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In Investing, You are likely to be your own worst enemy

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Benjamin Graham, considered by many professional investors as the father of modern day value investing once said that **“The investor’s chief problem—and his worst enemy—is likely to be himself. In the end, how your investments behave is much less important than how you behave.”** On the face of it this may sound counterintuitive. How can an investor behave in a manner that would ultimately harm his or her interest? In the world of investments there have been quite a few studies that have shown that the returns generated by the product and returns earned by an average investor in the same product can be vastly different. The scheme may have delivered 15% compounded growth over a decade, but the returns of an average investor in the same scheme can be 6 or 7%. These studies attribute the gap in the returns solely to the investors decision to buy and/or sell at various points of time in the investment journey.

The world of investing was very "accounting" led in the 50's and 60's. Eventually, more studies and research pointed to the impact of emotions and biases to investment outcomes. Daniel Kahneman, considered to be one of the founding fathers of this field won a Nobel prize for his work. His work and contributions from others like his compatriot Richard Thaler established that while in theory investors are guided by data and facts, in reality, the context of each individual and their emotional biases developed over the years play a critical role in decision making.

Over the coming few issues of this monthly letter, we would like to talk about these biases that are likely to creep into your decision making. The Idea is that as an investor, if one can be cognizant of the bias, then by avoiding the bias or by just recognizing it, he or she can improve the decision making thereby improving investment experience and outcomes.

In an increasingly digital world every individual faces an overload of data and information. This leads to a common bias known as 'herd mentality' while investing. Investors sometimes blindly copy large investors or what their peers are doing or what is reported in multiple media sources. Mostly it tends to be the 'flavour of the month' or popular theme. In doing so they are guided more by the emotions rather than independent analysis. In our own markets we have seen this happen, in 1999-2000, when most of the investors were focussed on buying the famous ICE i.e. information, communication and entertainment companies. This was despite data points suggesting that valuations were high and unsustainable. We saw a repetition of the same in 2007-8 when the clamour was for Infra, Cap Goods and Real estate stocks. Then came a phase when buying the physical real estate and gold was in fashion.

As recently as 2018, we saw a rush to buy Mid and Small Caps. Everytime investors chose to follow what the broad market or most people were doing, the returns were not upto the mark. Now the latest buzzword is Gold. We don't know what will be the gold price a year down the line, but we know for sure that the more opportune time to buy gold was a year back when probably very few were buying and talking about it. Same pattern of buying when going is good is seen in SIPs. As the markets were rising more and more investors were happy to do SIPs. Now despite the fact that with the same instalment you can get more number of units of the scheme some choose to discontinue the SIPs.

No investor or investment professional can predict the markets and behaviour of asset classes. So how does an investor ensure that he or she does not miss out on next asset class to rally. The question may sound complex but the answer is quite simple. Key lies in asset allocation that works in all weathers. Having exposure to as many asset classes as possible in a proportion that you are comfortable with and without concentration to any one asset class. Concentration is the killer. An experienced and trusted advisor can definitely help you with that.

The other aspect of avoiding the bias is to check, whether your fund manager is being a part of the herd or not. Again a simple way to check for the same would be to look at the overlap of the portfolios. Lower overlap with benchmark or peers indicates that the portfolio is different from the rest in terms of stocks and or weightages. This helps in achieving better diversification even within a single asset class.

These two simple ideas together can help in overcoming a herd mentality bias. So next time you decide to take an action on your portfolio, please pause and evaluate whether your decision is based on data and facts or is it based on what others are doing. Also not being concentrated in any one asset class due to recent events that impact your opinion. That is also a bias and known simply as the Recency bias. That's for the next newsletter.

I can assure you that just being aware of likely biases can lead to a better investment journey. Meanwhile, stay safe and stay invested.

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