COMMON MISTAKES OF INVESTORS

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Abstract

Behavioral finance is an actively discussed topic in the academic and investment circle. The main reason is because behavioral finance challenges the validity of a cornerstone of the modern financial theory: rationality of investors. In this paper, the common irrational behaviors of investors are discussed.

Keywords: Investors, Anchoring, Overconfidence, Information Overflow, Herd Instinct, Expert Reference

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1 Introduction

2011 was a painful year for a lot of investors in the stock market. With the deep correction in the stock market, a lot of investors suffered big losses.

What are the common mistakes of investors? What pitfalls that as investors should avoid during the investment selection, holding and selling decision? The research on common mistakes of investors started in the 1970s with figurehead including professors Amos Tversky and Daniel Kahneman which is collectively known as behavioral finance. Whereas the earliest documentation of the irrational behavior of investors can be traced back to Charles Mackay's Extraordinary Popular Delusions and Madness of Crowds and Vega's Confusions de Confusions.

2 Common Mistakes of Investors

Basically, investors suffer from six common mistakes in the investment. As good investors, we should bear in mind these errors and try to avoid them. The mistakes are information overflow, overconfidence, herd instinct, expert reference, loss aversion, and anchoring.

2.1 Information Overflow

With the current information era, the information available to us is huge. For instance, from your PC, from newspaper, from your smart phone, from special reports, from radio, from TV, from friend, from our daily life, from email, from mail, from RSS.... With such a rich source of information, investors are basically overflowed with information (Lindsley, 1958). The overflowing with information is the primary cause that leads to failure to distinguish important information from useless noise. The investors may fail to react to important information such as the provision for bad debt of HSBC well before the sub-prime meltdown and financial tsunami. In fact, enough warning signs were given to us well before the catastrophic free fall of the market. Worst still, investors may take useless news as important information and take action about it. For instance, during the SARS in 2003, a lot of Hong Kong investors dumped stocks and properties because of the epidemic. In fact, this was useless information because when the investor thinks twice, they would understand that epidemic happened from time to time such as Spain Flu, Black Death, super bacteria, TB.... However, all these did not stop the development of the world and advance of the stock market. This is because of epidemic usually last for at most 6 months to 1 year because by the time 6 months to 1 year end, most of the people are infected by the bacteria or virus and the people either die or acquire immunity. The epidemic as a result stops. We should distinguish between long lasting impact on the stock market from the short term impact on the stock market when investors invest.

2.2 Overconfidence

Overconfidence means that investors are too confident in their judgment of the stock market and over-exposed to the market. Overconfidence could be caused by positive illusions (Taylor and Brown, 1988). This happens especially when the investors are gaining from the stock market. Usually, when investors gain in a stock, they increase the exposure to the stock because they are confident that they pick a winner. Worst still, stake size investing in the stock is higher and higher in each additional bet. As a result, investors are over-exposed to the stock. When there is a big and deep correction of the stock, the investors suffer from huge loss and even the previously earned profit could not cover the loss. This happened in 1973 the stock market of Hong Kong. When the Hang Seng Index rallied from 100 in 1969 to 1700 in 1973, a lot of investors aggressively increased the bet size. Though they earned a good unrealized profit during the rally, they suffered huge loss when HSI free fall to 150 later. As good investors, we should not be too confident in our judgment. An important practice is: as we raise the exposure of a stock, instead of raising the size of each additional stake, we should lower the size of each additional bet to control the risk. This is an intuitive way to apply dynamic hedging. The literature on dynamic hedging is out of scope of this article. For interested investors, they can refer to the literature about quantitative finance such as from Paul Wilmott. All in all, this method can reduce the risk that investors expose to individual stock or the market.

2.3 Herd Instinct

Because human are a social creature. As a result, the idea and thinking of other people have a huge impact on our decision (Hamilton, 1971). This is due to the fact that our ancestors survive by moving together such as act together to hunt a strong ox. So, usually, people move in one direction seems like a single mind. The mentioned book, Extraordinary Popular Delusions and Madness of Crowd has very detailed description on the craziness of the crowd acting like a single mind to head towards perish. However, in our daily life, herd instinct is wisdom such as going to a crowded restaurant which is usually a good restaurant or consulting a busy doctor who is usually a good medical practitioner. However, this does not work for investment. In fact, a school of thought of investment known as market sentiment analysis espouses contrarian investment against the market sentiment and market sentiment is a representation of the herd instinct in the stock market.

2.4 Expert Reference

A lot of investors buy or sell stocks because of the opinion of experts. In One Up on Wall Street, a story about a good company selling leggings mentioned by Mr. Peter Lynch was a good example that investors invested because of research reports or experts' opinions. The research and analysis of the expert are advance and superb. However, when the large institutional researchers have attention on some triggers, it is usually a rather noticeable and widespread phenomenon, so it is usually a late and over-play as mentioned by Mr. Peter Lynch. This also fulfills the hypothesis of Kahneman and Tversky: cognitive biases (Kahneman and Tversky, 1972) of the experts.

In fact, according to Mr. Peter Lynch, our first-handed experience plus independent thinking are the best armor for us to select stocks. As a result, Mr. Peter Lynch, not only spent time reading research reports but also spent time going to shopping arcade, buying things, eating hamburger.... in order to look for investment opportunities. Furthermore, Mr. Peter Lynch mentioned in the book that we should invest in something that we were familiar and understood especially within our professional arena instead of something with a sexy name and seemed promising future.

2.5 Loss Aversion

Another common mistake of investors is the attitude of loss aversion (Kahneman, Knetsch, & Thaler, 1990). Usually, the loss aversion renders investors to sell their stocks at the bottom of the stock market. Why does this happen? This is because when the market falls, a lot of experts will give an opinion that the market shall fall further. For instance, during the financial tsunami, the Hang Seng Index dropped to around 11000-level which was a bargain purchase, a lot of investors did not buy-in at this record low, they sold their stocks. The main reason was because during that time, a lot of experts said that the Hang Seng Index would drop to 8000 level and the loss aversion attitude of the investors rendered them selling the stocks at this low level and hoped to reinvest at 8000 level. However, the Hang Seng Index not only did not fall further but also rallied to 25000 level within a year. This is comprehensible, according to Tversky's research, people perceive the senses of loss two times as much as the joy of the same amount of gain.

2.6 Anchoring

Anchoring (Tversky & Kahneman, 1974) is the phenomenon that investors memorize the price of a stock that they acquired and this affects the rational decision of the investors. For instance, a stock starts at HK$1 per share and investors invest 10000 shares with the original position intention of 40000 shares. Then, the stock rallies to HK$1.1 per share and the investors, though knowing that it is a good stock, decide not to invest if it does not fall back to HK$1 per share and as a result missing the major rally that the stock rises to HK$10 per share. Even Mr. Warren Buffett said in 2004 annual meeting of Berkshire Hathaway that he bought some stocks at a price and it went up for a bit, he might stop buying, and hoped the price would fall back again. He lost opportunities of earning around US$ 10 billion on Wal-Mart because of anchoring.

Furthermore, anchoring renders the investors feeling joy and pain by referring to the price of individual stocks without looking at the big picture. For instance, some small cap stocks, because of small and not well-established, are with higher risk of going bankrupt. As a result, a lot of investors shun these stocks and these also cause the famous anomaly in excess return, small cap premium (Fama and French,

1992) according to research of Professor Eugene Fama. This could be regarded as a result of anchoring. If the investors, instead of looking at individual stocks gain or loss, look at the whole portfolio of small cap stocks, the investors may have different attitude to small cap stocks. This is because of the abnormal return provided by small cap stocks as a whole, the overall return of the portfolio will be enhanced by having a group of the small cap stocks.

3 Conclusion

As investors, we are responsible to ourselves for the investment because the money belongs to us. We are also responsible for our families and beloveds. However, we are not responsible for the investment experts and we should have independent opinion and first-handed knowledge about an investment. Behavioral finance is a very big topic. This article is just trying to explicate some of the micro facet points about behavioral finance. May God bless you on your investment venture.

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