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BEHAVIORAL ASPECTS OF AN OVERCONFIDENT INVESTOR

Sanu S J

Assistant Professor, Asian School of Business, Thiruvananthapuram, Kerala, India

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ABSTRACT

Financial decisions are always a crucial decision for an individual and a business entity. The rationality of the decision depends on many factors like information the decision maker has , his analytical and decision- making skills, his past experience, his ability to draw a broad picture of the scenario, his skill in estimating future outcomes, etc. The decision maker is a social animal exposed to irrational and psychological feelings even though he tries to take the most logical decision free from all emotional feelings. This may not be always a possible majority of investors. This article tries to put some light on the behavioral aspects of finance and how overconfidence can affect the rationality of decisions.

KEYWORDS: *Behavioral Finance, Illusion of Knowledge, Illusion of Control, Overconfidence*

INTRODUCTION

Behavioral finance is a relatively new field that seeks to combine behavioral and cognitive psychological theory with conventional economics and finance to provide explanations for why people make irrational financial decisions. Behavioral finance is a field of finance that proposes psychology-based theories to explain stock market anomalies such as severe rises or falls in stock price. Within behavioral finance, it is assumed the information structure and the characteristics of market participants systematically influence individual' investment decisions as well as market outcomes. Behavioral finance attempts to fill this void by combining scientific insights into cognitive reasoning with conventional economic and financial theory. More specifically, behavioral finance study different psychological biases that humans possess. These biases, or mental shortcuts, while having their place and purpose in nature, lead to irrational investment decisions. This understanding, at a collective level, gives a clearer explanation of why bubbles and panics occur. Also, investors and portfolio managers have a vested interest in understanding behavioral finance, not only to capitalize on stock and bond market fluctuations, but also to be more aware of their own decision-making process.

OverConfidence

Confidence is considered to a positive trait than an individual can possess. Confidence improves performance and tends to give positive results. Contrary to that, psychologists have determined that overconfidence causes people to overestimate their knowledge, underestimate risks and exaggerate their ability to control outcomes. This is not an advisable scenario in a decisionmaking process.

Does overconfidence arise in the investment decisionmaking process? Studies prove that it occurs in the investment decision making process also and an investor may make blunders because of overconfidence.

The selection of which stock to buy and when to sell the stock of one specific company is always a tough decision. Research data proved that normally an overconfident investor exhibits the greatest overconfidence in stock selection decision and stock disposal decision.

How good a driver are you compared to the drivers you encounter on the road, are you above average, average or below average?

How would you answer this question? If overconfidence were not involved, approximately one - the third of those reading this book would answer above average, one –the third would answer average, and one – third would answer below average. However, people are overconfident in their abilities. Most people feel that they are above average. Being over confident in driving may not be a problem that affects your life. Sometimes overconfidence can affect your financial future.

Consider this financially oriented example. Starting a business is a very risky venture; In fact, most new businesses fail. But very few owners who start a new business thought that like majority businesses they are likely to fail also. Wall Street warns you "Don't confuse brains with a bull market". Over confidence increases trading and trading frequency because it causes you to be too certain about your opinions. Your investment opinions derive from your beliefs regarding both the accuracy of the information you have obtained and your ability to interpret. An overconfident investor believe more strongly in his own valuation and have less belief on others. He /she may over the trade and the chance of making losses from over trading also increase. An overconfident investor will perceive his actions to be less risky than generally proves to be the case.

The Base for Overconfidence in an Investment Environment

There can be *n*, number of reasons for overconfidence. Theoretically, the reasons for overconfidence in investment angle can be grouped under two heading; viz

- Illusion of Knowledge
- Illusion of Control

Illusion of Knowledge

We have the tendency to believe that the accuracy of our forecasts is increasesed with more information. This is anillusion of knowledge. This illusion of knowledge – that more information increases your knowledge about something and improves your decisions. However, this may not always be right.

For example, I roll a fair 6 sided die. What number do you think will come up and how sure are you that you are right? Clearly, you can pick any number between 1 and 6 and have a one - sixth chance of being right. What if I told you that, the last 3 rolls of the die have each produced the number 4? If I roll the die again, what number do you think will come up, and what chance do you have of being right? If the die is truly fair, then you could still pick any number between 1 and 6 and have the same probability of being correct, regardless of what previous rolls have produced.

The added information will not increase your ability to forecast the roleof the die. However, many people will believe that the number 4 has a greater (than one - sixth) chance to be rolled again? Others will believe that the number 4 has a lower chance to be rolled again. Both groups of people will think that their chance of being right is higher than

reality. That is the new information may make people more confident in their predictions even though their chances of being correct do not change.

This can repeat in an investment environment also. You may be a fan of Infosys Technologies Ltd and started investing in the market by buying shares of Infosys. Assume that over a period of time you may have booked sufficient profit from that particular scrip. In this scenario, you may have an idea of the price movement of Infosys shares based on your past experience. Continuous engagement and profit from Infosys scrip may tend to make you believe that you have sufficient knowledge regarding Infosys and how it behaves in the capital market. You may tend to forget the fact that the price of a share is the influence of *n* number of factors known to the market as well as unknown to the market. This is a classic example of the illusion of knowledge in an investment environment.

The i llusion of knowledge is dangerous in investing environment. This will give a false impression to investors that they can predict the share price or have enough knowledge regarding price movement of a particular stock or sector or the market as a whole. The m arket price of any share is affected by *n* number of factors, of which some may be known to the investor and some may be unknown to the investor.

Illusion of Control

People become even more confident when they feel like they have control of the outcome – even when this is clearly not the case. For example, if you ask people to bet on whether a coin toss will end in heads or tails, most will bet larger amounts if you ask for the best before the coin has been tossed. If the coin has already been tossed and the outcome concealed, people will offer lower amounts when asked for the best. People act as if their involvement will somehow affect the outcome of the toss. In this case, the idea of control over the outcome is clearly an illusion.

Earlier we discussed an example of an investor of Infosys stock. If that investor gets affected by the illusion of control also, then the situation becomes too serious. Here the investor will start thinking that he knows the outcome which is 100% an impossible affair.

The greater the amount of information obtained, the greater the illusion of control. When learning new information, people place too much emphasis on how extremely or important it is. Too little emphasis is placed on validity or accuracy. Much of the information received is really noisy and is not important – a lot of what we call information is inaccurate or outdated. In fact, some information used by investors, these days is really being misleading and causes damage to return.

Common Mistakes of an over Confident Investor

The illusion of knowledge and illusion of control creates the overconfidence bias and that may harm the net earnings an investor can make from the stock market. The common mistakes that an overconfident investor may make are stated below.

The most common mistake an overconfident investor is expected to make is over trading. Studies proved that over confidence increases the trading frequency. The stock market is not a place where if you trade more, you may get a better profit. In fac,t it may work the other way, in most of the cases. Overtrading will eat the profit which the investor already made and ultimately result in investment erosion

Overconfidence sometimes affects the analytical and logical thinking process. In other words, if we are over confident regarding anything, we may start believing it without applying our brain. It's a dangerous scenario, if the investor misses thinking logical and applying quantitative and qualitative techniques before taking a buying or selling decision.

If we truly believe something, our brain tends to ignore all factors which are against our belief. This will happen in investment environment also. An overconfident investor will be having a strong belief regarding a particular stock or an investment environment. Even though he gets some contradicting information which is against his belief, the normal tendency will be to ignore it. This may result in ignoring a probable threat and which may ,in turn, result in huge losses and bad investment calls.

Blind decision expected a desired outcome is another mistake of an overconfident investor. The desired outcome demands careful analysis, information and some amount of luck also. Assumptions, beliefs, over enthusiasm, etc. a harmful in generating wealth form the stock market.

Even though abundant information cannot always help in making a better decision, but lack of information can definitely be harmful to take a good decision. The overconfident may not have the motivation to collect more information regarding the market and stocks of his preference because he thinks that he knows all about the market and the stock. So invariably he is taking a decision with limited information. Taking the decision with limited information is not an advisable scenario. The profits will get diluted with a bad decision taken with the help of too limited information.

An Internet Psycho Investor

Unlike a few years back, now too much of information regarding anything ,including a company and the financial market is available at fingertips. But this information will not increase the skill of the investor in using this information. An investor in the stock market is not restricted to an individual who has fairly good knowledge of finance domain and financial market. He may a practicing doctor, real estate, businessman, and an IT expert etc. who has surplus funds available, havean interest in the market, but have only limited knowledge about finance.

Abundant information which the investor receives may tend to make him believe that he knows about the financial market. Even though he is not an expert as far as the stock market mechanism and price realization is concerned, he will start thinking that he has adequate knowledge and in a position to take decisions. This type of overconfidence arises because of the availability of online information and that type of investor can be called *An Internet Pyscho Investor.*

Managing Overconfidence

It's not an easy task to manage overconfidence. A knowledgeable and successful investor may have a probability to become overconfident. A few checklist can be employed to avoid taking a bad decision arising out of overconfidence:

- The first and foremost thing is to accept the fact that there is a chance of taking a decision based on over confidence. Once we know the fact, then the frequency of overconfident bad decision will reduce drastically.
- The investor has to be clear regarding his / her investment objective. If the objective is clear, then the chance of taking a psychological decision will be less.

- An investor needs to have an analytical outlook. The numbers hardly deceive reality. A careful analysis of the data can save the investor from taking illogical irrational decisions.
- An investor is expected to be vigilant always. The f inancial market is not an area where you invest some money, forget about it and expect capital appreciation in the future. The investor need to be updated always regarding the portfolio he is maintaining.
- The investor needs to review his portfolio on frequent intervals to avail holding a stock which is not lucrative and to book profit in frequent intervals.
- Finally and the most important aspect is to train your brain to be free from all sorts of emotions and psychological bias. Emotions including ove confidence are always harmful in taking a logical decision

CONCLUSIONS

Money making is not an easy talk, especially from the financial market. The success of an investor is to take a decision which is rational, based on sufficient relevant information, after making a careful analysis of the information based on quantitative and qualitative tools and also free from emotions and biases. Overconfidence can adversely affect the decision making process and erode the profit.

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