Cognitive Biases of Institutional Investors

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ABSTRACT:

This study focuses on cognitive biases that institutional investors exhibit. When it comes to forecasting market returns, investors are more optimistic, and this trend is especially evident for local markets and longer forecasting periods. This optimism is bolstered by the existence of availability heuristics. Herding behaviour has also been observed. Institutional investors, too, exhibit loss aversion, as Tversky and Kahneman (1979) observed. The goal of this work is to examine and characterize many biases in investment decision-making through a review of behavioural finance research articles. It also covers some of the analytical and foundational work that has gone into making behavioural finance a recognized and distinct field of study throughout the years. The research includes institutional investor's behavioural trends. The research papers are assessed by searching various published journals, conference proceedings, working papers, and other published books for keywords related to behavioural finance. These papers were gathered over a period of years, beginning with the most basic introduction paper (1979), which laid the groundwork for this subject, and ending with the most recent studies. A new era of human emotion and behaviour analysis has begun, which was previously dominated by the study of financial markets.

The research is based on some of the most current researches in order to provide a rapid overview of the most recent work in this field. So far, only a few comprehensive review papers highlighting research in the field of behavioural finance have been published. This research will aid in the development of fresh research in this sector as well as the identification of places where work may be done. The research has a practical application in the corporations, governments, and financial advisors can refer before investing in securities into the market.

Keywords: Institutional Investors, Behavioural Finance, Behavioural Biases, Investment Decisions, Prospect Theory

INTRODUCTION

Financial management popularly known as the art of wealth management has been the lifeline of the economic system for decades. Several theories and assumptions have been put forward by known scholars to explain the functioning of the finance models. The individuals, companies
and organizations in view of the associated risks and returns consider finance with procurement and allocation of financial resources. While investing is a complicated process, the stock market's behaviour adds to the complexity. The existence of a large number of participants who exhibit varying emotions and behavioural patterns while making investment decisions is the primary cause of complications in investment decisions.

Stock markets are efficient, according to the efficient market hypothesis, it states that the share price takes into account all accessible data.

In fact, the efficient market hypothesis is the foundation of classical finance theory. Because there are uncertainties in the securities market, contemporary portfolio theory implies that investor preference cannot be stated in terms of options, but with the help of mean and variance of returns, the modern finance trade-off may be shown as follows:

• The expected utility theory (Bernoulli, Daniel; originally published in 1738; translated by Dr Louise Sommer, 1954) is concerned with the decision-making process when faced with uncertain outcomes. The goal is to strike a balance between risk and reward.

• The Markowitz (1952) approach assists an investor in determining his or her ideal portfolio position and illustrates how diversity minimizes risk.

• The capital asset pricing model (Treynor, 1961; William, 1964; Lintner, 1965; Mossin, 1966) is a tool for determining the link between an asset's systematic risk and projected return. It can be used to price either a single investment or a whole portfolio of securities.

In the real stock markets, perfect market circumstances such as those stated in traditional economics and finance do not usually exist. The solution to this difficulty was not discovered until the 1980s. Behavioral finance, an emerging field in finance, was born as a result. It has addressed and explained some

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of the reasons for investors' behavioural shifts that lead them away from logical decision-making. The different factors for the stock market's unexpected and untimely adjustments, as well as the pricing of securities, have been discussed. It goes against both the rational investor theory and market efficiency. Kahneman and Tversky (1979) published a book called Behavioural Economics. Thaler (1980) made a significant contribution by explaining the prospect theory using an alternative descriptive theory. Instead of believing investors to be cold and illogical, he discussed that they are influenced by a variety of factors. Behavioral biases frequently lead to suboptimal decisions.

Shiller (2003) proposed a large body of literature in order to dispel reservations about the efficient market hypothesis. With the help of behavioural finance, the answers to many abnormalities in investors' investing behaviors have been discovered. Caginalp and DeSantis (2011) have developed theories that contradict the stock market's efficiency even further. The nature of the investments and the participants who trade or invest in the market, according to him, are the driving forces of market efficiency. Marchand (2012) connects old and modern finance theories with behavioural finance theories in his article, identifying irrationality in human behaviour in the form of biases. Nair and Antony (2015) see behavioural finance as a tool for understanding irrational investor behaviour and the causes of market ups and downs, rather than as a replacement for traditional finance theories. There are several biases which affects the choices of investors.

Overconfidence occurs when people are overly enthusiastic about trade outcomes and believe that the information available to them is sufficient to make sound investment selections. Investors also equate the market's strong performance with their own, neglecting the fact that focusing solely on their own capabilities and ignoring other aspects can lead to significant losses in the future.

Shefrin and Statman (1985) were the first to emphasis on disposition effect. Investors tend to sell superior selling equities early in order to realize gains, and they keep losing stocks for a long time in order to delay losses. The desire to prevent losses is far stronger than the desire to make gains. Investors make their ultimate judgments primarily on perceived rewards rather than perceived losses.

Shiller (2000), as well as Kahneman and Tversky (1979) identified herding as an important bias prevailing in institutional investors. The tendency of investors in the stock market to follow the decisions of other investors is known as herding. Because investors rely on collective knowledge rather than private information, this element of the investors is the focus of substantial research. As a result, price aberrations from basic values may occur, posing a risk of lower returns.

Thaler (1985) was the one who first proposed mental accounting as an investment bias. According to this idea, investors organize their investments into several portfolios based on a variety of mental categories. Then they divide investing policies for each mental account such that each one has a distinct goal to achieve, with the goal being to maximize returns while minimizing risk. This could lead to the selection of portfolios that are not profitable but please the investors' emotions. Thaler and Johnson (1990) discussed that when gamblers make money, they become less fearful of losing money and more inclined to take risks. As a result, successful investors are willing to take on more risk, and vice versa. According to Benartzi and Thaler (1995), loss aversion bias develops because people react differently to guaranteed losses and guaranteed earnings. When presented with certain gains, they are unwilling to take any risks, yet when there is a chance of losses, they are willing to take more risks. This indicates they place a higher priority on loss certainty than loss uncertainty.

Tversky and Kahneman (1981) identified framing bias. When information is presented in a positive light, investors avoid taking risks in order to ensure profits, but when the same information is presented in a bad light, they are willing to accept the risk in order to avoid losses. As a result, the same information can be provided to investors in either of these ways to persuade them to change their minds.

Tversky and Kahneman (1981) also identified anchoring as an effective bias in individual and institutional investors. Investors make their initial decisions based on the information they receive, and then make subsequent decisions based on the information they have already received. The subsequent decisions are all based on past knowledge. Representativeness entails evaluating an event's object's and comparing them to those of other events. This leads individuals to believe that the event is more likely to occur, even though it may or may not. It was offered in the early 1970s by Kahneman and Tversky.

Literature Review

The two psychologists Kahneman and Tversky (1979) provided the framework for the prospect theory, which is one of the most important and influential

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finance. As an alternative to expected utility theory, rational expectations theory, and the efficient market hypothesis, prospect theory was introduced. Thaler (1980) proposed theories for using prospect theory in financial markets. As a financial theorist, he contends that people do not always act rationally, and that they frequently make mistakes while making investment decisions. As a result, Kahneman and Tversky (1979) and Thaler (1980) are regarded as the founding fathers of behavioural finance. The psychological biases were described in order to explain the causes for the investors' illogical behaviour. Guler (2007) investigates the reasons for corporations continuing to participate in venture capital despite predicted losses. Feldman and Lepori (2016) investigated whether psychology has an impact on asset pricing using agent-based modelling. The author has integrated the rational and irrational investor regimes, as well as a hybrid of the two. According to behaviorists, the presence of both rational and irrational investors has a substantial impact on asset prices. According to the efficient market theory, in the long run, only rational investors remain in the market since irrational investors become insolvent and leave.

Institutional investors, like individual investors, are prone to behavioural biases, according to Fisher and Statman (2002), and these biases have similar impact on both investor groups. Furthermore, Otchere and Chan (2003) stated that institutional investors may act in an implausible manner. Noise traders have also been labelled as irrational investors. Because of their erroneous ideas, noise traders trade more and lose money (Lin et al., 2009). Institutional investors, on the other hand, are thought to act rationally because they put more effort and time into their investment decisions (Keim and Madhayan, 1995), and because they learn faster and have more knowledge than their individual peers, resulting in more qualified investment decisions (Chang & Wei, 2011). Recent research has cast doubt on these claims (e.g., Luo and Li, 2008). Dichtl and Drobetz (2011), in particular, demonstrated that institutional investors' investment practices were not rational, but rather common. Institutional investors, according to Grinblatt and Keloharju (2000), responded to the same information and engaged in irrational behaviours such as momentum strategy and herding behaviour, which they did not interpret from each other's trading activity. Institutional investors, in addition to their sentiment, have some biases that prohibit them from acting rationally. It demonstrated status quo bias (Freiburg and Grichnik, 2013), anchoring effect (Liao et al., 2013; Freiburg and Grichnik,
2013), endowment effect (Furche and Johnstone, 2006), ambiguity aversion (Bantwal and Kunreuther, 2000), and overconfidence bias (Bantwal and Kunreuther, 2000) within this scope (Shiller, 2000; Sun et al., 2013). Furthermore, it has been proven that the trading behaviour of institutional investors accommodated many irrationalities. As a result, the large company anomaly (Froot and Teo, 2008), weekend impact (Venezia and Shapira, 2007), and book-to-market value anomaly (Venezia and Shapira, 2007) were discovered in certain studies (Hur et al., 2010).

Methodology

Research is based on the review of literature. Various research platforms have been used to search relevant articles, using institutional trader and institutional investor search options. The search was carried out with the help of the "or" function. In addition, the commands "behavioural finance" and "behavioural bias" have been used with the "and" function. The database was utilized in this search, along with the "or" function. "Refine results," "English results only," "articles" as document kinds, and "business economics" as search criteria were utilized to focus on the right items of interest. After reviewing all the articles, the following analysis has been done to emphasis on major behavioural biases of institutional investors.

Home bias

Home bias is defined as an investor's unjustified preference for securities from their home country or region, and it has been extensively researched
in behavioural finance literature. Home bias is one of the most researched behavioural biases among institutional investors. There have been three strands of literature claiming home biases of institutional investors: the studies associating home bias to knowledge, those linking it to culture and the others. Those research proposing the association of home bias to culture have a similar aspect in that they have employed more data regarding both market and also country participants. Nonetheless, each of these studies has focused on a single aspect of culture. As a result, the importance of shared language, cultural familiarity, and social, psychological, and cultural aspects has risen. Selim Aren Sibel Dinc Aydemir Yasin Sehitoglu, (2016)," has mentioned home bias with the help of below mentioned diagram.

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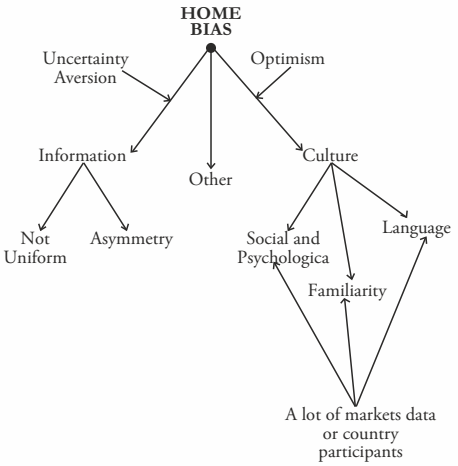
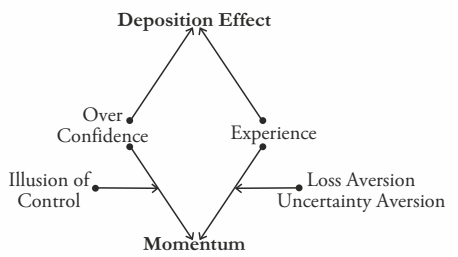


There have been a few studies that have linked home bias to culture. These studies were similar in that they used a huge data collection of investors from diverse markets and nations. Anderson et al. (2011) looked at more than 60 markets, whereas Beracha et al. (2014) looked at 38. Fedenia et al. (2013), on the other hand, used a data collection of institutional investors in the United States who came from 35 different nations.

Disposition Effect

The disposition effect is described as the proclivity to sell assets that are already gaining in value sooner and to hold assets that are dropping in value. Disposition effect, such as home bias, has been one of the most emphasized behavioural biases among institutional investors, albeit to a lower level. The home bias effect has been demonstrated in recent research, however the disposition effect has not been determined in these investigations. Aren Sibel Dinc Aydemir Yasin Sehitoglu, (2016)," has mentioned disposition effect with the help of below mentioned diagram.



The majority of studies on the disposition effect have been undertaken in Asian countries. In comparison to home bias studies, there has been minimal research arguing for a disposition effect, and these studies have used a smaller data set. Because of their experiences and overconfident attitudes, the overall conclusion from these very small studies has been that the disposition effect would not show on institutional investors. Only one study (Menkhoff et al., 2010) looked at the home bias and disposition impact together. It's worth noting that only one study used the survey method to acquire data. Previous research findings on disposition n exhibit consistency with each other.

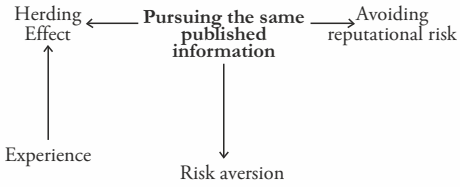
Chou and Wang (2011) researched the disposition effect in Taiwan Stock Exchange and linked it to overconfident investment behaviour, similar to Barber et al. (2007) and Sun et al. (2013). However, they differed in their explanation, claiming that overconfident investor behaviour is based on historical long-term investment performance rather than the ability to influence asset prices or the use of a momentum strategy. Furthermore, due to their professional training and experiences, as well as overconfidence bias, institutional investors were not prone to the disposition effect, according to this study.

Herding behavior

There is a large body of research examining whether institutional investors engage in herding behaviour, which is defined as the tendency for investors to act in a similar manner by following each other's actions. This prejudice, in general, is attributed to institutional investors. The most common explanation for biased behaviour is that it is based on information, however some research suggests that there are other explanations.

Previous research on the herding effect have encompassed the data set of a large number of nations, despite their limitations. Herding behaviour has been mentioned in all of the investigations. Although information was cited as the primary motivator, risk aversion, the fear of losing one's reputation, and specific demographics may have aided herding behaviour.

Suto and Toshino (2005) conducted a survey study on institutional investors in Japan in order to investigate herding behaviour. They claimed that not all institutional investors shared the same traits. Aren Sibel Dinc Aydemir Yasin Sehitoglu, (2016)," has mentioned herding bias with the help of below mentioned diagram.



Chang et al. (2012) looked at two types of herding: rational and irrational. They claimed that irrational herding behaviour observed in individual investors was due to a lack of confidence rather than a lack of information. Institutional investors, on the other hand, showed sensible herding behaviour. They suggested that the fundamental explanation for this conduct was that all institutional investors in Taiwan, like their peers, took advantage of the same information. They made identical decisions because they used the same information and processed it in the same way. Herding conduct is defined as a pattern of behaviour shared by all institutional investors.

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According to Wylie (2005), corporate investors' herding behaviour is far more prevalent at the sector level than at the share level. According to Andreu et al. (2015), in UK personal pension plans, the strategic allocation level is seen far higher than the individual security level. Herding behaviour on stock levels is substantially more prevalent in the largest and smallest stocks, according to Wylie (2005).

Discussion

According to recent studies, institutional investors do not always make rational decisions and are prone to a variety of behavioural biases. The current study attempted to investigate institutional investors by splitting them into groups or approaching them as a whole, as the phrase "institutional investor" refers to all financial intermediaries such as mutual funds, banks, insurance firms, and so on. Furthermore, some research divides institutional investors into two categories: domestic and foreign.

These researches provided substantial evidence that institutional investors displayed various behavioural biases, regardless of how they characterized them. The most common bias observed was home bias. Despite the lack of supporting evidence, disposition effect outperforms home bias in the existing literature. Herding behaviour is another interesting phenomenon that has been studied and labelled as irrational conduct in institutional investors.

The impact of home bias has been explained using information and culture. The institutional investors were also observed to be overconfident in most of the cases. Loss aversion had an impact on the culturally closed preferences and results into culture influenced home bias. According to risk tolerance classification, loss aversion necessitates a low-to-medium risk tolerance level, whereas optimism necessitates a high risk tolerance level. Furthermore, uncertainty aversion is associated with the passive investor model, whereas optimism is associated with the active investor model. A large number of researches have been undertaken on herding behaviour and evidence of this behaviour. The major drivers of this conduct have been indicated as pursuing the same public knowledge and avoiding reputational harm. In general, risk aversion can be considered as the driving force behind this behaviour. Even though studies on linked corporate investors who act irrationally were conducted across time and with data from many nations, risk tolerance thresholds were handled inconsistently.

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