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An Investment behaviour bias to guard against during difficult times

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Ajit Menon
CEO

In the April to June quarter as the markets witnessed sharp correction, there were quite a few headlines suggesting that net flows into equity mutual funds had dipped, the net monthly SIP input value at industry level dropped by more than 10-12% and so on. At the beginning of the year the picture was diametrically opposite. Markets were rallying, returns were looking good, inflows into equities were rising and the rise of monthly SIP input value was touted as the next big structural shift. All of us know the fact that to make money in any asset class, the investor has to buy low and sell high. If this is true then why does it not reflect in the behavior. Why do investors in equity markets exit when the market corrects to lower levels and enter when it is has risen ? At the crux of this is basic human behavior and especially emotions and biases. The above mentioned behavior can be best explained by way of what is popularly known as "Recency Bias".

Recency bias is a cognitive bias that gives greater importance to the most recent event. Like in day to day life while trying to memorize a long list of items chances are that the last items on the list are more likely to be remembered. In an uncertain investment world when an investor has to decide, this bias works like a shortcut or a hack. Now if we put this in perspective of investments, when ever there are sharp corrections, the recency bias plays a role and investors sell fearing that it will fall further. Sensex rose 380 times over last 40 years, so holding equity investments for long term does create wealth. But the recency bias prompts the investor to defy the logic. No amount of logic, communication helps. The investor behaviour in such situations can be aptly captured through the investment legend Philip Fischers words – "I have already made up my mind, don't confuse me with facts".

This bias also manifests in the form of investors chasing schemes with the highest returns posted for the past 1 year without ascertaining whether the returns can be attributed to a strong and consistent investment process. Needless to say recency bias works against the odds of investment success for the investor. So how can an investor avoid this bias and have a better investment outcome?.

Investing with specific goals in mind is the most important first step. Reviewing based on your time to goal and benchmark is where the journey begins. Taking an action on the investment only if at the time of periodic review, rebalancing is required to maintain the desired asset allocation keeping in mind time to goal. Or if the risk profile of the person or the product has changed. I also like the framework suggested in a Morningstar article by Samantha Lamas. It suggests that to achieve a fair degree of control over the bias, first and foremost investors have to cut out the noise. Ingraining the fact that the stock markets go through cycles and as long as the economy continues to grow they are likely to be higher than currently where they are in the long term.

The access to market values through apps, internet websites and alerts aids the recency bias. It can be countered by setting a longer time interval for monitoring the values. Instead of watching NAVs regularly, reviewing a portfolio quarterly or semi-annually reduces the chances of making mistakes. Before pulling the trigger on the decision investors should pause and evaluate the issues like tax implications, transaction cost etc. And finally if the investor is deciding to sell, then he/she should try and explain the opposite logic of why it may be a good idea to buy instead of sell and vice versa. This helps one see past the recency bias.

Whatever method one chooses to employ, it is important to overcome the recency bias for meaningful wealth creation. Times are tough. The lock down has also had an emotional wear and tear for most of us. Spate of negative news coupled with the natural human tendency in the form of recency bias can paint a grim picture for the future. But we must not underestimate the tenacity and ingenuity of the human race to overcome the odds through innovative solutions in every sphere of life and work .

Stay safe and stay invested.