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RESEARCH ARTICLE

THE ROLE OF PSYCHOLOGICAL FACTORS IN THE DECISION-MAKING OF INVESTORS IN INDIA

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Abstract

Many consider psychology and investing as two different unrelated subjects. However, this disregard or ignorance of people makes them prone to make bad decisions. Therefore, this review-based paper aims to cover the relationship between the two domains and how psychology affects investors' decisions specifically in the Indian context. The paper is a comprehensive review of the pre-existing literature that has been combined lucidly. The themes are based on various psychological traits and biases seen in Indian investors.

Introduction: -

It is generally assumed that humans are rational beings, but that’s far from the truth. According to behavioural economist Herbert Simon, humans base their decision-making on heuristics, when faced with a complex issue (**Dietrich, C., 2010**). Heuristics are mental shortcuts used to make quick decisions to save time and energy (**Kahneman, D., Slovic, S. P., Slovic, P., & Tversky, 1982)**. They are generally based upon the conventional thoughts prevailing in society or the rule of thumb but do not always hold.

This school of thought surely holds for India. Even though only 1.2 crores of the entire population of 138 crores are into investing, this highly selective audience makes some decisions with no rationale. For instance, many still consider investing in the markets as gambling and believe that all trades are based on luck (**Harrington, 2012).** Some who are so sure of this ideology reckon the stock market and casinos are the same. This thought process while unreasonable is fostered in Indian households.

Behavioural finance as a concept is often neglected by society as something not of great importance but individuals must understand that humans are irrational organisms who are driven more by psychological factors than by logic (**Subrahmanyam, 2008).** At its core, behavioural finance aims to analyse and explain this inefficiency of financial markets.

Research Rationale

There are various theories regarding how investors behave in the market. ‘Fear of Regret’ is one of them. The theory deals with the emotional reaction people experience after realizing they have made an error in judgment (**Slovic, 1972)**. For instance, when an investor realises that the investment that he made, is not a good one, he still would not sell the stock at a price lower than what he bought for, even though, it may have the potential to fall further. They avoid doing it to avoid the regret that comes after that and the embarrassment of reporting a loss. Such theories at their core show a significant relationship between behaviour with finance, which, is a highly ignored topic.

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Investment in the stock market
Indian societies generally prefer to keep away from the financial markets. This is quite evident empirically as 98% of the country's entire population steers away from the stock markets **(Edelweiss, 2021)**. This is a matter of serious concern for the southeastern nation because the fact highlights the lack of financial awareness in the Indian community. According to **The Times of India** in quarter 1 of 2020, 6 lakh new fixed deposit accounts were opened. This result indicates the casual attitude of Indians regarding money – we like to save, not invest. They think **- why invest in stock markets when banks give steady and safe returns? This attitude must change but that is only possible when further research is undertaken on the psychology of investors.**

Methodology:-

This paper aims to review the literature comprehensively and thoroughly in the field of behavioural finance and put forward various relations between the field of finance and psychology that have been discovered by the researchers.

The assessment of the academic literature is based upon work from (Investopedia) a renowned website that covers diverse topics relating to investing, a study of the role of behavioural finance in portfolio investment **(Rahul Subash, 2011)**, decision-making in the stock market (**Abhijeet Chandra, 2008)** and **(Kalpana's financial education)** a webpage that covers various aspects of finance. The cited researchers have compiled their thesis through citations from various other authors, which stands as proof of the validity of this paper.

Keywords such as 'Investing psychology', 'Investor behaviour in India', 'Behavioural finance' and 'Psychology Biases in Investing' and literary works from 1982 -2022 have been used to compile this review. These keywords were used due to their relevance and the wide scope of the studied topic.

Books like 'The Psychology of Money**(Morgan Housel,2020)** and 'The Intelligent Investor' **(Benjamin Graham,1971)** have also been referenced to complement the review.

Research Objectives:-

1) Understanding the role of psychology in investing.
2) Look into the factors influencing investor behaviour in India.
3) Difference between Indian investing psychology and that of the rest of the world.

a)Anchoring Bias
Anchoring is a cognitive bias in behavioural finance that highlights the incapability of the human mind to differentiate between what is useful and what is not and base their decision on irrelevant information**(Hayes, 2021)**. For instance, investors tend to be so focused on the buying price of the security that they take all the subsequent decisions keeping in mind the same price.

An anchoring bias can force a market participant to make illogical decisions. Placing too much focus on historical values, a rule-of-thumb valuation metric or a particular price range of financial security are some common anchors of investors nowadays (**Campbell, S. D., & Sharpe, S. A. 2009)**

Therefore, market participants need to understand that there is no substitute for comprehensive and detailed research of factors influencing the market as it is the only way to eliminate the anchoring bias**(Hayes, 2021)**

b) Illusion of Control
The illusion of control is another type of off-key behaviour. It describes the tendency of individuals to believe that they can influence the outcome of uncontrollable events when they have a significant amount of knowledge about a subject. However, the knowledge they possess is a small piece of an infinitely large pie.

Investors are guilty of such behaviours as it is due to it some try to trade more often than required, maintain an undiversified portfolio, and use other investing techniques to experience a false notion of control which is not present.

All this stems from three things: investor overconfidence, lack of financial knowledge and the role of heuristics in financial decision-making **(Statman, M., Thorley, S., &Vorkink, K. (2006)**. Therefore, Investors must realize that most of their earnings depend upon unpredictable scenarios like corporate earnings, geopolitical situations, and government policies, which cannot be controlled.

While controllable factors like where to invest and how long to invest come from proper analysis of reliable sources which are not creations of the mind. Henceforth, it requires adequate knowledge of various financial concepts.

Research themes

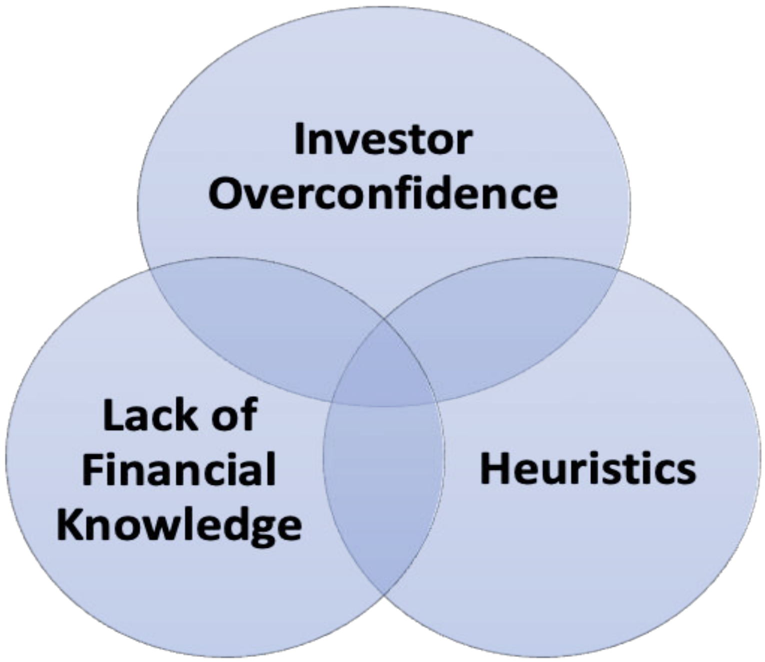

Fig1:- Pillars of Irrational DecisionMaking.

Overconfidence

Overconfidence is a widely used term that defines a tendency to hold a faulty and misleading assessment of our skills, intellect, or talent. In a nutshell, it’s an egotistical belief of assuming one’s skill greater than what it is (Burnside**, C., Han, B., Hirshleifer, D., & Wang, T. Y.,2011)**.

In investing, overconfidence stems from the belief that one has every knowledge of the world to predict the movement of the markets. This tendency fails to appreciate the importance of various other factors like government policies, natural calamities, and luck.

Understanding the markets is the most important factor in finance and investing. This field while being one of the most lucrative, holds a lot of overconfident analysts. Most individuals who are involved in this industry consider themselves above average; even though, it is statistically impossible **(Corporate Financial Institute, 2022)**

According to a survey conducted by **(James Montier, 2006)** of 300 professional fund managers, asked if they believe themselves above average in their ability. Some 74% of the market professionals responded in the affirmative. 74% believed that they were above the median at investing. And of the remaining 26%, thought they were average. In short, virtually no one thought they were below average. Again, these figures highlight the statistical impossibility of the claim.

It is due to this ignorance, that a significant amount of uncautious decisions take place that cost the economy billions of dollars. Ray Dalio, the founder of, Bridgewater & Associates, the world’s largest hedge fund, has commented numerous times that being overconfident can lead to catastrophic outcomes. Dalio says that he always makes it a point not to rule out the possibility of his assessment being wrong. “I knew that no matter how confident I was in making any single bet, I could still be wrong.”

Lack of Financial Knowledge

Financial literacy refers to the ability of an individual to understand and use money effectively. It is the basic framework upon which the relationship of an individual with money is based **(Jason Farando, 2022)**

Financial Literacy is an umbrella term that includes various dimensions under it **(Cole, S. A., Sampson, T. A., & Zia, B. H.,2009)** It ranges from the ability to manage and pay off debts and the aptness to differentiate between credit and investment products. These skills often require some working knowledge of financial concepts which is imperative for surviving in the world today.

However, while knowing these concepts is important India lags. Only 27% of Indian adults – and 24% of women – meet the minimum level of financial literacy as defined by the **Reserve Bank of India**

This lack of good financial knowledge has a direct relation with the quality of financial decisions made in the country. Research conducted by **(Jappelli,2009)** shows that this concept has a very positive effect on investment decisions. Another study conducted by (**Rasuma Putri & Rahyuda,2017**) found that financial literacy and gender have a positive effect on individual investment decision behaviour.

Based on this comparison, it shows consistently that the amount of knowledge an individual has on the financial side plays an important role in the investment decisions of the region.

Gullibility

Gullibility is the trait of being easily persuaded by others. If someone is described as gullible, it means they are easily tricked because they are too trusting. Indians are known to have this trait of trusting others easily.

The Global Tech Support Scam Report by Microsoft has found that approximately 7 out of 10 Indians — 69%, the highest worldwide— fell prey to a tech support scam in the year 2021. Indians lost Rs 15,334 on average to tech support scams in 2021. India has seen steady growth in such crimes over the past years. Which as a result has made India one of the most conned nations in the world.

This problem of trusting someone easily made, Parag Parikh a SEBI registered broker, wrote the ‘Value investing and Behavioural Finance’ (**Piotroski, J. D.,2000**). Which described the tendency of Indians to lean towards heuristics or shortcuts. This means that they rely on readily available information and make their investment decisions based on the same. According to him, his book can be summarized as “Today’s ruling ethos is to make money off the gullible”.

The same author also talked about representative Bias which means that the behaviour of one segment of the entire class is taken as the representative of the entire class (**Agrawal, K., 2012)**. This is another major problem from which the country suffers. This presence of this bias was evident in the IPO fury in the year 2021 in which the success of one IPO formed the rationale in the mind of investors that every IPO would pose listing gains.

Discussion:-

Psychological biases like Anchoring, representation and illusion of control lead to a significant number of impractical decisions (**Baker, H. K., &Nofsinger, J. R. 2002)**. The founder of the biggest hedge fund in the world, Ray Dalio, himself said that even he is not sure about his decisions as they may suffer from some prejudices. Therefore, the regular market participants should keep their minds open to the loopholes in their knowledge as“acceptance of ignorance is often the first step in our education”.

A study by **(Raj Aggarwal, Colm Kearney, and Brian Lucey,2009)** conducted to study foreign portfolio investment tendencies found that individualism, masculinity, and uncertainty avoidance are heavily related to cross-border investments, individualism and masculinity are associated with more foreign diversification (**Arshad, I., & Ibrahim, Y. 2019)**. On the other side of the coin, uncertainty avoidance is regularly associated with home nation bias, making market participants more prone to deal in investments familiar to them. Hence, cultural factors like these and a lack of knowledge about the working of the financial markets contribute to investment decisions made by the citizens of India.

India is known as one of the most conned nations in the world. Therefore, if that's the case the citizens of this south-eastern nation may also trust the unreliable pieces of news and tips easily. This gullibility has caused the market participants to lose billions of dollars. Alongside that 'the jugaad mindset' of Indians is also hurting them as every decision made in the market cannot be quick and impulsive as shortcuts do not take one far.

Conclusion:-

By the introduction, theory, and methodology, it can be concluded that psychology does play an important role in how investors behave while engaging in the money markets. They hold several prejudices and biases in their mind that affects the practicability of the decisions taken by them in the market. This paper presents it in a simple, concise, and articulate manner that can be easily understood and gives citations that stand as valid proof for the claims made.

Psychology is a dynamic subject which keeps on changing due to various aspects like cultural settings and environment. Therefore, India is striving toward growing into a developed economic powerhouse. Several future studies are required to trace the new trends and changes in the investing psyche which would in turn make the market investors aware of the importance of psychology as well as help them improve their decision-making.

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