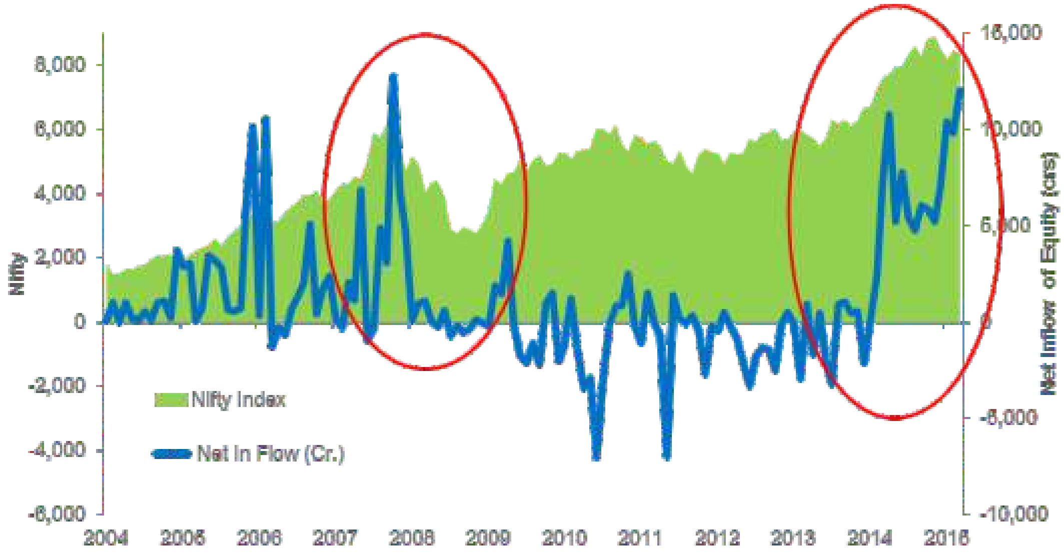
AXIS MUTUAL FUND

How difficult is it to behave yourself?

Traditional theories on finance assume that market is efficient, investors are rational and they take all their investment decisions based on underlying calculation of expected utility. Expected utility is the sum of all possible probabilities and their individual utilities. However, the question that arises here is whether it is really possible? If no, then should we rely on such techniques where the key assumptions doesn't hold true in the real world?

The reason why investment world cannot be simplified into some rational formulae is that human sentiments play a huge role in their decision making process. Behavioral Finance is a science that assumes human behavior to be irrational and it adjusts for such actions of humans. It is very well accepted that humans have psychological biases and these biases affect their decisions, may it be personal or professional. There is extensive research done in this field and there are evidences that prove how human behavior affects their investment decisions and how markets have reacted to such human irrational behavior.

It is easy to follow others and it feels right when one does so. Only tough thing is to accept that it is not rational. The sole motto of being a market participant is earning profits by buying low and selling high. Although it sounds straight and simple, it isn't practically possible always because it is almost impossible to ascertain if any market level is low or high at that point in time. Below chart depicts the net inflows in equity assets over the last 10 years mapped to the market levels at that time. It is clearly seen that when markets were at peak, inflows were also at their highest levels. These heavy inflows were followed by immediate sell-off when markets crashed. Such a behavior can be partly attributed to herd mentality. Like 'herding', there are many such biases that investors fall prey of. Some of the other key biases include confirmation bias, hindsight bias, over confidence, anchoring bias, etc.



Data source: ACEMF – AMFI data of monthly net inflows in equity mutual funds

Conclusion:

Behavioral Finance has brought up a completely different yet more realistic perspective in analyzing investor behavior. There is no concrete answer to unpredictable human behavior. However various studies in this field can definitely help investors in inspecting their own investing patterns and decisions.

Data updated as on 30th Nov 2015.