An Understanding of Role of Heuristic on Investment Decisions

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Introduction

Investors have to take many decisions on day to day basis. Decisions can never be made by relying on the personal resources and complex models, which do not take into consideration the situation. The neoclassical models in economics and finance assume that the typical decision maker has all the information and unlimited cerebral capacity. He considers all relevant information and comes up with an optimal choice under the circumstances using a process called constrained optimisation. With respect to investor's decision making, it needs better insight, and understanding of human nature in the existing global perspective, plus development of fine skills and ability to get best out of investments. In the real world, people make decisions with inadequate and imperfect information and have limited cognitive capacity. Behavioural finance has become an integral part of the decision-making process, because it heavily influences investors’ performance. They can improve their performance by recognising the biases and errors of judgement to which all of us are prone. Understanding the behavioural finance will help the investors to select a better investment instrument and in turn they can avoid repeating the expensive errors in future. A heuristic is a crude rule of thumb for making judgements about probabilities, future outcomes, and so on. A bias is a tendency towards making judgemental errors. The heuristics and biases approach studies the heuristics people employ to form judgements and the associated biases in those judgements.

The pertinent issues of this study are how to minimise or eliminate the heuristics and biases in investment decision process.
LITERATURE REVIEW
Most of the theories in finance and economics are based on the rational decision making processes. These theories consider that investors are always rational in decision making and they consider all aspects while deciding about anything (Kim & Nofsinger, 2008). Generally financial behavior of investors is based on the cognitive and intellectual model which includes various factors related to psychology, sociology and finance. The agents of the behavioral models are not considered as rational because the investor perception and preferences lead them to behave irrationally (Farlin, 2006). Although there are many of studies in this area but most of the people are unaware of the concept of financial behavior and the elements which lead toward the irrational behavior (Montier, 2002) and one such is Heuristic behaviour in Decision Making.

OBJECTIVES
1. To understand Heuristics and its implications for Decision Making

RESEARCH METHODOLOGY
Descriptive study has been used. The paper is based on a comprehensive study of secondary information through books and articles related to heuristics.

Heuristics and its implications for Decision making
Heuristics are defined as the rules of thumb, which makes decision making easier, especially in complex and uncertain environments (Ritter, 2003, p.431) by reducing the complexity of assessing probabilities and predicting values to simpler judgments (Kahneman & Tversky, 1974, p.1124). These heuristics are quite useful, particularly when time is limited (Waweru et al., 2008, p.27), but sometimes they lead to biases (Kahneman & Tversky, 1974, p.1124; Ritter, 2003, p.431). Kahneman and Tversky seem to be ones of the first writers studying the factors belonging to heuristics when introducing three factors namely representativeness, availability bias, and anchoring (Kahneman & Tversky, 1974, p.1124-1131).

A) Representativeness - Representativeness refers to the degree of similarity that an event has with its parent population (DeBondt & Thaler, 1995, p.390) or the degree to which an event resembles its population (Kahneman & Tversky, 1974, p.1124). Representativeness refers to the tendency to form judgements based on stereotypes. For Example, you may form an opinion about how a student would perform academically in college on the basis of how he has performed academically in school (Chandra, 2016). While representativeness may be a rule of thumb, it can also lead people astray. For example
Investors may be too quick to detect patterns in data that are in fact random (Chandra, 2016).

Investors may believe that a healthy growth of earnings in the past may be representative of high growth rate in future. They may not realise that there is lot of randomness in earning growth rates.

Investors may be drawn to mutual funds with a good track record because such funds are believed to be representative of well performing funds. They may forget that even unskilled managers can earn high returns by chance (Chandra, 2016).

Investors may become overly optimistic about past winners and overly pessimistic about past losers.

Investors generally assume that good companies are good stocks, although the opposite holds true most of the time.

There are four variants of Representative Heuristics:

1. Ignorance of sample size - Representativeness also leads to the “sample size neglect” which occurs when people try to infer from too few samples (Barberis & Thaler, 2003, p.1065). In stock market, when investors seek to buy “hot” stocks instead of poorly performed ones, this means that representativeness is applied. This behavior is an explanation for investor overreaction (DeBondt and Thaler, 1995, p.390).

2. Base rate Neglect - This heuristic involves attending to the particular characteristics of the individual, ignoring how common those categories are in the population (called the base rates). People can overestimate the likelihood that something has a very rare property, or underestimate the likelihood of a very common property (Chandra, 2016).

3. Conjunction Fallacy - When people rely on representativeness, there can be an error which breaks a fundamental law of probability. Example, of probability related difficulty is that people often have a poor understanding of the difference between simple probabilities(probability of A) and joint probabilities(probabilities of A and B). Example, people often think that the probability that they will win lottery and be happy is higher than the probability that they will just win a lottery (Chandra, 2016).

4. Innumeracy - People have difficulty with numbers. People tend to pay more attention to big numbers and give less weight to small figures.

**B) Anchoring** - Anchoring is a phenomena used in the situation when people use some initial values to make estimation, which are biased toward the initial ones as different starting points yield different estimates (Kahneman & Tversky, 1974, p.1128). There are two plausible explanations for anchoring. The first is based on uncertainty relating to true value. When there is uncertainty, the decision maker adjusts his answer away from anchoring value until he enters a plausible range. This
explanation works best for relevant anchors. The second explanation is based on cognitive laziness. Since it requires effort to move away from the anchor and people are cognitively lazy, they tend to stop too early. This explanation works best for irrelevant anchors (Chandra, 2016).

C) Availability Bias - Availability bias happens when people tend to judge the frequency of something by the ease with which the instances can be recalled. Availability heuristics substitutes the harder question (How likely an event is?) with the easier question (Have I seen something like this?). The availability heuristics says that events that can be easily been recalled are deemed to occur with higher probability (Chandra, 2016). In stock trading area, this bias manifest itself through the preference of investing in local companies which investors are familiar with or easily obtain information, despite the fundamental principles so-called diversification of portfolio management for optimization (Waweru et al., 2003).

CONCLUSION

Even though heuristics can lead to deviations from optimal decisions, some psychologists are increasingly interested in decision makers’ use of heuristics. Heuristics are rules of thumbs for problem solving that do not guarantee optimal solutions. However there is some accuracy close to more complex decision rules which can be useful in difficult decision making contexts. Many managerial decisions are highly uncertain and involve a large number of attributes and mostly base their decision only on return on investment. They furthermore do not always use systematic approaches to information gathering and decision making, but often rely on readily available internal information and “gut feeling”. At some decision points, the gathering of information by decision model could result in long time delays and high costs, and, if decision errors are “cheap”, it is acceptable to sacrifice decision quality and choose a simpler, fast, and less expensive evaluation method.

REFERENCES


**Books**
