational have been unable to explain the behavior and pricing of the stock market completely. The question is how efficient is the Efficient Market Hypothesis? The occasional errors of these models were accounted for as anomalies. But as time passed on, the number of anomalies increased and so did their impact on the markets fluctuations (Phung, 2008). All of a sudden there was the January effect, the Weekend effect, the Small Firm effect and the Holiday effect – to mention a few. As more and more anomalies were recorded, scholars began wondering whether the traditional finance theories were incapable of explaining what determines security prices (Shefrin, 2000). For an investor, the volatility of markets has led to increased uncertainty and unpredictability, as market conditions cannot be judged with the help of standard financial measures and tools. These dramatic changes in prices of the shares, throw doubt on the concept of intrinsic value and rational investment behavior. The traditional models fail to explain the past adequately, or predict the future reliably. Largely as a result of these failures, scholars have started to look beyond fundamentals to the role of other “non-fundamentalist” influences on investors.

Expected utility theory views individual investment decision as a trade-off between immediate consumption and future one. Individuals maximise their utility based on classic wealth criteria making a choice between consumption and investment though time. Individuals do not always

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follow the classical theory of economics and we will have to look for some other sources to understand their investment behaviour. Behaviourial fiancé could be one of these sources.

BEHAVIOURAL FINANCE

Behavioural finance is a new paradigm of finance, which seeks to supplement the standard theories of finance by introducing behavioral aspects to the decision-making process. It deals with individuals and ways of gathering and using information. Behavioral finance explores the psychological factors affecting investment decisions; it attempts to explain market anomalies and other market activity that is not explained by the efficient market hypothesis. The concept of behavioral finance takes into consideration a range of psychological variables and how the resulting emotional reactions of these variables can impact both personal and general economic conditions, the concept seek to explain what occurs when emotional responses are involved in decision making. There are many concepts or the type of factors that are normally considered by behavioral finance theorists to influence decision making. In this study we are concentrating only on a few of them and how they are influencing the individual investor's decisions.

Recent theories of Investment behavior show that investors do not behave rationally, rather several factors influences the investment decision. In this regard Mittal and Vyas (2008) have explored the relationship between various demographic factors and the investment personality exhibited by the investors. Empirical evidence suggested that factors such as income, education and marital status affect an individual's investment decision. Kannadhasan (2006) examined the factors that influence the retail investor's decision in investing. He found that the decisions of the retail investors are based on various dependent variables viz., gender, age, marital status, educational level, income level, awareness, preference and risk bearing capacity. Mittal and Vyas (2007) have investigated and found that investment choices were affected by the demographics of the investors. The salaried class preferred to invest their money in equities and mutual funds while business classes have shown an inclination to invest their money in debenture/bonds and real estate/ bullions.

In studies on overseas markets, Sung and Hunna (1996) have found that education is also an important factor to evaluate the risk- tolerance ability of an individual. Lewellen at el. (1977) found that age, sex, income and education affect investor preferences for capital gains, dividend yield and overall return. Hussein (2006) identified the factors influencing the UAE investor behavior, six factors were found to be influential. While the most influencing factors were expected corporate earnings, get rich quick attitude and past performance of the stocks. On the other hand, factors like expected losses in international financial markets, family member opinion, gut feeling about the economy were found to be least influencing. Cohn et al. (1975) provided tentative evidence that risk aversion decreases as the investor's wealth increases, Riley and Chow (1992) showed that risk aversion decreases not only as wealth increases, but also as age, income and education increase. Baker and Haslem (1974) contended that dividends, expected returns and the firm's financial stability are critical investment considerations for individual investors

RESEARCH METHODOLOGY

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Individuals have become increasingly active in financial markets and market participation has greatly been promoted by invention of new financial products (Rooij et.al. 2007). This study examined the factors that appear to exercise the greatest influence on the individual stock investors while making their investment decisions. The study includes factors investigated by previous studies, those derived from prevailing behavioral finance theories and additional factors generated through discussion with investors. This study was conducted with the following objectives

OBJECTIVES OF THE STUDY

1. To identify the factors that influence individual investors in capital markets.
2. To study the demographic characteristics of individual investors in capital markets.
3. To understand the influence of various behavioural biases on investments in capital markets

DATA AND METHODOLOGY

This paper is based on a study conducted among investors of Malappuram and Calicut districts of Kerala state. The sample for the study consists of one hundred and fifty individual investors. The data was collected using a structured questionnaire consisting of three sections. While the first section had questions to understand the demographic details of the investors, the second section had questions to understand the objectives, preferences and factors influencing the investors and the third section dealt with the biases. In the second part, participants were asked to evaluate the importance of 24 variables, identified from the literature and discussion with investors that are considered as potentially influencing stock investment decisions. Respondents were asked to mark only one of the three choices for every one of the 24 variables: “Very important”, “Slightly important”, and “Not important”.

RESULTS

The data collected through the questionnaire was analysed and regarding the demographic characteristics the following were inferred.

Gender: It was found that the female investors were negligible, with them constituting only 6 percent of all investors. This has to be taken into consideration because if female investors are attracted into the capital markets then it would result in large increase in investment in this market.

Age: It is found that majority of investors in capital markets are in the age group of 25 to 35 years, those in this age group form 46 percentage of the investors. This is followed by 32 percent of investors whose age is less than 25 years. Those more than 35 years of age constitute only 22 percent. From this it can be inferred that the investors in capital markets are mostly young people.

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Table 3: Average annual savings per household

Age of Chief Earner of Household (in years)	Average Annual Savings per Household (in Rupees)
Less than 25	8,515
26-35	13,465
36-45	15,522
46-55	20,444
56-65	21,196
More than 65	17,011
Average	16,139 ⁵

Source: Max Life New York - NCAER Survey (2007)

It can also be seen from Table 3 that average annual savings in India is more in the case of households with age more than 46 years, but investors in capital market in this age group is very small. So if capital market investments are to be enhanced, investors with age more than 45 years have to be attracted to this market.

Education: It is seen from the study that majority of the investors are educated with graduate or post-graduate degrees. This shows that educated people more attracted towards the capital market.

Occupation: From the study it is seen that majority of investors are privately employed or do their own business. Only very same investors are employed in the government.

Objective of investment: Majority of the investors consider short term capital gain as important objective which shows that these investors enter capital markets with an intention of making faster returns. It is also seen that dividend income is only slightly important. Majority of investors do intra-day trading.

Risk taking: It is also seen that majority of investors are ready to take average or above average risk, only a very few of the investors are not ready to take risk. This shows that most of the people entering capital markets are ready to take risk and thus expect higher returns.

TABLE.4: VARIABLES THAT SIGNIFICANTLY INFLUENCE INVESTOR DECISIONS

RANK	ITEM	PERCENTAGE
1	Past performance of the share	64%
2	Govt./Political decisions	64%
3	Affordable share price	60%
4	Risk minimization	56%
5	Current economic factors	56%
6	Fluctuation in international markets	56%
7	Firm status in the industry	50%
8	Condition of finance statements	48%
9	Fluctuation in SENSEX/NIFTY	48%
10	Products/Service of the firm	44%

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Table 4 ranks the variables which significantly influence investors when making stock purchases. For investors, past performance of the share, government/ political decisions are the most important variables that influence their decision making. Also factors like share price, risk and economic situation also influence their decision making. The other important factors are given in the table 4.

TABLE.5: VARIABLES THAT LEAST INFLUENCE INVESTOR DECISIONS

RANK	ITEM	PERCENTAGE
1	Recommendations from brokers	36%
2	Recommendations from friend/family	34%
3	Coverage in press	32%
4	Attractiveness of non-share investments	26%
5	Information from news paper	24%
6	Perceived ethics of the firm	20%
7	Reputation of the firm	20%
8	Ease of obtaining borrowed funds	20%
9	Diversification needs	20%
10	Recommendations from investment analysts	18%

Table 5 ranks the variables which respondents ignore when making stock purchases. It is seen that experienced investors rely mostly on wealth maximization criteria and they are self-reliant ignoring inputs of family members, politicians, and co-workers when purchasing stocks. The other major least influencing factors are given in the table 5.

With respect to the behavioural biases exhibited by the investors, the study reveals the following.

Overconfidence: Overconfidence refers to the habit of overestimating own ability to perform in given tasks. People tend to be overconfident about own capabilities and level of knowledge. Overconfidence can be summarized as unwanted faith in one’s intuitive reasoning, judgments, and cognitive abilities. In short people think that they are smarter and have better information than they actually do. In this study on the individual investors, it is found that about 83% of participants rate themselves as average or above average with respect to their investment skills. This shows that vast majority of the participants are highly confident or overconfident about their investment skills. The existence of overconfidence among investors in financial markets have been demonstrated by many studies (Barber and Odean, 2000). According to Shiller (2000) overconfidence, however generated, appears to be a fundamental factor promoting the high volume of trade we observe in speculative markets. Without such overconfidence, one would think that there would be little trading in financial markets. According to Lewellen et al (1977) overconfident investors trade more. Barber and Odean (2000) are of the opinion that overconfidence causes excess trading which can be risky to financial well being. Similarly in the Odean (1998) framework, it is found that overconfident investors believe that they have superior information even when this is not actually the case. The overconfidence hypothesis predicts that such investors will trade more, thereby reducing their returns.

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Overconfidence and Age: In this study a correlation was run between age of the investors and overconfidence. The results did not give any significant correlation, so it can be concluded that there is no relationship between age and overconfidence. This is in tune with the findings of Salma & Ezzeddine (2008) who in their study of Tunisian investors have found that age and income are not significantly related to confidence.

Overconfidence and investment experience: This study finds there is a perfect positive correlation between experience and confidence. According to Kathleen Byrne (2005), risk and investment experience tend to indicate a positive correlation and past experience of successful investment increases investors tolerance of risk.

Conservatism bias: Conservatism bias means that investors are too slow (too conservative) in updating their beliefs in response to recent evidence. This means that they might initially under react to news about a firm, so that prices will fully reflect new information only gradually. Such a bias would give rise to momentum in stock market returns (Bodie, Kane and Marcus, 2005). From this study, when the investors were asked what they would do in case of negative news with respect to an investment they have made, only 19% of the participants are ready to re-evaluate their decision. Majority of the investors are willing to continue with their investments. This shows the conservatism bias, the investors are too slow (too conservative) in updating their belief in response to recent evidence. Generally conservatism is a mental process in which people cling to their prior views or forecasts at the expense of acknowledging new information.

Self-attribution: Self-attribution bias occurs when people attribute successful outcomes to their own skill but blame unsuccessful outcomes on bad luck (Shefrin, 2000). In this study it is found that only 13% of the investors who participated in the study attribute their misjudgement of the market for making losses. The remaining majority attribute factors external to them for the bad investment decisions. This indicates self-attribution bias on the part of the investors. This has been observed by many researchers in various markets and is considered a source of investor overconfidence (Hsu, 2010).

CONCLUSION

This article discusses a study conducted among the investors in Malappuram and Calicut districts of Kerala state to understand the factors influencing the behaviour of the individual investors and its impact on their investment decisions. This study has only considered only few factors and it is found that the investors studied are influenced by these factors and are in line with studies done elsewhere in other markets. These behaviours exhibited by the investor's surveyed show that they need not act rationally while making investment decisions, as considered by traditional financial theories like Efficient Market Hypothesis. There are many more aspects which need to be studied which can be done by other studies.

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