Impact of Herd Mentality on Investment Decisions — Implications for India

Capital markets of an economy are a significant and indispensible source of investment and financing activities for corporate and other investors. Most of the financial assets are traded in these markets and they serve as the backbone of economic development. Such markets if engulfed in cognitive biases and psychological errors will result in misvaluations, excessive volatility and panic trading, thereby resulting in not just loss of capital from global sources, but also increased cost of capital for seekers of funds within the economy. It is therefore, imperative to understand these biases and the corrective actions necessary to reduce their effect. One of the major behavioural patterns observed among investors is herding. Read on...

Bharti **Dr. Ashish Kumar**

The authors are Assistant Professors at USMS, GGS Indraprastha University. They can be reached at bharti.1119@gmail.com and eboard@icai.in

Standard financial theories are rooted in the assumptions of rationality and profit maximisation that are based on the premise of efficient markets. These theories assume that investors are guided by fundamentals and asset prices discount all available information at all points in time. However, the financial market anomalies have shown that mean variance portfolio allocation is not always the case and limits to arbitrage exist and markets remain inefficient for longer than suggested periods of time. Thus, a new framework of behavioural finance is required to explain the phenomenon where conventional finance theories fail. Behavioural patterns influence investment decisions and result in sub optimal outcomes. The scope of behavioural finance focuses on the role and impact of psychology on the investment decisions. In the past decade, this study has received a major impetus as it is important to understand the role of cognitive biases and why people make irrational investment choices. Among the many, one social bias is herd behaviour that leads to imitation and collective actions while making investments. Herding occurs when group actions are thought to carry better and more useful information than an individual. Financial literature argues that local group interactions in the absence of a central control mechanism triggers the pattern and although research asserts that it moves the asset prices closer to the fundamental value, yet continued periods of imitation

disregarding the real value can lead to bubbles and market inefficiency. Herd phenomenon is demonstrated at two levels- micro or investor category where money managers and fund managers herd due to reputational concerns or aggregate level with respect to the market returns which over a period of time can lead to the financial environment of high asset correlations. Although the study of heuristics and herd pattern specifically is exciting, it has some inherent risks like unethical applications in research. Despite this the scope of the field continues to grow and is a gold standard providing compelling evidence in explaining the anomalies especially for India which is at a turning point and remains an attractive investment market for retail and institutional investors and is vulnerable to psychological biases due to its emerging character.

Emerging financial markets are characterised by limited retail investor participation, information asymmetry and weak disclosure mechanisms, to name a few, that augment volatility in the returns and make them fragile and vulnerable. These features have the potential to induce systematic errors and psychological biases that result in mispricing and misallocation of resources in the economy. Numerous studies have proved that investors are normal and not rational and while making investment decisions. These psychological biases guide the process, sometimes to the extent of making the financial environment susceptible to major events. In extreme cases, these behavioural patterns have the capacity to even cause financial crisis.

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According to Richard Thaler, the Nobel Prize winner of Economics, human beings are real and lack self-control and driven by social preferences and sentiments. Their emotions affect the investment decisions too and rational asset pricing models like CAPM and APT do not always hold valid making the standard finance theories questionable. This observation is further reinforced by studies that suggests that the existence of a disparity between assumptions of financial theories and how investors actually behave. These theories assume that a rational investor performs risk-return trade-off while making an investment decision and profitable payoff is the driving force behind any investment. However, the recent financial market busts, for instance subprime crisis and Eurozone crisis demonstrate otherwise, that market participants and investors do not design portfolios according to the mean variance theory, rather through behavioural approach and expected returns are not just a function of beta, but something additional as well. When faced with complex situations that demand substantial time and effort, investors have difficulty in devising rational strategies and approaches and they tend to follow a sub-optimal path of choice and create bias in decision making. The investment cycle is full of psychological pitfalls and biases like overconfidence, herding, self attribution, loss aversion, disposition, framing and mental accounting to name a few. Investors rely on these heuristics- mental shortcuts and fall prey to cognitive biases and emotional predispositions. The interdisciplinary field of behaviour finance examines these biases and the effect on financial markets by taking insights from psychology and human behaviour and incorporating them to investment decision making to find answers to why investors behave the way they do.

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What is herd behaviour?

As teenagers we have experienced doing something that was suddenly cool or because everyone else was doing it- known or even unknown. People have a tendency to mimic the actions of others in the group that may not always be due to rational reasons. A number of motivating factors like, cost of information acquisition, intrinsic preference for social conformity, reputational concerns, compensation schemes and incentives can make the process of analysis challenging and complex resulting in investors relying on collective behaviour. Herd behaviour has been extensively studied in various disciplines like sociology, psychology, zoology, biology and also economics. In especially economics and finance, herding is the phenomenon when investors follow the crowd and take investment decisions that might not be in accordance with their private information. Hence, there

is an obvious tendency to imitate others that leads to a collective behaviour of buying or selling the stocks or assets in large numbers. Herd behaviour starts when the investor decides to make an investment based on private information, but do not do so, after learning that others are not investing or vice-versa.

Spurious and Intentional Herding:

Herding can be categorised as spurious and intentional, where the former leads to an efficient outcome as investors react similarly to the available public information whereas the latter leads to the 'lemming' like behaviour and in extreme cases excessive buying or selling, thus impacting the asset prices.

Such patterns over a continued period of time lead to bubbles as it is not in tandem with the efficient market hypothesis. A primary reason for a utility maximising investor to ignore private information and herd may be based upon the fact that group knows more and possesses better information than an individual or probably for social conformity and to be 'one among the boys'. After all it is better to fail conventionally rather than succeed unconventionally. Money managers and portfolio managers may display the tendency to herd due to reputational reasons or sometimes their compensation and incentives schemes are such that imitation is rewarded and they follow the bigger fund managers only to confirm to the 'big boys' choices. In addition, if a fund manager is not confident of his investment selection and his ability to pick the right stocks, then herding prevents the fog as the manager is in-line with others in the market. At the aggregate market level, herd behaviour may be exasperated during

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periods of market asymmetry for instance, high volatility or extreme movements making the markets fragile and vulnerable. Such periods cause clustering of the assets around the market and the dispersion between the individual asset return from the market return decreases. The research claims that the periods of extreme market movements and crisis provide a fertile ground to observe herding, although such phases prove to be corrective times as investors focus on fundamentals rather than fads. The prevalence of herd pattern in the financial market shows that the system is fragile and exposed to systematic risks. It provides the warning to strengthen the information disclosure mechanism and regulations governing financial literacy and education.

Implications for India

In the above context, the examination of such a behavioural pattern has huge implications for the Indian financial market and its stability. The Indian economy is expected to be an outperformer and become a USD 5 trillion economy and a global economic powerhouse by the year 2024-25. It provides huge growth potentials for institutional and retail investors alike and acts like an investment magnet. Diversity of cultures and geographies add to the vastness of the country that is replicated in the investment pattern. Add to this the evolving nature of market and high transaction costs and higher uncertainty in an informational asymmetrical environment that can potentially dictate the behavioural patterns thereby making the investment decisions a function of prejudice rather than fundamentals. This is where the legal and regulatory policies can limit the damage caused by these cognitive biases. Better investor education and training programs should be designed to improve the trading sophistication for reducing cognitive bias while investing. Investor awareness campaigns should be launched to promote efficient allocation of capital. In this context, The Institute of Chartered Accountants of India conducts regular Investor Awareness Programmes under the aegis of Investor Education and Protection Fund Authority, Ministry of Corporate Affairs. More than 6,600 such programmes have been organised till date. Securities and Exchange Board of India has also launched investor education portal under Securities Market Awareness Campaign where it offers free of cost study material to empower investors through education. More such steps to improve the literacy among investors are welcome. Herding can also arise at sector or industry level. This has implications for portfolio and fund managers as they have an affectation towards a particular sector and tend to cherry pick industry specific 'hot' stocks, and sell losers thereby suggesting abnormal profit making scope. This also indicates the extent for diversifiable risk as more number of securities is required to minimise the same level of unsystematic and idiosyncratic risk. To minimise herd behaviour at sector level, more emphasis should be made to build stronger client-fund manager relationship so that during dynamic market movements, investors trust the mutual cooperation and skills of the manager and trade accordingly.

Focusing and understanding this implication is complex and necessary for the Indian market as it involves developing better tools to help investors overcome the nudges and biases to strengthen the financial environment. Next, irrational collective behaviour also has the potential to alter the asset prices during extreme bull or bear phases or asymmetrical trading volume and volatility periods. Trading volume is a measure of market transparency and high value implies improved information disclosure systems thereby reducing the probability of herding. Whereas, high volatility is associated with greed and fear and such panic phases have the ability to amplify herd behaviour as investors prefer to act collectively.

The Indian market has witnessed many setbacks and recessions including the global financial crisis and has proved to be resilient to a good extent compared to the other emerging economies. In spite of this, currently the domestic financial market is highly linked with other major global markets and the impact of spill over cannot be undermined. Since investors track other markets, any sentiment driven or socially influenced movements occurring outside the economy also have a tendency to impact the valuations here resulting in panic trading and causing asset mispricing. During such periods, the role of financial market regulators becomes even more imperative as the surveillance mechanisms have to be strengthened and risk containment measures installed. Rumours have a tendency to cause considerable damage to the normal functioning of the market and quick verification of information is necessary especially during periods of high volatility or fear and panic stricken times. Appointment of compliance officers who can be contacted for quick verification of information, coordination officers in stock exchanges for immediate exchange of information, development of stock watch mechanisms to detect any improper activity to guard the integrity of the market, are a few of the steps taken by SEBI in the right direction to improve the market functioning making it more efficient.

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Conclusion

This article only touches the tip of the iceberg on the theme of behavioural bias of herding and its implications for financial market and investors. Although the regulators have taken proactive measures by installing mechanisms and systems to mitigate the risk and minimise the aberrations caused in the financial market due to these behavioural biases, more preventive measures for instance, initiatives focussing on individual, peer and social learning of investors, rationalising the transaction costs, introducing diverse financial products, better trading methods of executing pre-programmed trading instructions such as algorithm trading that uses high frequency trade mechanics in wide variety of situations like arbitrage or trend trading need to be introduced. Also, an emergent technology of machine learning and the use of artificial intelligence can help in developing programs that will be self improving through deep learning. Such technologies can help in faster order executions at lesser costs. Additionally, developing markets like other financial instruments, bonds and interest rate futures, that currently do not witness active participation will aid in improving the market efficiency. Further, financial markets should be made more inclusive by increasing the proportion of retail investor participation which currently stands at a mere 2.5% for the Indian equity market. This will ensure increased liquidity and better price discovery. Increased financial education and investor literacy programs should be developed and made available to the investors across categories to enable them to make informed decisions. Such programs will provide the market long term benefits and enable the investors to differentiate between rumours and true news and prevent them from making poor financial decisions. These programs also provide the benefit of greater investor confidence and act as a catalyst for higher participation in the securities markets, thereby improving liquidity and volumes. Further the regulator should ensure that the investors are aware of their rights and responsibilities to make the markets more efficient. For academicians, the subject of herding offers a lucrative ground for more impactful research as the aspect of psychology in finance is unexplored at various levels and experimental studies in this area are the need of the hour. Such initiatives towards creating a more transparent market will generate more incentives to invest in the Indian financial markets. ■

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