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Investor's Dilemma: Fundamentals or Biasness in Investment Decision

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Abstract: In the present world Investment decision is most important phenomena. Investment is current sacrifice for future benefits, So while making investment decisions we have to keep different things in mind. Investment decisions are influenced not only by their fundamentals but also depend on different factors. One factor is the biasness of any investor to their investment, biasness depends on the cognition and emotions, because some investors use them as heuristic for the investment decision instead of fundamentals. Keeping this in view, this paper shows how cognitive biasness (i.e. Representativeness, Adjustment and Anchoring, Leniency) effects the investment decisions over the fundamentals. This study also show different types of investors which depicts significant relation of Representativeness, Adjustment and Anchoring, Leniency with investment decisions over fundamentals, and explain under which biasness an investor become more optimistic and moderate for investment decisions. While considering Representativeness biasness over fundamentals investor become more optimistic, In Adjustment and Anchoring biasness investor show moderate behavior about investment decision, and In Leniency biasness investor also take investment decision over optimistically.

Key Words: *Investor, Investment, Investment decision, Fundamentals of Investment, Cognitive biasness*.

1. Introduction

Investment decisions are significantly influenced by the biasness as well as the fundamentals of investment. Investment decision by investor has been considered as base for success or failure of his or her business. While making investment decision fundamentals and different heuristics (i.e. representativeness, Anchoring and Adjustment, Leniency) are also used as mentioned by Amir and Ganzach (1998) and these heuristics are cognitive biasness as mention by Pompian (2006) which effects the investment decision significantly. However, Peltonen et.al (2009) described fundamentals effects investment decision greatly but it also depend on the investor's type as mentioned by Kuzmina (2010), as well as the biasness. Investment decision making depends on different type of investors. Some investors use fundamentals and some take decision on the basis of emotions, feelings, thoughts, affective reaction which come in to the biasness of the investors, so investment is effected by both biasness and fundamentals. Therefore, to find out the relationship we have made a conceptual paper under the light of persisting literature.

This study shows how biasness (i.e. Representativeness, Anchoring and Adjustment, Leniency) influence over fundamentals while making investment decision. In Representativeness an investor usually do overoptimistically investment decisions by considering one extreme value in his mind, In Anchoring and Adjustment investor take moderate decision by making an anchor value where as in Leniency investor take overoptimistic decision due to leniency in his or her mind. Different decisions taken by different investors show different results for the future expected outcome. Shefrin (2002) describe that most of investor take investment decision on the basis of analytical abilities means using fundamentals and techniques for decision. Sometimes decision taken on the basis of fundamentals go failed as mentioned by Abarbanell and Bernard (1992).

Under the light of literature this conceptual paper depicts whether investment decisions depend on fundamentals or biasness (i.e. Representativeness, Anchoring and Adjustment, Leniency). Investors choose either fundamentals or made decision on the basis of their biasness. Recent Research has shown effect of biasness (i.e. Representativeness, Anchoring and Adjustment, Leniency) mention by Amir and Ganzach (1998) and fundamentals (Shefrin, 2002) separately on investment decision. Little research work has been done on combine effects of biasness and fundamentals i.e. whether investor choose biases or fundamentals for investment decision as mention by Rubaltelli (2010) but this paper conveys the message of both biasness (i.e. Representativeness, Anchoring and Adjustment, Leniency) and fundamentals influence on investment decision, how both are singnificantly interlinked with each other for investment decision making and which phenomena is used by investor for decision.

This conceptual paper throw light on different types of investors (i.e. Emotional, Rational, noise) and their way of making decision, Emotional investors uses emotions, feelings, thoughts, Rational investors uses fundamentals and techniques where as noise are inexperienced and take random decisions (Kuzmina, 2010), and explain for which investor biasness is most important and where fundamentals play their significant role in decision making. The aim of this study is to show both biasness and fundamentals effects on investment decision, while making decision investor should consider both things in mind so investor can take a fruitful and beneficial decision for his or her investment to acquire the best outcomes.

2. Theoretical Framework

Investment decisions are made on the basis of different economic models and fundamentals but sometimes these decisions not become beneficial for the business as well as for investors and not get its expected returns. While making decision we use different models but these models did not take into account behavioral aspect of human decision making as mention by Kahneman and Tversky (1979), and the author strongly rely that behavioral aspects of human decision making play a significant role for real understanding of investment environment. Ganzach and Krantz (1990, 1991) and Czaczkes and Ganzach (1996) made contribution by their research work for the development of behavioral decision theory which indicate different decisions are often influenced by various heuristics and also mention intuitive predictions are influenced by concurrently operating heuristics. Amir and Ganzach (1998) throw light on different heuristics (i.e. Representativeness, Anchoring and Adjustment, leniency) while making investment decisions. These heuristics show significant influence over decision making and it causes market over-reaction and under-reaction as well.

Representativeness is cognitive bias of an investor mention by Pompian (2006). Under this biasness investor select a prediction value and match extreme of that prediction value with the extreme of predictive information for making an investment decision described by Kahneman and Tversky (1973), and this bias lead market toward the overreaction as explain by Amir and Ganzach (1998). Anchoring and Adjustment is also a cognitive bias for investor mention by Pompian (2006, p.75). This investor's biasness causes to anchor at some particular outcome value and made adjustment which is based on predictive information, this heuristic significantly influence investment decision and it causes moderation (Slovic and Lichtenstein, 1971; Kahneman and Tversky, 1973), and also take market toward moderate condition. Leniency bias is also used as heuristic for investment decision as mentioned by Amir and Ganzach (1998). Investors who have Leniency bias show lenient predictions and under this bias investor is overly optimistic about their investment decisions (Givoly and Lakonishok, 1984; Schipper, 1991). However, leniency bias create over optimism in investor and this optimism is related with preference of investor to sustain beneficial relation for primary source of information on which investor made investment decisions (Affleck-Graves et al., 1990; DeBondt and Thaler, 1990).

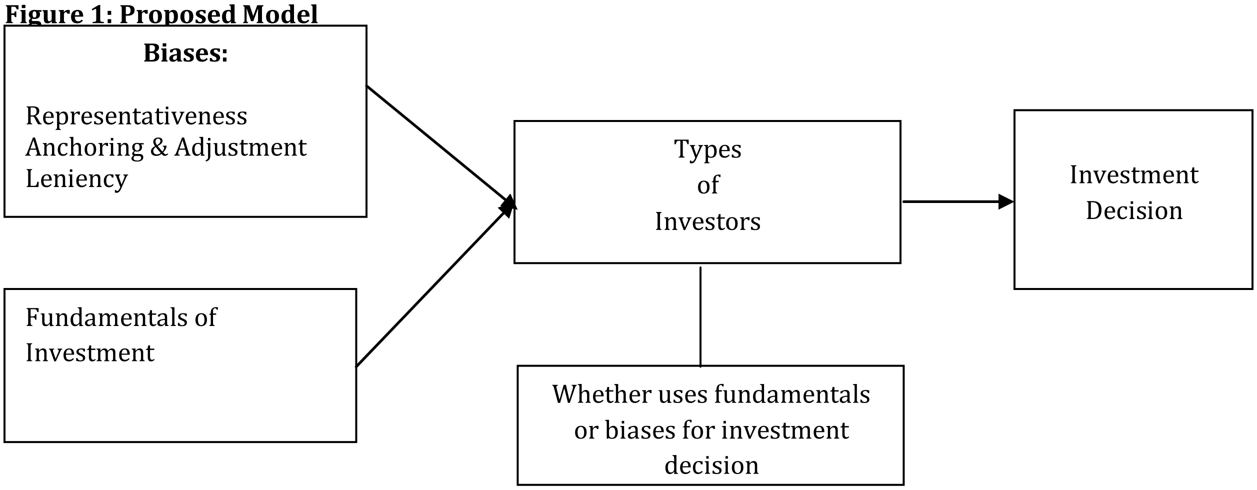
Although different biasness influence on investment decisions, fundamentals also have effect on investment decisions. There are two models which describe the fundamentals of investment. (i) Neoclassical model, i.e., the Jorgenson (1963) approach; and (ii) Alternative Q approach by Tobin (1969). Jorgenson depicts that there are two fundamentals of investment and it is combine process with outcome and the cost of capital. However, this approach is used widely by different investors to forecast about the investment decision and this model contains system of equation for investment decision but it has been rejected by many researchers as mention by Lucas (1976). Q approach tells about investment is the combine procedure with Tobin's Q ratio which is ratio of the market valuation of an investment to the replacement cost of the physical assets as showed by Brainard and Tobin (1968). Tobin's Q ratio is used as an indicator of future profitability described by Fischer and Merton (1984) that combines asset prices in a sufficient statistic which consist on prices bond prices and the replacement cost of capital stock.

Different researchers have conducted research on different fundamentals and determinants of investment and most of researchers found that credit has significant effect on investment decision and taken as financial determinant of investment (Stiglitz and Weiss, 1981; Fazzari et al., 1988; Calomiris and Hubbard, 1989; MacKie-Mason, 1989; Mayer, 1988; Hubbard, 1990; Whited, 1991). Investment decision not only depend on fundamentals or biases it is also affected by the types of investors who uses fundamentals and who uses biases as heuristic for investment decision as describe by Kuzmina (2010) and author also define different kinds of investors who take decision on different criteria, and Investors types are rational investor, emotional investor and finally noise investor. Kuzmina (2010) depicts that Rational investors usually take into account both previous and current available information for making an investment decision. Rational investors mostly depends on fundamentals and count all fundamentals which influences the investment and sometimes they use intuition instead of using fundamentals and analytical tools (Tversky and Kahneman, 1974 ; Shefrin, 2002).

Emotional investors made investment decision on the basis of their emotions and different heuristic approaches (Kuzmina, 2010). Emotions become bottom line for destruction of rational behavior of investor and have negative impact on different fundamental models for investment (Smith, 1759 : Peters and Slovic, 2000). Investment decisions made only on fundamentals not take into account the original heuristics-and-biases went to failure and not get its expected outcome as mention by Kahneman and Tversky (1979). So emotional investors take decision on their emotions, feelings & affective reaction and it also depend on their personality traits (Kuzmina, 2010). Affective reaction play an important role for investment decision (Epstein, 1994; Lowenstein, Weber, Hsee and Welch, 2001; Slovic, Finucane, Peters and MacGregor, 2002). Emotional investors while making investment decision attached an affective reaction means develop different feeling about the alternatives which are available for investment decision as mention by Slovic et al. (2002) & Peters (2006).

Noise investors are the investors who have little know how about the investment and they usually act randomly on investment decisions and usually show herd behavior as shown by Kuzmina (2010). Herd behavior means have incomplete information about investment and don't know what's going on (Rubaltelli, 2010), following the crowd where they were going follow them because we don't have understanding what is going on as mention by Shiller (2000). Sometimes they go against the crowd and have belief they got expected returns but they failed mention by Zeelenberg and Beattie (1997). While considering above literature review we can say that all above factors influence investment decision and research has been conducted separately on heuristic and fundamentals. But we proposed a model in which we take both factors in to account to describe the influence of both biasness and fundamentals on investment decision as shown below in the figure.

Figure 1: Proposed Model



3. Discussion and Practical Implication

Different investors take different investment decisions on the basis of their experience, emotions and cognitive biasness (Kuzmina, 2010). The above model showed significant relation of Biases (i.e. Representativeness, Anchoring and Adjustment, Leniecy), Fundamentals with type of Investors and investment decision. So, Investment decisions depend on investor's type whether they use fundamentals or biases for investment. Both fundamentals and biases have significant influence over investment, in some investors (i.e. Emotional) biases are over influenced as compare to fundamentals and some investors (i.e. Rational) prefer fundamentals over biases (Kuzmina, 2010).

In emotional investors emotion is combination of complex and simple evaluative process of mental which result in an emotional state of the body as additional change in mental and emotion could be seen both as a state of human brain preparing the body to react in one or another way or as a reaction to the particular situation as expressed by Damasio (1996), Oatley and Jenkins (1996) and Frijda et al. (2000). Elster (2003) claims that decision making can be improved by emotions in respect to avoide the delay of decisions as help to come to some decision and to improve the decision quality (even though it could be achieved exclusively by rational consideration). Emotions are also considered as cognitive biasness in investor as described by Kahneman and Tversky (1979). Different biases influence investment decision in different ways. Amir and Ganzach (1998) expressed that Representativeness bias made an investor over optimistic and he take decision on the basis of his previous extreme value and he invest over optimistically and don't take into account all fundamentals for investment decision, in Anchoring and Adjustment bias investor show moderate behavior and anchor at silent outcome value not on the whole fundamentals, In Leniency bias investor become overoptimistic and take investment decision over-optimistically. All biases influence over fundamentals of investment decision in emotional investors and Lo and Repin (2002) claiming that emotions are significant determinants of the evolutionary fitness of financial investors to make investment decision. However, investment decision which are extremely based on emotion is unproductive to get benefits of that decision (Lo et al., 2002), so fundamentals are also important for the investment decision.

However, in emotional type of investor investment decisions are influenced by emotion & feelings over fundamentals. Feelings also play important role for the investment decision as mention by Statman, Fisher and Anginer (2008). But in Rational investors fundamentals are used mostly and accurately to made rational investment decision. Rational investors are not influenced by emotions or biases for decision making, they use rationality, fundamentals and techniques for investment decision (Kuzmina, 2010). The above mentioned model have practical implications while investment decision, Investor can choose best heuristic for decision to make a good and beneficial decision for the fruitful future outcome if an investor come to know their type of investor .

4. Conclusion and Direction for further Study

In this business environment, investment decisions are most significant for success or failure of any business. Good investment decisions lead business toward success where as bad investment decisions lead toward failure of business. Every investor try their best to get maximum fruitful benefits from investment decision and make every possible effort for good investment decision. However, some investors go toward failure because of some factors. Factors which they consider for decision may be only their emotions or biases instead of fundamentals, or fundamentals instead of emotion or biases. The best investment decision is only that decision which consider both fundamentals as well as emotions and biases, and to make best and fruitful decision an investor should know what kind of investor he/she is than apply both heuristic fundamentals and biases for investment decision. Further research can be conducted on different cognitive biases according with fundamentals for investment decision.

Limitation: This paper has limitation that is we take only three kind of biases that are Representativeness, Anchoring and Adjustment, and Leniency. And We used in fundamentals only two models not used all techniques for investment decision making.

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