

In the following section, we'll explore the balance five key concepts (the first three covered in Part 1) that pioneers in the field of behavioural finance have identified as contributing to irrational and often detrimental financial decision-making. As you read through them, consider whether you've fallen prey to some of these biases.

**Key Concept No. 4: Gambler's Fallacy:**

When it comes to probability, a lack of understanding can lead to incorrect assumptions and predictions about the onset of events. One of these incorrect assumptions is called the gambler's fallacy. In the gambler's fallacy, an individual erroneously believes that the onset of a certain random event is less likely to happen following an event or a series of events. This line of thinking is incorrect because past events do not change the probability that certain events will occur in the future.

For example, consider a series of 20 coin flips that have all landed with the "heads" side up. Under the gambler's fallacy, a person might predict that the next coin flip is more likely to land with the "tails" side up. This line of thinking represents an inaccurate understanding of probability because the likelihood of a fair coin turning up heads is always 50%. Each coin flip is an independent event, which means that any and all previous flips have no bearing on future flips.

**Gambler's Fallacy In Investing**

It's not hard to imagine that under certain circumstances, investors or traders can easily fall prey to the gambler's fallacy. For example, some investors believe that they should liquidate a position after it has gone up in a series of subsequent trading sessions because they don't believe that the position is likely to continue going up. Conversely, other investors might hold on to a stock that has fallen in multiple sessions because they view further declines as "improbable". Just because a stock has gone up on six consecutive trading sessions does not mean that it is less likely to go up on during the next session.

**Key Concept No.5: Herd Behaviour:**

One of the most infamous financial events in recent memory would be the bursting of the Internet bubble. However, this wasn't the first time that events like this have happened in the markets. How could something so catastrophic be allowed to happen over and over again?

The answer to this question can be found in what some people believe to be a hardwired human attribute: herd behaviour, which is the tendency for individuals to mimic the actions (rational or irrational) of a larger group. Individually, however, most people would not necessarily make the same choice.

There are a couple of reasons why herd behaviour happens. The first is the social pressure of conformity. You probably know from experience that this can be a powerful force. This is because most people are very sociable and have a natural desire to be accepted by a group, rather than be branded as an outcast. Therefore, following the group is an ideal way of becoming a member. The second reason is the common rationale that it's unlikely that such a large group could be wrong. After all, even if you are convinced that a particular idea or course of action is irrational or incorrect, you might still follow the herd, believing they know something that you don't. This is especially prevalent in situations in which an individual has very little experience.

In many cases, it's tempting for a money manager to follow the herd of investment professionals. After all, if the aforementioned gimmick pans out, his clients will be happy. If it doesn't, that money manager can justify his poor decision by pointing out just how many others were led astray. While it's tempting to follow the newest investment trends, an investor is generally better off steering clear of the herd. Just because everyone is jumping on a certain investment "bandwagon" doesn't necessarily mean the strategy is correct. Therefore, the soundest advice is to always do your homework before following any trend.

Just remember that particular investments favoured by the herd can easily become overvalued because the investment's high values are usually based on optimism and not on the underlying fundamentals.

**Key Concept No.6: Overconfidence:**

In a 2006 study entitled "Behaving Badly", researcher James Montier found that 74% of the 300 professional fund managers surveyed believed that they had delivered above-average job performance. Of the remaining 26% surveyed, the majority viewed themselves as average. Incredibly, almost 100% of the survey group believed that their job performance was average or better. Clearly, only 50% of the sample can be above average, suggesting the irrationally high level of overconfidence these fund managers exhibited. As you can imagine, overconfidence (i.e., overestimating or exaggerating one's ability to successfully perform a particular task) is not a trait that applies only to fund managers. Consider the number of times that you've participated in a competition or contest with the attitude that you have what it takes to win - regardless of the number of competitors or the fact that there can only be one winner.

Keep in mind that there's a fine line between confidence and overconfidence. Confidence implies realistically trusting in one's abilities, while overconfidence usually implies an overly optimistic assessment of one's knowledge or control over a situation.

Keep in mind that professional fund managers, who have access to the best investment/industry reports and computational models in the business, can still struggle at achieving market-beating returns. The best fund managers know that each investment day presents a new set of challenges and that investment techniques constantly need refining. Just about every overconfident investor is only a trade away from a very humbling wake-up call.

#### **Key Concept No.7: Overreaction and the Availability Bias:**

One consequence of having emotion in the stock market is the overreaction toward new information. According to market efficiency, new information should more or less be reflected instantly in a security's price. For example, good news should raise a business' share price accordingly, and that gain in share price should not decline if no new information has been released since. Reality, however, tends to contradict this theory. Oftentimes, participants in the stock market predictably overreact to new information, creating a larger-than-appropriate effect on a security's price. Furthermore, it also appears that this price surge is not a permanent trend - although the price change is usually sudden and sizable, the surge erodes over time.

According to the availability bias, people tend to heavily weight their decisions toward more recent information, making any new opinion biased toward that latest news. Perhaps the most important lesson to be learned here is to retain a sense of perspective. While it's easy to get caught up in the latest news, short-term approaches don't usually yield the best investment results. If you do a thorough job of researching your investments, you'll better understand the true significance of recent news and will be able to act accordingly. Remember to focus on the long-term picture.

#### **Key Concept No.8: Prospect Theory:**

Traditionally, it is believed the net effect of the gains and losses involved with each choice is combined to present an overall evaluation of whether a choice is desirable. Academics tend to use "utility" to describe enjoyment and contend that we prefer instances that maximize our utility.

According to prospect theory, losses have more emotional impact than an equivalent amount of gains. For example, in a traditional way of thinking, the amount of utility gained from receiving Rs.50 should be equal to a situation in which you gained Rs.100 and then lost Rs.50. In both situations, the end result is a net gain of Rs.50.

However, despite the fact that you still end up with a Rs.50 gain in either case, most people view a single gain of Rs.50 more favourably than gaining Rs.100 and then losing Rs.50.

Prospect theory also explains the occurrence of the disposition effect, which is the tendency for investors to hold on to losing stocks for too long and sell winning stocks too soon. The most logical course of action would be to hold on to winning stocks in order to further gains and to sell losing stocks in order to prevent escalating losses.

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