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Importance of Behavioral Finance – Indian Context

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Abstract:

This article examines the relationship between investors' perception on various factors that influence mutual fund performance. For analysis, the data was obtained from a random sample in Andhra Pradesh (n=400). An investor – behavior model was developed which helps future investors before investing and industry in making their growth. One way analysis of variance (ANOVA) was applied and inferences were drawn. A structured analysis was done and model was developed. Overall, this article provides empirical support for investors' investment behavior in mutual funds with the help of demographic variables.

Key Words: Investor Behavior, Mutual Funds, Investments, Demographic.

Introduction

Earlier, finance had lot of theories like CAPM, APT, MM Approach etc., which are to be followed by investors and investment managers and argue that they have perfectly rational and logical sense in making sound investments. However, truth seems to be far from this. Investors are also influenced by emotions, personal factors, past experiences, etc. which drive their decision in investments. It is important for investors as well as investment managers to understand this anomaly to factor things better. Thus scope of behavioral finance arrives.

According to modern portfolio theory (Markowitz, 1952) which led to the development of CAPM and APT theories, to reach the efficient market hypothesis, that is the alpha return , the investors are considered to be independent and rational, which is sometimes difficult to arrive at(Fama, 1970). While considering the efficient market frontiers and risk free interest rate, the allocation of investments plays a crucial role. The implication of efficient market hypothesis is that nobody can consistently beat the market and get a superior return in the long run. However, we see a lot of investment sagas such as Mr. Warren Buffett (Buffett and Clark, 2001), Mr. Peter Lynch (Lynch and Rothchild, 2000), Sir John Mark Templeton (Templeton and Scott, 2008) , Mr. Ginzo Korekawa (Ginzo, 1991), Mr. Andre Kostolany (Kostolany, 1996), Mr. Jim Slater (Slater, 2000), Mr. Jim Rogers (Rogers, 2004), Mr. George Soros (Soros and Volcker, 2003) , Mr. Philip Fisher (Fisher, 1997), using investment methods mentioned in the quoted books generating large extent of alphas. There is huge list of these investment sagas and cannot be named all. Therefore, the theory of behavioural finance was developed to enroot some of the scholars such as Kahneman, Daniel, and Amos Tversky in research on decision under uncertainty (Tversky and Kahneman, 1974) and Prospect Theory (Kahneman and Tversky,1979).

Under behavioral finance, there are a decent number of theories developed including: , status quo bias, prospect theory, loss aversion, disappointment, mental accounting, gambler's fallacy, self- serving bias, money illusion, cognitive framing, anchoring, disposition effect, present-biased preferences, endowment effect, inequity aversion, reciprocity, , momentum investing, greed and fear, and sunk-cost fallacy. And as a total it says that the investors are not always rational but sometimes irrational too (Wikipedia: Behavior Economics 25 Apr 2012). It seems that behavioral finance is a promising theory to fill the gap that left by modern portfolio theory in explaining the existence of so many investment chronicles, and encounters whether the market is efficient.

The individual, group emotions, and behavior in markets are basically covered under behavioral finance and it carries together specialists in personality, social, cognitive and clinical psychology; psychiatry; organizational behavior; accounting; marketing; sociology; anthropology;behavioral economics; finance and the multidisciplinary study of judgment and decision making". (Source: Journal of Behavioral Finance).

Behavioral finance is more persuaded towards the investors and their decision making for the following reasons as an individual who learns from his mistakes is more efficient in decision making process. Individuals, who believe in the fact that markets are rational and the prices are inclusive of all type of information available, are capable of relying on passive management.

Need for the proposed study

With increasing freedom of choice in the Financial Market, retail investors are constantly looking out for better and better financial products to park their surplus cash. With a number of financial products flooding the economy, each claiming to be the best, the most crucial challenge faced by the investors today is perhaps in the area of taking investment decisions. Keeping large amount of money in bank is not a wise decision as it would give a return lower than the current inflation rate. Tactical investing needs expertise, skill in reading the market signals, as well as the ability to reallocate assets. Traditional finance theory is based on some fundamental assumptions. Firstly investors make rational decisions. Secondly investors are unbiased in their predictions about future returns of the stock. Thirdly every investor takes careful account of all available information before making an investment decision. However as time went on, academics in both finance and economics started to find anomalies and behavior that could not be explained by the theories available at the time. Financial economist have now realized that the long held assumptions of traditional finance theory are wrong and found that investors can be irrational and make predictable errors about the return on their investments. Recent researches have shown that the average investor makes decision based on emotion, not logic; most investors buy high on speculation and sell low in panic mode. A variety of financial securities are created and marketed in order to satisfy the variegated requirements of both the suppliers and the users of the funds. Mutual funds and insurance have emerged as an important segment of financial market of India especially in channelizing the savings of millions of individuals into the investment in equity and debt instruments. Though real estate and gold have in the last few years yielded good returns, they are quite cyclical in nature and overexposure in any of them could be dangerous. The best part about equity investing is that it is liquid, can be sold in parts, is much more manageable and historically returns in the longer term would be much higher than any asset class. However, retail investors face a lot of problem in the stock market due to risk factors such as limited resources, lack of professional advice and information and so on. This study of investors' perception towards mutual fund investment is based on the north coastal districts of Andhra Pradesh. The study being conducted with taking respondents from all the areas and they show some significant factors which can be related to rest of the investors inIndia.

Objectives and Methodology:

Our main objective is to study investor perception towards mutual fund investments.

Here we show the significance level of behavior of investors in relation to their demographic attributes based upon a sample survey. And we also focused to develop a perception-investment model which suitable for behavioral finance. The implication of this model is to deliver a better understanding of behavioral finance for various investors.

The sample size is calculated with confidence interval 5 and confidence level 95% the sample size for the study is confined to 400 respondents from three districts. The three north coastal districts of Andhra Pradesh, according to the 2011 census spread in an area of 92,906 square kilometers (35871 sq. Mt) which is 57.99 % of the total state area and a population of 34,193,868 which is 69.20% of Andhra Pradesh state population. The area includes the coastal districts of Andhra Pradesh between the Eastern Ghats and Bay of Bengal. The region is well distributed with natural resources suitable for agriculture, manufacturing and services. The sample covers all the levels of the investors viz., small, medium and large. An administered close ended questionnaire was circulated to the selected investors in order to collect first-hand information. We mainly took four major demographic factors for the study such as age, education, occupation and annual income. This is because; these factors influence the individual investment behavior. To analyses and compare the study, various tools are been followed, out of which tools conveniently used for analyzing and interpretation of the data are: Analysis of Variance (One-way Anova).

Results & Discussions:

Table 1:Showing the significant values after running one way analysis of variance between various factors influencing mutual fund performance and investors' demographic variables

Factors	Age	Education	Occupation	Annual Income
Political situation	0.68	**0.04**	**0.05**	0.45
Attitude of government towards FDI	0.01	0.93	0.95	0.20
Taxation	0.61	**0.03**	**0.05**	0.62
Country track record in investments	0.69	**0.05**	0.33	0.69
Overall investment climate	0.05	0.13	0.11	**0.04**
Innovativeness of the scheme	0.02	0.16	**0.04**	0.76
Reputation of sponsoring firm	0.75	0.46	**0.05**	0.95
Sponsors expertise in managing money	0.04	0.40	0.47	0.69
Disclosure of investment objective in the advertisement	0.37	**0.04**	0.09	**0.05**
Investor guidance	0.61	**0.02**	0.88	0.38

Andrew W. Lo (2005) mentioned that the degree of market efficiency is related to environmental factors consisting of market ecology such as the available competitors in the market, the level of profit opportunities available, and the compliance of the market participants. Therefore, while choosing the right fund to invest, an investor and his advisor have to look beyond the performance of the fund to other relevant factors such as the social structure which is measured by a high range of factors that determine the social status of a person in the community, their ability to cope up with presenting problems and getting re-sources to deal with these problems. Traditional measures used to assess social structure include education, occupation, and ethnicity, RONALD M. ANDERSEN (1995).

Therefore, the quantum of risk that exists in the investments of the respondentsis measured by considering opinions gathered from the respondents on the topic of risk and its related factors. Also the decisions regarding choosing the investment in mutual funds is also based upon its benchmark index returns. Besides the risk and expected returns, perhaps the most important factor to be considered by an investor would be the package of overall services provided by the fund operators. The fund management operators' growth totally depends on the services they offer to the investors after making their investments. We have considered four major demographic factors which are responsible for the investors' decision making i.e. age, education, occupation and annual income to be compared with the risk, return and service factors. It was concluded that (i) male investors' were more risk tolerant than females, (ii) older respondents were more risk tolerant than younger respondents, (iii) professionals were more risk tolerant than those with employees, (iv) respondents with higher level income were more risk tolerant than those with lower level income, (v) respondents with higher education were more risk tolerant than others. (John E. Grable,2000).

From the table, it is clear that factors like attitude of government towards FDI and overall investment climate in managing money are significant and hence, we can accept the hypothesis that age influences investor's perception on risk. By going through the above analysis when age is compared with all the factors, only few factors such as attitude of government towards FDI and overall investment climate are considered to be significant in decision making. Whereas, remaining factors are taken as nominal without having much significance. There are, however, other factors such as "security", "opinion", "awareness", "hedging", "benefit" and "duration" which affect the investors' perception regardless with their age group, Gaurav Kabra (2010). R A Nagy, R W Obenberger, (1994) also say that there is a significant influence of various attitudes of age groups ofpeopleontheinvestmentdecisions.Age,opennes

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spersonality,andmotivationtomentoralso act as influencing factors for investors. C Mitteness, R Sudek, (2012).

The factors like innovativeness of scheme, sponsor's expertise in managing money are significant and hence, we can accept the hypothesis that age influences investor's perception on returns in the light of these factors. By going through the above analysis when age is compared with all the factors, only few factors such as innovativeness of scheme and sponsor's expertise in managing money are considered to be significant in expecting the returns. Whereas, remaining factors from the above factors are taken as nominal factors without having much significance. Among the respondents there are various age groups forming important factors responsible for arriving at significant and insignificantvalues.

Further, it can be understood that when various age groups are compared, the age group of 36 – 50 have opined that they found more risk when government presents negative attitude towards FDI's. In such case, they felt that the net worth values of their mutual funds are being reduced. When last risk factor i.e., overall investment climate relating to mutual fund investment is compared with different age groups, the age group ≤35 have opined that they find more risk with the investment climate i.e., speculation in prices, market conditions and government policies etc., play a significant role in keeping best climate for mutual fund investments. But in the above case it can also be vice versa. We can also say that the younger and older generations are less risk tolerant than the middle aged, Chia-Chi Chang, (2004). Further, another study says that higher aged respondents were more risk accepting than younger respondents. (John E. Grable, 2000).

The table reveals the analysis of the opinion of respondents, in respect to the return factors. Due to various influencing factors like peer pressure or family influence, people of different ages exhibit different behaviors in various situations considering their beliefs, faith, previous experiences, etc., Similarly, the expectation on return also varies with age. The age group of 36 - 50 opined that sponsors' expertise in managing money is an influential factor in returns of mutual funds. As various services are offered by an organization, considering the above significant factors may become more important for them to have more investors.

From the table, it is clear that factors like political situation, taxation and country's track record in investments are found to be significant against the education variable. Hence, we can accept the hypothesis that educational qualification influences the risk perception of investors. The selection of investments are also based on two main factors such as the risk bearing capacity of the investor and his education levels, G Mohanta, SS Debasish (2011). Since education helps people in analyzing different factors in an extensive way, we find significant differences in the opinions of the respondents when we classify them on the basis of their educational qualification. As the level of education Increased, risk tolerance increased. In particular, households who were less educated that is up to high school or below that were least risk tolerant, Sharon A. DeVaney (2004).

It is also clear that factors like disclosure of investment objective in the advertisement, disclosure of deviation of investments from the original pattern, disclosure of period of valuation in the advertisement, investor guidance and transferability are significant and hence, we can accept the hypothesis and state that educational qualification influences perception of investors on servicesfactors. Investors with higher education are keen to consider above factors before investing and take informed decisions.

Further, a better understanding may be obtained while comparing respondents with different educational qualifications with five significant factors found to be significant in the analysis. When political situations and educational qualifications are correlated, then the investors' possessing post-graduation have opined that they find more risk when country has instable political situations. In such a case the net worth values of their mutual funds may be affected because of change in policies, Similarly, when other significant factor i.e., taxation relating to mutual fund is considered, the same group felt that they have more risk with the frequent change of taxation procedures in relation to mutual fund investment. Also investors' who possess professional education felt that there is more risk factor when business establishment procedures are not clearly defined, and also country's track record may reflect in mutual fund investments. The investors' possessing graduation as educational qualification have opined that they find more risk in some schemes which are formed just because of limited knowledge towards mutual fundinvestments.

The table reveals the analysis of the opinion of respondents, in respect to the return factors. Investors' who possess SSC/Intermediate which is basic and minimum qualification opined that minimum initial investment and performance in terms of risk and return are to be considered before investing by the investors. From the analysis when educational qualification is correlated with various factors only few are considered as significant because of their educational awareness. The study revealed that investors with lower educational qualification felt that they require investment guidance before and after making investments in mutual funds. One of the researches says respondents with higher education were more risk tolerant than others, investors with higher levels of knowledge on financial aspects were more risk accepting than respondents with less knowledge. John E. Grable, (2000).

From the table, it is clear that factors like political situation, taxation are significant with reference to their occupation, we can accept the hypothesis that occupation (or) nature of work of respondents influences their perception levels on investment risk. The fact that nature of work of the respondent will develop a social status and this will influence the person in making the decisions. So, the occupation of the respondent allows them to speak out about different factors in diverse ways and hence, we found significant differences in the respondents when we classify them on the basis of occupation like public, private, professional and self-employed. The households who were self-employed were more risk accepting than the households who were not doing any work, Sophia T. Chiremba (2004). It is seen that there is significant relationship between income and occupation on investment avenues in order to satisfy safety, periodic return, liquidity, better future and future contingency needs, G Mohanta, SS Debasish (2011).

It is clear that factors like innovativeness of the scheme and reputation of sponsoring firm are significant and hence, we can accept the hypothesis that occupation (or) nature of work of respondents influences perception levels of investors. It is also seen that professionals were more risk accepting than those with lower level of income. John E. Grable,(2000).

From the analysis it can be presumed that the investors' occupation also matters for making investments in the mutual funds. As per their opinions the investors whose occupation falls into public sector organization felt that speculation in the political situations and taxation policies is affecting them while making investments in mutual funds. Similarly, investors working in private sectors also felt the same but whereas the investors who are engaged in professional and other service activities did not consider them as significant.

An investment in funds depends upon earnings through the occupations too. In this study, when the investments and returns are compared with their nature of occupations, the following results were disclosed. For a person working in private organization, the flexibility and organizational background is more important and both are considered as significant factors, and an investor who is a professional, expects novelty in nature of funds. He looks for more returns by taking more risk. Hence to conclude irrespective of occupation of the investors the fund should be managed with less risk, more returns and containing novelty.

From the table, it is clear that factors like overall investment climate is significant and hence, we can accept the hypothesis that annual income of respondents influences their risk perception. Though there are number of demographic factors that have been influencing the investment decisions, monetary factors have their own role to play in considering the investments of respondent and this influences the person in taking their decisions. The annual income of the respondent enables them to consider different factors in diverse ways and hence, we found significant differences in the respondents when we classified them on the basis of their income levels. As income level of people increases, households and other heads were more likely to be risk tolerant, Chia-Chi Chang, (2004).

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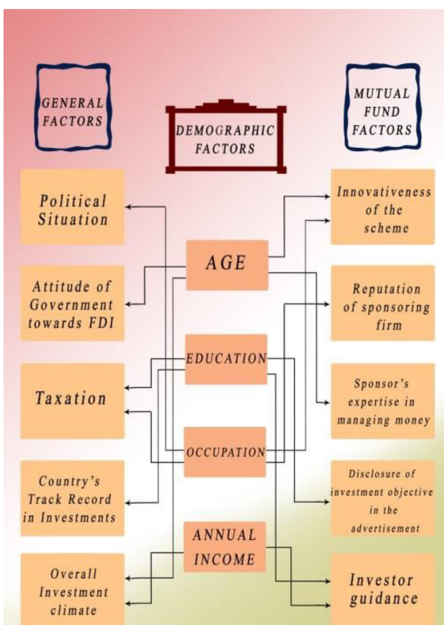
Also, the factors like disclosure of investment objective in the advertisement, mutual funds investor's grievance redressal mechanism and preferred mutual fund to avoid problems, that is, bad deliveries, and needless follow up with brokers and companies are significant and hence, we can accept the hypothesis that annual income of respondents influences service perception levels of investors.

When all the variable factors and income of the respondents are correlated, it is found that the market conditions, investment climate and other related costs are primarily responsible for speculating more risk. Hence these three factors must be properly coordinated and regulated in order to keep the risk factor in lower levels. One of the researches says investors with higher level of income were more risk accepting than those with lower level of income. John E. Grable,(2000).

In the process of analysis annual income of an investor is also taken as significant factor to know proportion of investment from the incomes and also service required from MFI's to retain them in the organization.

From the inferences drawn in this study, the following model is developed to better understand the investor behavior in mutual funds.



In this model, the inter- relationships between the general environmental factors such as Political situation, attitude of the Govt., Taxation, etc. with the demographic factors such as Age, education, occupation, etc. and the mutual fund factors such as the innovativeness of scheme, sponsor's expertise in managing money, disclosure of investment objective and investor guidance are illustrated for better understanding of the investor behavior.

Utility of the study:

From the above analysis we can see that, it helps an investor to make the best possible decision to invest his/her money into various funds available. This analysis not only helps the investor but it also proves to be useful for the industry and the management as well. As compared to the pre-liberalization India and post- liberalization India, the savings were more upsurge in the second phase because of which the mutual fund companies are continuously putting an effort to launch new funds into the market so as to mobilize the savings of the investors. The future of mutual fund and life insurance industry will be undeniably competitive not only within the industry but also as compared to other financial products that provide many of the same economic functions. Unless the mutual fund and life insurance schemes are tailored to the changing needs and unless investment companies understand the investor's psychology, survival of the funds will be difficult in future. Here we considered four major demographic factors such as age, education, occupation and annual income. We found that when we take these four demographic factors in consideration, we found out various significant factors such as Political Situation, Attitude of the government towards FDI, Investor Guidance and so on which influences these four demographic factors in return. Therefore, when the industry wants to launch a new fund into the market or to make an existing fund perform more effectively in the market, they must focus on the above significant factors and should launch the fund. These significant factors must be considered while making the promotional strategies so that it attracts new investors to invest into these funds. Further this will actually help in educating an investor, and will make him/ her much more aware of their needs and the type of savings that they are actually willing to do. It will bring them in much more proximity to the world of mutual funds and investment and it will help them to choose a fund accordingly. Hence by understanding the entire analysis an investor will be thorough with what he/ she will be doing in future in terms of savings, And hence it will give them certain amount of clarity regarding their investments and savings. The study is equally beneficial for the academics' purpose as such it is similar to various consumer behavior models. Hence it will help them to know the requirements of the investors and the management can design their products in a manner which will be found appealing to the investors, this will also provide an understanding to the facultyandstudents.Anditwillformabasisofthepointsoneshallkeepinmindwhilemakingapolicy.

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