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Investor's Herding Behavior and Investment Performance: An Empirical Evidence From Delhi

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Abstract:
"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."
Charles Mackay (1841)
Behavioral finance is an evolving field which studies how psychological factors influences decision making under conditions of uncertainty. It attempts to study how emotions and cognitive errors influence individual investors' behavior. This research papers aims to find out the influence of an identified behavioral finance concept, namely, Herding Effect, on the decision making process of individual investors in Indian stock market. The herding effect has been examined on by taking individual investors of Delhi. Primary data for analysis was gathered by distributing structured questionnaire among individual investors. The study also tries to find out the relation between the behavioral factor and investment performance. Of the 124 responses received, it was found that herding effect is visible among Indian investors to some extent. Also, investors in general were satisfied with the performance of their investment decisions owing to low levels of technical knowledge, though the rate of return on such investments was in most cases lower than that of market return. Further it was found that investors believe decisions of herd are always true howsoever irrational they may be.

Keywords: *Behavioral finance, Herding, Individual Investor, Investment performance.*

1. Introduction

Most of the economics and financial theories are based on presumption that investors always act rationally while taking investment decisions by taking into account all available information. Whatever decisions investors take are solely guided by objective of maximizing return and minimizing risk. To achieve this objective it is presumed investors undertake technical and fundamental analysis. But there is evidence to show repeated patterns of irrationality in the way humans arrive at a particular decision or choice when faced with uncertainty.
Behavioral finance a study of human psychology throws light on why people buy or sell stocks or sometimes do not buy or sell any stock. According to Sewell (2007), "Behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets."
Behavioral economists firmly believe that psychological factors influence investment decisions. They argue that today's investment decisions demand a better understanding of individual investors' behavioral biases.
The present study aims to study one such psychological factor influencing rational decision making in context of Indian investors-Herding behavior. "Herding in financial markets can be defined as mutual imitation leading to a convergence of action" (Hirshleifer and Teoh, 2003). Herd behavior is basically the tendency of people to mimic the behavior of larger groups. There are a number of reasons why herding prevails. First is the social pressure of conformity. You probably know from your experience that this could be a powerful force. This is due to the fact that people are sociable and have natural desire to be accepted by a group, rather than be branded as outcast. Therefore following the group is an ideal way of becoming the member. The other reason is the common rationale that such a larger group could not be wrong. So even if you are convinced that a particular idea or course of action is irrational or incorrect, you might still follow the herd, believing they know something that you don't. This is especially true for the situation when individual has a very little experience. The study further aims to study the impact of such behaviorally influenced decisions on investment performance of investors.

2. Behavioral finance- An overview

"Behavioral finance relaxes the traditional assumptions of financial economics by incorporating these observable, systematic, and very human departures from rationality into standard models of financial markets. The tendency for human beings to be overconfident causes the first bias in investors, and the human desire to avoid regret prompts the second" (Barber and Odean,1999).
Simon (1955, 1959), Margolis (1958) and Cyert & March (1963) are among the early authors to talk about the results of human psychology involved in financial decisions. Money making remains the prime motive of all investment. During past years, the investments were based upon forecasts and performance. But the returns which were received and those which were available

produced huge gaps which forced the investors to find out why such difference was existing, so, the fundamental mistakes were identified to be involved in decision making process under uncertainty. Such mistakes showed that investors make irrational decisions during investment choice and psychological impact was found during these mistakes.
Thus this subject of Behavioral finance which got so much of popularity in the world of investment decisions and stock market is not completely new concept as researchers started working on it many years ago though the field has evolved in true aspects in past few decades only.
Since many years, investors have been considering psychology an important factor while determining the market behavior, but formal studies have only been conducted in recent years in this field of behavioral finance (Muneer & Rehman, 2012). Seminal role has been played by the paper of Slovic, (1972) regarding the misconceptions of an individual about risk and Kahneman & Tversky (1979) papers on heuristic rule biases and the frames of decision. They have been considered as the father of behavioral finance. The findings of those studies were not in accord with rational traditional finance & economic theory. Although there exist various definitions of Behavioral Finance but still a level of significance can be found. Lintner, (1998) explains about the definition of Behavioral Finance as 'the study of how humans interpret and act on information to make informed investment decisions'.
Different researchers have given their own views on irrational behavior of investors in market place and have tried to explain this relatively new field of finance from time to time. Over a period of time several behavioral finance theories have been developed, most popular being Prospect Theory, Heuristic Theory, and Herding. However there is no specific criterion for categorizing psychological factors into different theories. A number of psychological factors so far have been studied to be impacting investor's rational decision making capability such as overconfidence, mental accounting, herding, loss aversion, anchoring, representativeness bias, availability bias. It's not essential that all these factors would be always affecting or forming a part of decision making process. But some of them can either individually or in a joint fashion may impact decisions under uncertainty. Further the resultant performance of such influenced investment may not necessarily be positive or negative for all factors. It varies with respect to how information has been taken by investors and what his surrounding conditions have been under which he took such decision. With this brief understanding of behavioral finance and herding effect, now I proceed with doing the literature review relevant for the topic of this research.

3. Literature Review

The following section is dedicated to explore the literature review undertaken based on the literature survey done. This section defines the general idea of my topic and the research done so far in this field of study.
Herd behavior is a term implying alignment to a mode of collective conduct and is expressed as a
"similarity in behaviour" following the "interactive observation" of actions and payoffs (arising from those actions) among individuals (Hirshleifer and Teoh, 2003). In the stock market context, herding involves the intentional sidelining of investors' private information in favor of the observable "consensus" (Bikhchandani and Sharma, 2000) irrespective of fundamentals (Hwang and Salmon,2004) and the roots of such behavior can be traced to a series of factors be they of psychological or rational nature.
Tan et al. (2008) conducted a research on A-shares which are held by domestic investors and B- shares usually held by foreign investors to determine whether herding impact investors decisions. It was found that herding exists in both categories of shares but more in A-shares which are owned by domestic investors. Also found that for herding to take place the investor's trading decisions have to be positively correlated to each other.
Lao and Singh. (2011) observed the impact of herding behavior in Indian and Chinese markets during extreme market conditions, increasing and decreasing markets, high and low volume state. Their findings suggest herding behavior is presented in both markets and is greater during extreme conditions in both markets. However herding is greater in china when market is falling and trading volume is high whereas in India it occurs during upswings in market trends and it was not affected by trading volume.
Welch (2000) in his study found out analysts could be exhibiting Herding behavior too. It was not confirmed due to lack of micro level data. Whenever and analyst revised his recommendations, it had a positive correlation with the next two analyst's revisions. The revision was found to be heavily influenced by the prevailing market consensus, and to recent information updates.
Brabazon et al. (2004) have talked about the emotions, overconfidence, illusion; gamblers fallacies that sway individual investor can also sway markets. It was said that behavioral factors do not completely overthrow efficient market hypothesis but provides an explanation of some unanswerable changes in financial markets which would otherwise be called anomalies.
Theoretical models of herding behavior have been developed by Bikhchandani et al. (1992),
Scharfstein and Stein (1990), and Devenow and Welch (1996). Empirical studies have mainly focused on detecting the existence of herding behavior among mutual fund managers (Lakonishoket al., 1992; Wermers, 1999) or financial analysts (Trueman, 1994; Graham, 1999; Welch, 2000; Hong et al., 2000; Gleason and Lee, 2003; Clement and Tse, 2005).
Economou, Kostakis and Philippas (2010) examined herd behavior in extreme market conditions using daily data from the Greek, Italian, Portuguese and Spanish stock markets for the years 1998- 2008 i.e. the existence of asymmetric Herding behavior associated with market returns, trading volume, and return volatility. Along with this, they also investigated the presence of herd behavior during the global financial crisis of 2008. The results of the study showed that Herding is found to be stronger during periods of rising markets in these stock markets. Herding is present in the Portuguese stock market during periods of down returns and there is no evidence of Herding in the Spanish stock market. Finally, it is said that there is evidence of Herding during the global financial crisis of 2008 only for the Portuguese stock market and evidence of anti-Herding for the Spanish and the Italian stock markets. Investor behavior seems to have been rational for the Greek stock market during the global financial crisis.

The literature review done indicates that there are certain evidences and empirical results available which show that there exist a relationship of investor's herding behavior and the investor's decisions regarding investment. These factors overthrow the notion in financial markets that investors always act rationally. At times investor's behave opposite the notion of rationality and in diverse way which are not explainable and hence considered as market anomalies. This field of study has been extensively studied for markets like China. However in India, the field is relatively new and not many specific studies have been conducted in relation to psychology of Indian investors as evident from literature review.

4. Objective of Study

The basic objective of this study is to understand the relationship between herding behavior and investment decision of Indian investor. Further the study aims to find out the resultant performance of such influenced investment decision.

5. Methodology

The study has a descriptive research design. Both primary and secondary data has been used. Primary data has been gathered by conducting a survey in which structured questionnaire was emailed to respondents to access their investment behavior. The structured questionnaire was mailed to 150 individual investors in city of Delhi. A usable response of 124 respondents has been received for this study. Secondary data has been collected from journals like SSRN journals and so on. Collected data has been analyzed using Microsoft excel and descriptive statistics.

6. Survey Analysis

The result of the survey analysis has been as analyzed from two perspectives. Firstly to find out what extent of respondents are influenced by herding and secondly what has been the success rate of such investments.

- On being asked the question "Other investors' decisions of choosing stock types have impact on your investment decisions." 74% of respondents strongly agreed i.e. their decisions to choose stock type is based on others decisions while 26% were of the view that it doesn't matter much to them.
- On being asked the question, "Other investors' decisions of the stock volume have impact on your investment decisions." Nearly 70.5% of respondents strongly agreed while remaining were not much bothered about what peers were doing as income level creates constraints for them.
- On being asked question, "other investors' decisions of buying and selling stocks have impact on your investment decisions." To this answer results again showed herding among investors as nearly one third respondents supported the question.
- When it was tried to found out whether investors do any technical or fundamental analysis in making investment decisions it was found 59% respondents felt that they cannot predict future prices of stock better than others. It is inferred thus people rely more on others opinion and action than their own.
- It was found that 35% of respondents use fundamental analysis to some extent while making a choice while 24% believe that their skills and knowledge can result in better decisions for them.
- As far as the performance of investment of respondents was concerned they were asked three questions:
- "The return rate of your recent stock investment meets your expectation?"
- 12% of respondents were in complete favor that returns met expectations. While nearly 58% were partially satisfied with returns. Remaining 30 % never got the returns as expected.
- "Your rate of return is equal to or higher than the average return rate of the market."
- 65% respondents said it was always lower than the market return.
- "You feel satisfied with your investment decisions in the last year (including selling, buying, choosing stocks, and deciding the stock volumes)."
- 47% respondents were almost satisfied while 35 % were neutral in this respect. However 18% respondents felt dissatisfied by their decision of investment.
- 47% respondents agreed that the main reason for their less successful investment has been their own errors in decision process.

7. Limitations of Study

- The scope of study is limited to city of Delhi
- Sample size is 124 questionnaires. This size is small and thus the inferences drawn may not be applicable in broader context.
- Time and resource constraints also restricted the scope of present study.

8. Conclusion

Above analysis of survey reveals that herding is very well visible in investor's behavior in context of India also. Though investors try to act rationally by taking into consideration all available information still human psychology plays its role at times. No decision taken can be considered as fully rational or fully irrational. Being a human we are very easily swayed by what is happening in our surroundings, how our friends, colleagues and other society members are responding to particular information. Thus sometimes even if an investors knows that he is write in his own action he might not choose to go in a direction different

from herd thereby end up making a less rational decision. It is thus important to get a better insight on how psychology affects better decision making so that appropriate strategies could be formulated to achieve wealth maximization objective.

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