Factors affecting Investment Decision making & Investment Performance among Individual Investors in India

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Abstract:

Purpose: Investments are made to earn returns and capital appreciation to overcome uncertainty in future. Decision making for investing involves biases which has an impact on the performance of investments.

Objective / Methodology: The main objective of this paper is to study the impact of psychological biases, spouse effect and level of engagement in investment decision making and investment performance through review of literature from secondary sources like Journals, magazines & periodicals.

Findings: The findings of the literature review indicates the mediating effect of level of engagement and the moderating effect of spouse effect on investment decision making and investment performance. Investment advisors must frame strategies depending on these factors to ensure better investment decisions. This research paper is the first of its kind to include spouse effect and level of engagement in the role of mediating and moderating effects in decision making and investment performance.

Implications: This paper provides insights to the professionals and service providers to substantiate effective investment strategies for the investors.

Key words: Behavioural biases, level of engagement, spouse effect, decision making and Investment performance

Paper type: Literature review
1. **Introduction:**

Traditional finance states that Humans act rational. They try to maximise utility by selecting the best option among the available alternatives (von Neumann and Morgenstern, 1944) in times of uncertainty (Kumar & Goyal, 2015) Efficient market hypothesis states that markets are efficient and prices reflect all the available information (Fama, 1970) But this is in contradiction with the reality. Humans tend to behave irrational while making investment decisions. Behavioral finance tries to find out the causes for such irrational behavior among individuals. Behavioral finance focuses on the psychological aspects of why such irrational behavior arises among individuals. It is assumed that psychological biases has an influence on investment decision making which leads to less returns (Kumar & Goyal, 2015) It is also found that lack of information and memory errors has an impact on irrational decision making (Simon, 1956)

Empirical evidences identified various psychological biases and its impact on decision making. But the mediating effect of level of engagement in trading activities in stock market and the moderating effect of spouse effect in decision making has not yet been explored earlier. This paper tries to find out the impact of the mediating and moderating effect of level of engagement and spouse effect in relation to the psychological biases like overconfidence, familiarity and anchoring in investment decision making and its performance.

2. **Behavioural biases, Investment Decision making & Investment performance**

Individuals tend to make decisions using past experience, intuition or rule of thumb to avoid information processing, due to which they earn poor returns in the long run (Jain et al., 2015). The individual behaviour differs over time and situation due to certain behavioural biases (Hossain Nasrin, 2012). The influence of such biases are discussed below (T.Karthigaipriya et al 2014).

2.1 **Overconfidence**

Overconfidence refers to the over estimation of one’s own ability (Hsin_Hue Chang, 2010) to achieve his/her goals by under estimating the future uncertainty. (Fabre & Francois –Heude, 2009) Over confidence bias occurs when an individual believes that his/her judgment to be more reliable than others (Jain et al., 2015) Empirical evidences shows that Generally men exhibit more confidence than women (Barber & Odean, 2001), nearly 40% of investors exhibited overconfidence in stock markets (Allan & Evans 2005) over confident investors over react to market information (Barber & Odean, 1999; Daniel et al., 1998) and stick to in accurate prediction about the stock market (Tongren & Montgomery, 2004) There exists a positive relationship between information search and overconfidence bias (Kumar & Goyal, 2016)

2.2 **Familiarity**

In the absence of required information, the neural connections in the brain processes information through shortcuts, to achieve a desired objective. Past experience is used to process such information. It was found that individuals who buy houses compare the price of
other houses which are familiar to them in the nearby location, to assess the risk of the property and assess the future value of the investment. (Harrison et al., 2008)

Familiar features may undergo changes over a period of time (Niklas, 2000). Humans tend to observe familiar events rather than unfamiliar events and assign more importance for the happening of such events which leads to belief reversal (Fox & Levav, 2000). Women seem to display more familiarity bias in the case of investments (Harrison et al., 2008). Investors prefer to buy stocks which are familiar to them, leading to home bias (Shefrin, 2002) and deficit diversification (Pompian, 2006). Empirical evidence projects that money managers invest in firms which are familiar to the investors even though it may yield less returns (Hiraki et al., 2005).

2.3 Anchoring

In the process of decision making, humans tend to rely on the first-hand information, which is arrived either from family or any other recommended source (Mahapatra & Mehta, 2015) rather than new information. In case of stock investments, it is the behavior of the individual, who recalls the price of the share when they engaged in investing for the first time rather than the value of the share after some time (Simon Brown, 2015). Investors are influenced by anchoring bias while estimating the profitability of the firm (Cen et al., 2013)

Individuals waver processing more information as it involves complex processes (Chandra, 2002; Jain et al., 2015) and stick to the past information (Hoguet, 2005; Talha et al., 2015) about the investments by ignoring new information, leading to forecasting errors (Campbell & Sharpe, 2009; Jain et al., 2015). Empirical evidence elucidates that anchoring bias leads to judgment errors with a possibility of reduction in gains (Lowies G.A., 2014). Both men and women are influenced by anchoring bias (Mahapatra & Mehta, 2015).

3. Level of engagement and Investment performance

Individuals include pension funds, gold, real estate & mutual funds in their investment to escape from risk and losses. The current trend involves investment in equities by the common households. Nearly 47% of the equities are held by the households. It was found that, those who trade frequently earn very less returns compared to the investors who trade very less (Chatham: Newstex, 2016).

The level of return in stocks, depends on the level of engagement by an investor. Individuals influenced by overconfidence tend to involve in active trading which leads to less returns (Barber & Odean, 2000). Increase in the volume of trading in the stock market is the reflection of the overtrading by an investor (Odean, 1999). Hence the level of engagement creates a mediating effect in the investment performance.

4. Spouse effect and investment decision

Marriage has an impact on financial decision as it involves pooling of wealth from two families, increase in the salaried income and influence of decision making due to dependability & responsibility of the family. An increase in the value of wealth leads to the
The higher the expertise in the field of investments increases the dominance of the spouse effect in decision making (Meier et al., 1999) Investments are made to acquire benefit in the future. Hence people invest in retirement plans & utilise the retirement funds to invest in stocks to lead a better life and earn income after retirement (Sung & Hanna, 1998)

Individuals prefer less risk when it comes to investing in stocks. Married couples who are working compensates the decrease in the investment return through their partner’s income. It was found that married couples invest similarly in 401 (k) plans and there exists a significant correlation among husbands and wives who are involved in 401(k) plans and in the process of asset allocation. (Uccello, 2000) Married couples who are employed doesn’t show any significant difference in the process of decision making by investing their funds in retirement plans as well as use their retirement funds in stock investments (Sung & Hanna, 1998) When a married women invest her funds in the retirement plan, the male counterpart also makes an identical decision. Whereas when the female partner decides to invests the retirement funds in stocks, her spouse also invests in stocks. It was found that spouse effect has an impact on the investment decision making among married couples (Sung & Hanna, 1998; Uccello, 2000; Nancy et al., 2003)

5. Conceptual Framework:

Based on the review of literature, a conceptual model is proposed as shown:
6. Discussion & Conclusion

It is assumed that people are rational and they try to maximise their utility by choosing the best alternative among the available options. But the irrational behaviour of individuals lead to the existence of Behavioural Finance which focuses on investigating the reasons for such irrational behaviour among individuals. Empirical evidences show that emotions and insights which are referred as behavioural biases has an influence on investment decision making.

Behavioural factors such as overconfidence, familiarity and Anchoring bias influences the decision making of an individual. Besides these, an individual is also influenced by external factors such as level of engagement and spouse effect, which has not been explored earlier. This paper tries to find out the impact of behaviroal factors and the level of engagement and spouse effect in investment decision making and performance. In the process of literature review, it was found that level of engagement has a mediating effect on investment performance and spouse effect has a moderating effect on investment decision making. The findings of the study would be useful to investors, and investment professionals to construct an effective investment portfolio to achieve the investment objective.

References


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