advisor tum kab aaoge ?

The financial sector is evolving at a rate faster than one ever thought. Staying in tune with the latest changes has become an onerous task. While there are some who describe the changes as "unprecedented and catastrophic" and paint a doomsday scenario, there are others who are bracing up to take on the challenge.

On the face of it, the picture can look dismal for distribution when seen through a pessimistic lens. But if one were to look at things differently and examine the situation from a long term perspective, the picture taking shape could look quite the contrary.

To the optimistic it appears that the bedrock is being laid for a future based on sustained and inclusive business. The investor clearly seems to have become the center of focus. He now has a choice of either investing directly or through a distributor.

The distributor on the other hand has an opportunity to evolve and climb up the learning curve and dispel high quality advisory that will not only make him proud of his vocation but would also give him the joy of delivering meaningful service.

This is the moment of truth when advisors will realize that advisory is not merely about suggesting a product. There is much more to advisory than what was being thought until now. This is a moment when advisors need to question their raison d'être. What is their calling? What is their purpose?

If one were to see it from the perspective of "purpose", several advisory opportunities come to the fore. These are opportunities that stem from the science of "behavioral finance". Investors seldom take investment decisions based on rational behavior. The "calling" or "purpose" of a advisor is to help an investor by

preventing him from swaying with the winds of irrationality and guiding him towards making dispassionate decisions, keeping every trace of emotion in check.

When financial advisors are aware of the psychological and behavioral consequences of their clients' behavior, they can intervene and protect them from the consequences of irrational decision making. This allows advisors to build a stronger partnership with their clients.

The landmark 2009 DALBAR study - "Qualitative Analysis of Investor Behavior" - showed that over a 20-year period, the S&P 500 returned 8.4 percent but the average equity fund investor returned only 1.9 percent. Or the 2009 study by Brad Barber, "How much do investors lose by excessive trading?" documents an annual loss of 3.8 percent for trading-addicted investors who can't stop themselves. So clearly people are not as smart as they think they are. And this is where advisors can bring real value.

There are several typical behavior traits of investors which have been listed as under:-

OVERCONFIDENCE

A number of psychological studies have demonstrated that people have a tendency to regularly overestimate their abilities.

So how does overconfidence affect investment behavior? Models of financial markets with overconfident investors predict that trading will be excessive. Many psychological studies have shown that men are more prone to overconfidence than women. If overconfidence causes overtrading, then men should exhibit a greater tendency toward overconfidence by trading more. The results of the study show exactly that—for a large sample of households, men traded 45% more than women, and single men traded 67% more than single women over the period of the study.

Is the active trading that overconfidence leads to actually 'excessive,' causing lower performance? A study of the trading activity and returns for a large national discount brokerage suggests that it is. For all households, returns averaged 16.4% over the period. However, those that traded the most averaged 11.4% in annual returns, significantly less than for an account with average turnover. Over the same period, the S&P 500 returned 17.9% on an average.

So what can investors do about the general tendency toward overconfidence? You can profit from this research only by heeding its message: TRADE LESS.

Another behavior that is related to overconfidence is the tendency to treat historical information as irrelevant and to place more importance on current circumstances as a determinant of future outcomes. The cry of "this time it's different" has a special place in investment lore. It is perilous to ignore stock market history based on a belief that present circumstances make historical market performance irrelevant to current decisions.

The Advisor clearly has a role to play in helping investors curb their overconfidence through wise counsel based on facts and figures.

AVAILABILITY BIAS

In 1985, behavioral finance academics Werner De Bondt and Richard Thaler released a study in the Journal of Finance called "Does the Market Overreact?" In this study, the two examined returns on the New York Stock Exchange for a three-year period. From these stocks, they separated the best 35 performing stocks into what they called a "winner's portfolio" and the worst 35 performing stocks what they called a "loser's portfolio". De Bondt and Thaler then tracked each portfolio's performance against a representative market index for three years. Surprisingly, it was found that the loser's portfolio consistently beat the market index, while the winner's portfolio consistently underperformed it. The cumulative difference between the two portfolios was almost 25% over the three-year period.

IN OTHER WORDS, IT APPEARS THAT THE ORIGINAL "WINNERS" BECAME "LOSERS" AND VICE VERSA. So what happened? In both the winners and losers portfolios, investors essentially overreacted. In the case of loser stocks, investors overreacted to bad news, driving the stocks' share prices down disproportionately. After some time, investors realized that their pessimism was unfounded and these losers began rebounding as investors came to the conclusion that the stock was underpriced and started buying them in large numbers thereby boosting their price.

The exact opposite is true with the winner's portfolio: investors eventually realized that their exuberance wasn't totally justified and that the portfolio was overpriced. This led them to sell off and prices started to cool off. Thus the loser's portfolio overperformed while the winner's portfolio underperformed in the subsequent three years period.

ACCORDING TO THE AVAILABILITY BIAS, PEOPLE TEND TO WEIGH THEIR DECISIONS HEAVILY TOWARD RECENT INFORMATION MAKING ANY NEW OPINION BIASED TOWARDS THAT LATEST NEWS.

This happens in real life all the time. For example, suppose you see a car accident along a stretch of road that you use to drive to work. Chances are that you will begin driving extra cautiously for the next week or so. Seeing the accident causes you to overreact. But in due course you will be back to your old driving habits. Similarly when the 26/11 terrorist attacks took place, there was a major uprising of citizens. But in a few days, things calmed down. So has been the case with the anti-corruption crusade led by Anna Hazaare. It snowballed into a national issue spreading its tentacles across Indian towns and cities. But over time the momentum subsided. We also call this as "SHORT LIFE OF PUBLIC MEMORY".

It is here that the advisor can step in and advise investors to retain a sense of perspective about the purpose of investment. While it is easy to get caught up in the latest news, short-term approaches don't usually yield best investment results. The advisor can bring value by doing a thorough job of researching the investments, highlight the frailty of recent news in the context of his rational dispassionate research and guide the investor to focus on the long-term picture.

ANCHORING

Anchoring is a behavioral pattern wherein investors base their decisions on a single event. They lay anchor around a specific event which influences their subsequent behavior. The

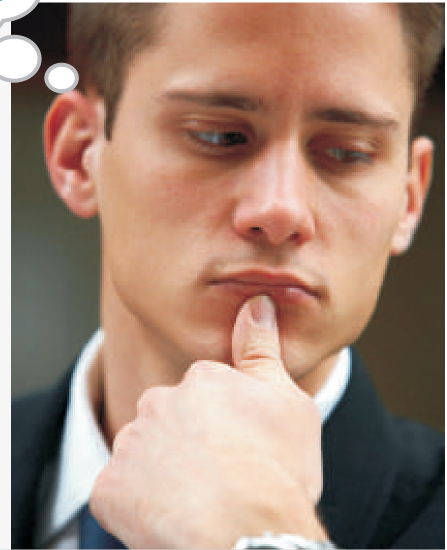
influence of the event is so profound that the investor is blind towards the underlying realities. Suppose, a salesman offers 50% off on a list price of Rs 1000, a customer tends to feel that he has earned himself a good bargain. But in fact the actual price of the product was only Rs 600 and the real discount works out to be only 16%. Since the customer had no knowledge of the actual intrinsic value of the product, he anchors his decisions around the inflated list price of Rs 1000.

In investments too, a sudden fall in price engineered by strong head winds has a tendency to become the anchor point for making investment decisions. The advisor can play a vital role in such circumstances by cautioning the investor to steer clear of the anchor point and present a long term perspective of investments towards meeting life's goals. If the simple tenets of financial planning are well explained, investors would realize that they are in good hands and this would prevent them from becoming a prey of the "ANCHORING" trap.

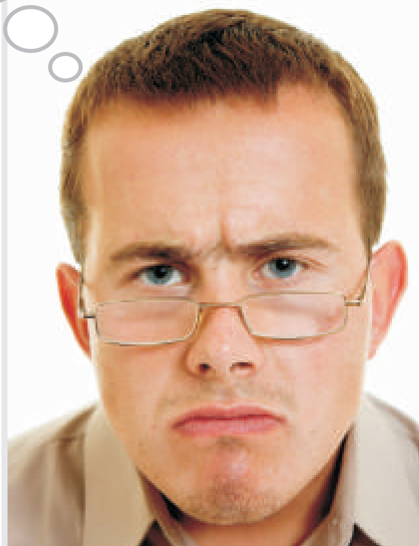
MENTAL ACCOUNTING

Some investors divide their money into earned money and "found" money. When they earn a profit, they treat the profit as "found" money and treat the principal as "earned" money. They then subject the "found" money to speculative forces by taking unfounded risks but invest the "earned" component conservatively. Although the mental accounting seems logical, in reality money cannot be divided into such mental compartments. Money has only one color. What is important is to simply follow the principles of investing such as following a disciplined pattern of investment, asset allocation, asset re-balancing etc. All other mental compartments need to be demolished. Another good example is when clients keep money in the savings account but desist from paying off their debts. If the savings account earnings are less than the interest on the loan, it makes more sense to pay off the debts instead. An advisor can ensure that the investor is kept away from becoming a victim of the mental accounting trap.

GAMBLER'S FALLACY



If the markets continue to rise seven days at a stretch or fall seven days at a stretch, it is wrong to believe that a U-turn is round the corner. The probability that the trend will continue is as good as the opposite. The advisor should help the client make rational decisions by looking at fundamentals and making him follow the principles of financial planning.



HERD MENTALITY

This is perhaps the most popular investment behavior seen. Investors have a tendency to blindly follow a trend. If an investor notices that the public in general is investing in a particular asset class, they too proceed to do the same.

While it is tempting to follow the herd, it is better to steer clear of the herd. Just because everyone is jumping on a certain investment "bandwagon" doesn't necessarily mean the strategy is correct. Therefore the soundest advice is to always do your homework before following any trend. The advisor is in a good position to remind the investor that investments favored by the herd can easily become overvalued.

COGNITIVE DISSONANCE

This is a psychological behavior which is observed in day to day life. A customer purchases a car and the very next day realizes that he could have got it cheaper elsewhere. Immediately he gets defensive and starts to justify his decision howsoever baseless it may sound. One of the most common symptoms exhibited by a person suffering from cognitive dissonance is to avoid looking at advertisements and news that prove him wrong. On the contrary he will seek information that even remotely authenticates his decision, howsoever weak the argument may sound. The advisor can step in here and explain the role of dispassionate thinking in investments.

PAIN OF REGRET

It is often seen that investors wait endlessly for a loss making portfolio to turn around. In the process the investor loses the opportunity to replace the portfolio and recover the losses made in the earlier portfolio. The advice given to sell off a loss making portfolio and switch investments to another

portfolio having better prospects is commonly known as "STOP LOSS". It is also seen that when a portfolio turns positive, a typical investor behavior is to sell off earlier than needed. He begins to feel that the price is high and could turn the corner any moment and this leads him to pull the "SELL" trigger prematurely. An advisor can emphasize the tenets of financial planning and the underlying fundamentals of the portfolio from a long term to help safeguard the investor from falling into the "Pain of regret" trap.

REPRESENTATIVENESS OR PERCEPTION BIAS

To make judgments based upon superficial indicators can prove to be a costly mistake. For example a bad news about an asset management company need not mean that the portfolio belonging to the company is necessarily bad. After all a portfolio is a collection of stocks that represent the stock market and has nothing to do with the asset management company. One should also bear in mind that the risk of the portfolio is in keeping with the Scheme Information Document and regulator guidelines. So if news about the asset

management company is not good, one need not think likewise about the mutual fund schemes of the asset management company. At the same time positive news flow about an asset management company also need not have any kind of rub off effect on the portfolio schemes belonging to that company. The tendency of the human mind of picking up a few good or bad words and using them to represent other things is a mistake that needs to be curbed. This is also called the perception bias. Hence there is a saying that perceptions are greater than reality. It is this tendency that can damage investment objectives. The advisor can help the investor separate the perception from reality and restrain the investor from making any knee jerk decisions based upon perceptions.

MYOPIC RISK AVERSION

The term "myopic risk aversion" refers to the tendency of decision makers to be shortsighted in their choices that involve potential losses. Consider an investor saving for retirement. Two leading researchers in behavioral finance have concluded that investors in this situation tend to hold less than the optimal amount of equities because they place too much emphasis on the potential loss from a single year's investment in equities. They term this shortsightedness myopic risk aversion. In one study, investors in a company retirement plan chose larger equity allocations after they were shown the actual results of investing in equities over many different 20-year periods. The research suggests that if investors focus on the long term across any period, the probability of making healthy returns in equity is reasonably high. Therefore for the long term, equities are the asset class that should form a key part of an investor's portfolio without considering too much about the short term volatility. The advisor has a unique opportunity to ensure that investors having time on hand should never ignore equities and the power of compounding.

PROSPECT THEORY

Research has found that we don't actually process information in such a rational way. In 1979, Kahneman and Tversky presented an idea called prospect theory, which contends that people value gains and losses differently and will base decisions on perceived gains rather than perceived losses. According to prospect theory, losses have more emotional impact than an equivalent amount of gains. For example, in a traditional way of thinking, the amount of utility gained from receiving $50 should be equal to a situation in which you gained $100 and then lost $50. In both

situations, the end result is a net gain of $50. However, despite the fact that you still end up with a $50 gain in either case, most people view a single gain of $50 more favorably than gaining $100 and then losing $50. The implication is that people are willing to settle for a reasonable level of gain (even if they have a reasonable chance of earning more), but are willing to engage in risk-seeking behavior where they can limit their losses. The advisor can help the investor take risks based on his risk profile and age dispassionately. There is no need for an investor to increase his risk to avoid a potential loss without basis. This is where advice to stop loss comes to the fore. At the same time there is no need for an investor to play extra safe when he has time on hand. This where the advisor can step in and advise investment in equities when there is time on hand for the investor.

Advisors need to be cognizant of peculiar behavior of people when it concerns their investment decisions and need to realize that their raison d'être stems from there. They need to keep this in mind while rendering counsel.

Financial advisors can help individual investors by:

1. Building an investment plan that diversifies funds across a broad spectrum of asset classes.

2. Rebalance occasionally.

3. Be watchful of bad investment behavior that tend to influence investors during stressful investment periods and counteract these corrosive behavior with insightful and powerful questions, discipline, patience as well as a heavy dose of investment humility. It may not seem like much but if a financial advisor can help their clients avoid these mistakes and as a result protect portfolio performance to the tune of 5 or 6 or as much as 7 percent per annum, the financial advisor is doing a great service to their clients and reinforcing their relationship, creating a stronger bond of trust going forward.

1. Investors feel the pain of loss TWICE as much as the pleasure they derive from an equal gain.
2. Investors put disproportionate weight on the current environment when making decisions about the future.
3. Investors display the tendency to sell winners too early and keeping losers too long.
4. Investors display a tendency to rely too heavily on a single piece of information while making decisions without considering all other factors that can influence.
5. Investors tend to be short-sighted and look at recent volatility of equities either to feel over optimistic or over pessimistic.
6. Investors tend to paint everything with the same brush and create generalized perceptions.
7. Investors take irrational decisions to avoid the pain of regret
8. Investors tend to justify incorrect decisions and seek support for the same and turn a blind eye to that which exposes their decision.
9. Investors tend to be overconfident
10. Investors resort to baseless mental accounting by looking at the same money through different lens
11. Investors tend to take decisions based on one key point that seems to guide their subsequent decisions
12. Investors tend to believe that everything is cyclic in nature and a series of losses will certainly turn the corner
13. Investors take long term future decisions based on recent events
14. Investors have a tendency to blindly follow the herd

■ Dharmendra Satapathy