

EFFECT OF CONSERVATISM BIAS AND SELF-ATTRIBUTION BIAS ON FINANCIAL RISK TOLERANCE OF INVESTORS

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Abstract

Whenever we talk about finance it was usually thought that we are talking about traditional finance theory which includes efficient market hypothesis. According to traditional finance theory it was assumed that investing people are always rational thinking being and that the resources are allocated efficiently. But Kahneman and Tversky in 1974 found that this is not the case i.e people who are investing in the market do not always behave rationally which somehow helped to understand the anomalies in the financial market. From these facts and more facts like these with the help of different approaches by different authors a new field of finance emerged also known as Behavioral Finance. Behavioral finance is the field of finance which helps in understanding the anomalies related to investors behavior, market behavior and asset price behavior. In this paper I am only showing behavioral finance in the context of investors behavior. According to behavioral finance people are irrational. People show biases which according to Kahneman and Tversky (1983) are of two main types cognitive biases and emotional biases. In this paper we will talk about some of the cognitive biases. A cognitive bias is a systematic pattern of deviation from norm Or rationality in judgment (Pompian,2006). We have a plethora of information regarding different kinds of cognitive biases. The main attempt of this paper is to study from the vast amount of literature present on some selected cognitive biases and understand its effect on financial risk tolerance. Financial risk tolerance is the maximum capacity of an investor to bare loss on an financial investment. It was found that there is a significant relationship between cognitive biases and financial risk tolerance. The main cognitive biases selected for this paper is conservatism bias and self-attribution bias and it was found that these both biases have a confounded relationship with financial risk tolerance.

Keywords : Financial risk tolerance, Cognitive biases, Conservatism bias, Self-attribution bias.

2. INTRODUCTION

As the time has passes there is a growing competition present in the market. There is a lot of investment choices for the investors to choose from and that's why investors are seeking new ways to invest. However investors do not have a sure shot way at investing and they certainly are not well equipped to invest their hard earned money in the financial market. Hence investors resort to certain decision making processes which are which are influenced by both cognitive and emotional biases. A cognitive bias is a systematic pattern of deviation from norm Or rationality in judgment (Pompian,2006). A cognitive bias can be corrected by increasing the awareness of the investor of that particular topic but emotional bias may or may not be corrected as it is completely based and influenced by human emotions. This paper helps to understand how financial risk tolerance affects individual

biases of investors. For the purpose of study research is limited to two cognitive biases namely conservatism bias and self-attribution bias. The decision making of investors is affected by many factors which are influenced by the fact that they want to satisfy their needs or wants according to their risk tolerance level. This paper helps in establishing a relationship between the conservatism bias, self-attribution bias and financial risk tolerance of investors. Conservatism bias is a type of cognitive bias in which investors cling on to the historical information or facts about a particular subject and they give little to no notice to a new piece of information regarding that particular topic. Self-attribution bias is a type of cognitive bias in which an investor if does well in an investment tends to have full credit for it and if the investment does not do well blames it on outer peoples or events or circumstances. Financial risk tolerance is the capability of an investor to handle losses in an investment.

3. LITERATURE REVIEWS:

3.1 COGNITIVE BIASES

Whenever an investors shows deviation from the normal thinking pattern it can be called as the investor is showing some kind of bias. If that bias can be corrected by giving additional knowledge to the investor about the particular topic then it can be known as Cognitive bias and if the bias is completely influenced by the human emotions then it can be known as Emotional bias. Emotional biases may or may not be corrected by giving additional information to the investors.

The benefit of making decision through heuristics is that the investors can make decisions very quickly and the drawback of it is that the probability of occurrence of errors increases so the authenticity of the output may not be as assumed by the investors (Kahneman, 2011).

Traditional models of decision making suggests that people are rational and they take decisions after taking into account all the facts and data related to that decision but Tversky and Kahneman (1974) suggested that this is not true in all the scenarios. When people make decisions under uncertainty they usually do it with the help of heuristics. They make intuitive judgments without any rational fact backing that decision which leads them to make various mistakes in decision making while making investments.

3.1.1 CONSERVATISM BIAS.

Conservatism bias is a type of cognitive bias in which investors usually cling to the previous information they had about the investment and give little or no notice to the current information which leads them to forecasting in lieu of absorbing new information. (Watts, 2001) "Conservatism is defined as the degree to which profits are anticipated".

(Pompian, 2006; Pompian, 2012) stated that because of conservatism bias investors behave too inflexibly when they are given new information about a subject about which they had prior information. Investor usually holds on to the previous affirmative information about a particular subject and neglects the negative information about the same subject. Because of conservatism bias investors take too long to react to the market as opposite to representativeness bias. In representativeness bias investors show overreaction towards the new information and in conservatism bias investors show under reaction towards the new information. Investors have difficulty processing the new data which creates internal conflict, so to avoid this internal conflict investors usually avoid giving attention to new data and hold too long to the previous data which sometimes leads to greater losses than gains.

(Montier, 2002) investors hold on to a forecast graciously and once a position has been fixated it is very hard for investors to move from that position. (Barberis, Vishny, and Shleifer, 1998) believe that investors sometime gives under reaction to some new information of financial markets which leads to financial loss of investors. (Pompian, 2012) states that active investors show quality of financial risk tolerance much higher than that of passive investors.

3.1.2 SELF-ATTRIBUTION BIAS

Self-attribution bias is a cognitive bias. It is a human tendency of investors to credit themselves when something good happens and blames it on the external circumstances if something bad happens. All the positive credits of a successful event will be taken as self work by the investors and all the negative credits of an unsuccessful event

will be blamed on the outer circumstances i.e., it was out of the reach of the investor. This kind of thinking of the investor leads them to self-attribution bias.

It is the propensity of the investors to impute successes to personal skills and failures to uncontrollable circumstances (Feather and Simon, 1971; Miller and Ross, 1975; Zuckerman, 1979).

According to (Bradley, 1978) investors tend to give credit to themselves in the event of a success and they think that it is their innate talent and their vision of the future and blame their failures to the situations.

According to (pompian,2006) self-attribution bias can be categorized as self-enhancing bias which is the propensity of investors to take full credit for their success and self-protecting bias which is the tendency of the investors to deny the fact that they are responsible for their failure as well.

There are basically two components that drive self-attribution bias i.e., cognitive component and motivational component. (Miller & Ross, 1975) because of the limited capacity of the human mind investors can retain only so much of the information and it creates a deviation from the regular rational thinking hence the cognitive component. (Zuckerman, 1979) found that the sense of achievement boosts the confidence of the investors, increases their self-worth in their own eyes, makes them feel good and gives a sense of well-being to them in the present society hence the motivational component.

According to (Daniel et al., 1998; Gervais and Odean, 2001; Statman et al., 2006) overconfidence is directly proportional to success which is again directly proportional to self-attribution bias. So in many cases the greater the success of the investors the greater the overconfidence they will show and greater are the chances of them to lean towards the self-attribution bias.

According to (Farwell and Wohlwend-Lloyd, 1998) narcissism is directly proportional to optimism from one's own performance and if the investor gets a successful result it leads to the self-attribution bias and through which investors become overconfident. Because of self-attribution bias successful investors become overconfident in their decision making which sometimes leads them to unexpected losses.

The investors who show self-attribution bias can be found overconfident if they get desired positive successful results which lead them towards greater risk and towards greater losses.

3.2 FINANCIAL RISK TOLERANCE OF INVESTORS

Risk can be defined as "the unexpected variability (negative) of returns than those expected from investments". (Kannadhasan, 2006; Kannadhasan & Nandagopal, 2010). Whenever we talk about risk it is considered that the outcome and probabilities connected to that particular outcome is known (Shapira (1994)).

"Financial risk tolerance can be defined as the willingness of a person to feel the discomfort of making risky financial decisions for future growth in lieu of current wealth." (Jain Nidhi, Kesari Bikrant, 2018).

Awareness in financial risk tolerance behavior in investors leads to helping people in decision making in adverse conditions (Grable & Lytton, (1999a, 1999b)). Financial risk tolerance can never have the same effect on two different peoples or two different events or two different circumstances. It will vary from people to people, events to events and circumstances to circumstances (Van de Venter (2012)). Van de Venter, Michayluk, and Davey (2010) found that the risk tolerance of investors shows a comparatively straight line on the time curve as it does not change that much over time.

Whenever we talk about risk in an efficient market it can be directly related to return that is people perceive that higher the risk higher the return and lower the risk lower the return. (Yao, Hanna, & Lindamood (2004); Hanna, Waller, & Finke (2008)).

Whenever it comes to investment investors usually play it safe as they avoid pain and move towards pleasure. (Kahneman, & Tversky, (1979)). Financial risk tolerance is now a days being applied to many fields such as economics, psychology, finance, management science etc. (Roszkowski et al., (1993)). Financial risk tolerance is directly proportional to risky assets investment and vice versa. (Irwin (1993)). Simon, Houghton & Aquino (1999) found that as different people are influenced by different types of cognitive biases their financial risk tolerance is also affected by it. Some investors perceive some investments highly risky and still invest in those investments because of the cognitive biases which affects them and some investors perceive some investments less risky as they are influenced by different kinds of biases.

“Even if they do not have high-risk propensity, individuals who perceive less risk than others might unknowingly take risky action.” (Simon, Houghton&Aquino (1999)).So we can conclude that investors perceived risk is inversely proportional to financial risk tolerance.

4. CONCLUSION

In this study attempt was made to understand that cognitive biases influences the decision making power of the investors which in turn also influences their financial risk tolerance . It was found that both conservatism bias and self-attribution bias show significant relationship with financial risk tolerance and have different effect on different kinds of investors .

5. LIMITATIONS

This paper has only studies two types of cognitive biases and its relationship with financial risk tolerance furthermore types of biases can be studied. This paper only states the theoretical aspects of the biases , practical aspects can be studied by using different kinds of statistical tools.

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