Investor Behavior in the Times of Covid

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The past few months have been like none other for most of us, including the grizzled veterans in the investment industry. This is not the first major financial or economic crisis for most of us; we have seen the Asian financial crisis in the late 1990s, the dot com crash in 2000 and the Indian stock market crash in 2001, the global financial crisis and its impact on Indian markets in 2009 and 2010, and more recently the shake down in the Indian financial sector starting in 2018. However, the Corona virus or the Covid 19 situation has been unparalleled in many ways. For one, it has been a truly global event, impacting practically all major countries and markets almost simultaneously. It has had all of the characteristics of a true "black swan" phenomenon. It is an unprecedented situation, a completely outlier event which occurred as a total surprise with almost no warning indicators. Further it is an event of a very large magnitude and it is almost impossible to calculate or realistically estimate the probability of impact and time. The impact is not only economic or financial, but the Covid situation is profoundly affecting the way we work, live, earn, spend, invest and think. And this is not only for individuals but also for companies, institutions and even Governments. To put it differently, this is no longer a subject just for the financial and investment experts, but also for sociologists, psychologists and behavioral economists, among others.

The Covid phenomenon has the potential to have a radical impact on investment behavior of individuals and institutional investors both in the short run and in the longer term. In the process, there are several common cognitive biases and phenomena which influence decision making. Some of these are examined below.

Loss-aversion bias or Risk-aversion bias is one of the most pervasive pitfalls. Simply put, this is the tendency to experience the pain of loss to a greater extent than the reward of an equivalent gain. For example when there is a sudden drop in the stock indices by 20%, the feeling of loss is much more acute and sharper than the joy experienced when there is a similar gain in the markets. This leads to risk aversion or resistance to higher risk, or preferring lower risk alternatives in difficult times. In practical terms this results in an investor adopting a more conservative strategy than what may be warranted in order to ward off an exaggerated sense of loss. The result is that investment goals may not be met through such a strategy.

Herd behavior is equally common in such unusual times. This is the tendency to blindly follow the actions of a group, usually a closely allied or proximate group without thinking through the consequences or implications. Herd behavior does not take into account the obvious fact that individual circumstances are usually different from others even in similar groups and therefore merit different strategies. Here one tends to discount private information or data and over value group information, often with disastrous consequences. In general it has been found that herd behavior is most common in the early stages of any such crisis when the degree of opacity of the future is higher.

The Optimism bias is a combination of over confidence, miscalculation and illusory control. Over confidence stems from a misplaced sense of belief that an investor has a better chance of achieving positive results as compared to others. This happens typically when an investor begins to believe that they are different from others or better than others when in reality it may not be significantly so. This results in miscalculation which is faulty estimation of potential gains or losses without adequate information. Optimism or over confidence is usually interlinked with an inability to rationally separate controllable and uncontrollable events. The illusion of control may be related to one's own abilities or to mathematical models or to previously applied strategies.

Closely allied to the above is the Affect syndrome which refers to decision making short cuts in which good or bad feelings influence decision making. An event which makes us feel good leads to over optimism and conversely a negative event leads to excessive pessimism. If information relating to the decision makes us happy, we tend to over-estimate the benefits of the decision and vice versa. This results in decisions or strategies which are led by emotions rather than by a rational or logical interpretation of information or events. Very often the emotional quotient subjectively overrides or suppresses the rational conclusion leading to skewed decision making.

The Familiarity bias is the widely known preference for one's comfort zone. This is the tendency of an investor to stick to what is known and done in the past rather than attempt to alter one's behavior in response to radically new circumstances. This has the consequence of missing out on newer options, trends or ways of looking at a situation which has undergone or is undergoing rapid change. The familiarity bias ultimately means that the investor is preferring to stay with a small subset of the several possibilities available, to the exclusion of potentially better alternatives. Familiarity or comfort is confused with safety in this phenomenon.

Closely related to the familiarity bias is the Availability bias. This is a much researched and written about psychological heuristic which essentially means that decisions are based on the instances or examples that immediately or quickly come to mind. Memorability and nearness are valued greater than accuracy or relevance in formulating a response. More recent information tends to dominate and decisions are based on this to the exclusion of other information. In other words, if the consequences of an event can be recalled better, the greater such consequences are perceived to be. Memories that are frequently recalled are only a small part of the total information available and thus leads to a decision based on low quality or inadequate information.

The Representation bias arises when an investor erroneously compares two situations because of a perceived similarity. This is often referred to as horizontal representation. Similarly vertical representation happens when a judgement or forecast is based on historical trends. The tendency to consider past returns in a stock or in a market as representation or indication of future returns is an example of the classical representation bias. Similarly, the comparison of the Covid impact on markets with the Great Depression of the 1930s or the Global Financial Crisis of 2008 is due to the representation bias. The real fact is that each of the events is totally different in terms of their cause, impact on markets and the eventual mitigating solutions. The prevailing economic and political trends are also totally different from those in the other periods and therefore to apply prescriptions from one to the other is most likely to result in flawed decisions.

In conclusion, investors must be cognizant of the several subjective and subconscious biases and influences on the decision making process. Two quotations from the famous economist John Maynard Keynes sum it up well – “Markets can remain irrational longer than you can remain solvent.” Hence one needs to be conscious and flexible and remember his words “when the facts change, I change my mind. What do you do, sir ?”