"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions."

– Seth Klarman.

When Warren Buffett famously stated that investing was simple but not easy, he meant that the rules we ought to use in order to make good investment decisions are easy to learn but actually adhering to them is difficult. Disregarding rules while investing cannot be attributed to open rebellion but can be ascribed to the basic human survival instincts that have been ingrained in us since time immemorial. Certain traits favored in the process of Natural Selection and helped our ancestors survive in the jungle actually do not help in the market.

Fear is probably the biggest behavioral bias affecting investors. While the fear of approaching an unknown object or creature helped our ancestors to survive, today it limits the capacity of weighing probabilities and calculating risks in investment.

Confirmation bias occurs because humans by nature are social beings. Banding together has helped mankind survive through the ages. People tend to seek validation of their opinions from their peers. The shared opinion leads to a feeling of comfort while making a decision as it is a decision that is agreed upon by consensus. This does not work favorably for an investor in the market as it can often lead to the creation of bubbles in the market. Retail and sometimes non-retail investors tend get into these cycles at their peak. Prime examples of how this 'herd mentality' has led to bubbles in the market can be seen in the cases of the tulip mania in 17th century Holland, the tech bubble in 2000 where just having the word "technology" in a company's name meant that it entered the market at a high price or the global financial crisis when the housing bubble occurred as bankers and financiers assumed that property prices would always rise and never fall.

Behavioural biases could also occur due to bounded rationality. The concept that the cognitive limitations of one's mind and the finite amount of time one has to make a decision is known as "bounded rationality". If these limitations are not acknowledged, overconfidence in one's abilities while carrying out complex tasks like investments will prevent one from reaching an optimal solution. The interaction of complexity of investment decisions and bounded rationality gives rise to several well-documented behavioural biases like overconfidence bias, illusion of knowledge and illusion of control.

John R. Nofsinger, while speaking about the over confidence bias stated “Psychologists have determined that overconfidence causes people to overestimate their knowledge, underestimate risks, and exaggerate their ability to control events. Security selection is a difficult task. It is precisely this type of task at which people exhibit the greatest overconfidence.”

The illusion of knowledge occurs when an investor gathers information in the belief that more knowledge is equal to better decision making whilst not accounting for bounded rationality and the human brain’s linear processing powers. The illusion of control develops from an investor’s unwarranted belief in one’s ability to control outcomes by acquiring more information.

Following a set of rules can often be difficult as investors are mostly guided by cues from the external world like news coming through the papers, TV channels or simply by word of mouth. By accepting that behavioural biases are due to human fallacies, it is possible to develop methods to eradicate or minimize their effects in the investment decision making process.

Assessment of Equities to avoid Behavioral Biases: The Multi-Act Way

In order to ensure a rational, risk- controlled approach to investing, it is important that an investor follows an evidence based approach. Basically an investor should have a set of rules and application of such rules should be based upon objective evidence.

Rational Analysis and GRAF:

John Bollinger coined the term “Rational Analysis”. The process of using different types of analyses has been likened to using multiple, specialised tools to complete a task. The rational approach is to use as many relevant tools that are at your disposal to complete a task effectively instead of just choosing one.

At Multi-Act, we have developed a system in-house called the Global Rational Analysis Framework (GRAF) based on the concept of Rational Analysis. It merges all four schools of investment analysis, namely fundamental, technical, quantitative and behavioural analyses. At Multi- Act, we use all these different tools while analysing a potential investment opportunity. And when most of these tools are saying the same thing, the possibility of making mistakes from a behavioural standpoint reduce. This makes the investment process both simple and easy as the rules are well laid out. This system thereby allows us to focus on the main goals of preservation of capital.

Avoiding Behavioural Biases using GRAF:

Multi-Act has a process in place to identify market sentiments of greed and fear and filter out the noise.

If we look at the example of Maruti Suzuki; the market was fearful of the labor clashes happening on ground. The market was also wary of significant competition entering the small car segment. Our fundamental analysis suggested that Maruti continued to enjoy high relative market share wherein the second largest competitor had market share half of that of Maruti. Maruti was available at a valuation at which we believe most of these negatives were already factored in while ignoring the strong fundamentals of the business. The GRAF framework helped us to not be affected by the noise and focus on the extremely favourable reward vs risk opportunity that was present at that point.

The Bottomline:

Equities by their very nature will continue to be volatile. As an investor it is important to stick to your Investment processes and use the volatility to your advantage.

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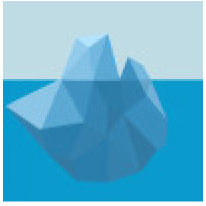

Bounded Rationality, Unbounded Confidence