Learn to unlearn in the matter of Investing with the help of Behavioral Economics

Behavioral Finance is a study of the systematic errors made by market participants due to psychological biases. It explains, amongst other things, why investors are often reluctant to sell shares (or other investments) if doing so would result in "*booking a loss*". In this presentation, we hope to make you aware of the common biases and how to overcome them, especially when it comes to investment decisions. We begin with one of the most well-known biases in the investing world - ***Loss Aversion.***

Investor Dilemma

In the case of stocks, two particular instances are common. The first is the tendency to hold on to stocks that have lost considerable value since purchase. Several instances spring to mind from recent years. For instance, investors in shares of BUMI Resources TBK are probably amongst the ones who have fared most badly. As late as May 2012, shares of BUMI traded at Rp 2,000. Since then, there have been consistent fall in the share price but at each point, investors expected that the fall would be arrested and the price would rise again but most held on to the shares – not because of some conviction about the change in fortunes, but because of an aversion to booking losses. The side-effect, however, has been an even further loss.

Almost any investor with an investing track record of a few years, especially if it dates before January of 2008, has likely seen at least some of his or her investments lose 50% or more of their value. However, this investor is unwilling to part with such shares – even if the price reflects no great possibility of future growth.

Consider the reverse condition – rarer – but one that certainly does occur. For instance, the shares of a company were trading at Rp. 100 at the end of 2011 but share began a sharp upward rally and by mid May increase to Rp 700. While the stock was now much riskier at Rp. 700 a share, those who had purchased the share at Rp. 100 were quite complacent, on the ground that there is no way they can lose money now.

The answer to the above to examples should not be whether or not to book ones profits/losses. The question should be – what is the outlook for the company (and more importantly, the share price) *going forward.* The choice should be made on whether the investor considers a real possibility that the share price performance will be better than any alternative investment options he may have for that money.

I feel that overconfidence happens because people are often blind to their own blindness. Daniel Kahneman, the father of Behavioral Economics, even has a word for it: cognitive illusion.

Learn to Unlearn

Quoting these studies, Kahneman rightly points out that financial institutions are also not of board. And there is fifty years of research to testify to this belief that the selection of stocks by investors and traders was a mere roll of dice and not a skillful game of poker because at least two out of every three mutual funds have underperformed in any given year.

Kahneman strongly advocate that we have to learn to unlearn, amend and recognize our mistakes. That I feel is true expertise and it comes from experience. Then again, intuition works in different circumstances. If you are to ride on your judgment based on empirical evidence, the work situation should be 'sufficiently regular'.

As normal human beings with all our limitation, we are all subject to the forces of cognitive biases. However, by accepting that we may be making suboptimal decisions due to such biases and by understanding the nature of these biases, the hope is that we can overcome them and become better investors – and therefore wealthier than we might otherwise be.

Wondering why this is no great thesis to 'beat the market'? Because only luck can beat the market and luck is no human. I am.

Thanking you very much.

Pankaj Kumar