PGIM
India Mutual Fund

A bias to watch out for while taking Investment decisions

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Dear Investor,

I have been writing to you about various biases that get inbuilt in the human mind. These biases impact the quality of decision making and hence the outcomes that define the quality of life. Even investment decisions are not insulated from biases. The Idea behind writing about these is to help discerning investors identify them and work upon them to improve the financial decision making thereby improving the investment journey.

For instance, when faced with the choice of buying product A, originally priced at Rs.800 and now available at Rs.500, and another similar product B, that is priced at Rs.500 and available at Rs.500, most buyers are likely to buy the former. The thought process is that something worth Rs.800 is available at a discount so it must be a good deal. A critical thinker probably will look at it the other way round, thinking that if Product A is good why is it quoting at a discount? So why are most people likely to opt for product A? Predominantly due to what is known as "Anchoring Bias". Anchoring bias normally occurs when people rely on pre-existing or the first information they find when making decisions.

Noted behavioural economists Kahneman and Tversky conducted a unique experiment to check this bias. The study was done with the help of spinning a wheel that had numbers from 1 to 100. The wheel was rotated and the respondents were asked whether the percentage of U.N. memberships accounted for by the African countries was lower or higher than the number on the wheel. The experiment showed that when the wheel landed on a lower number people gave lower estimates and vice versa. So the random number thrown by the wheel had an anchoring effect even though there was no correlation.

You may be wondering what this has got to do with the world of investments? We quite often witness anchoring bias at play even in investments. In the world of equity investing, many investors are seen buying a stock because it has corrected from its highs and it is quoting lower. They anchor their decision solely on the price of the stock which itself is not the right anchor. What matters is the quality of the business, its prospects, competitive advantage and fair value. If the investor is buying without considering these factors then the anchoring bias at work here.

The Anchoring bias works on the fixed income side as well. For variety of historical reasons large number of Indian investors believe that the fixed income or debt alternative should give 8% or more in interest. When overall interest rates are in the range of 6-7% and an investors decides to opt for an option just because it gives 9% interest, then the investor has clearly anchored her decision without accounting for risk. We have seen many episodes where retail investors lost their hard earned money because they anchored their investment decision on only one anchor i.e. interest rates.

What could be ways to overcome this? First one obviously is to be aware of the existence of this bias. Second, while making a decision, define the most relevant and crucial factors that will define the outcome and lastly by checking if adequate relevant information is available for the decision making.

A simple hack to overcome biases like these (yes, there are more), is to stick to your asset allocation through the cycles. To make it easier for the investors to maintain asset allocation through the cycles we offer Dynamic Advantage Asset Allocation Facility and Age Linked Asset Allocation Facilty. In case you wish to know more about them do get in touch with your MFD, RIA or visit us on www.pgimindiamf.com.

Stay safe and stay invested.