INVESTMENT AND INVESTMENT PRODUCTS

WHAT IS INVESTING?

- It involves committing money in order to earn a financial return. This essentially means that you invest the money you saved to make money and achieve your financial goals.
- It is usually associated with devoting money in some products for longer period of time to achieve certain goals
- It is different than saving. Saving is nothing but difference between Income and expenditure whereas Investing involves planning how to use the saved money effectively and efficiently to increase your wealth.
- Saving generally involves putting money in a bank or money market investment which guarantees fixed return (low) with minimal risk. Whereas Investing helps you create and preserve the wealth.
- Planning and discipline are pillars to become successful investor. Goal/milestones setting with definite time frame is extremely crucial to achieve desired results.

INVESTMENT PROCESS:

1. MAKING A FINANCIAL PLAN: What are the things you want to save and invest for? Make the list and then think about which goals are the most important. List most important goals first.
2. KNOW YOUR CURRENT FINANCIAL SITUATION: Create net worth statement which should clearly describe what you own and what you owe. Difference between Assets and liabilities will be the Net worth.
3. KNOW YOUR INCOME AND EXPENSES: The next step is to keep track of your income and your expenses for every month.
4. FINDING MONEY TO SAVE OR INVEST: Small savings add up to big money. Hence analyse each expense and identify which expenses can be done away with to increase the savings. Understand the power of compounding.
5. UNDERSTAND RISK: All investments involve taking on risk. It's important that you go into any investment in property, stocks, bonds or mutual funds with a full understanding that you could lose some or all of your money in any one investment. This strategy is called "diversification." One of the ways to define risk is the likelihood that an investment's actual return will differ from expectations.
6. GET STARTED: Identify suitable investment asset class and products within specific asset class matching with your risk and return profile for each goal
7. REVIEW AND REBALANCE: You may decide to review your portfolio, for example if your personal situation has changed, or market conditions have altered. If you do not review and adjust your portfolio in light of changing circumstances, you risk not achieving your investment goals. When you rebalance, you need to think carefully about the costs and tax implications.

INVESTMENT OBJECTIVES: An investment objective is the purpose a particular investment or combination of investments serve for the investor's financial goals. Once the objective is

determined, it will then dictate what particular asset classes and investment security types the investor should buy and hold to fulfill the purpose of the portfolio.

- Safety of funds to manage emergency situation.
- Growth of wealth to achieve desired goals
- Regular Income from investment in order to meet day to day expenses
- Tax benefit by investing in financial products offering tax rebates or lower tax rates
- Liquidity in the market to know how fast investment can be liquidated
- Future needs like Gold for marriage of children, real estate for future business plan etc.

INVESTMENT CONSTRAINTS:

- Availability of funds / regular income: Some investment products require investment in lump sum may be due to the terms of investment like minimum investment amount or market situation. Irregular income source can affect the selection of particular asset class or investment product demanding regular investment.

- Liquidity constraints: Liquidity refers to the ability to turn investment assets into spendable cash in a short span of time without having to make significant price concessions to do so. Illiquid investments in hedge funds and private equity funds, which typically are not traded and have restrictions on redemptions, are not suitable for an investor who may unexpectedly need access to the funds.

- Time horizon: In general, the longer an investor's time horizon, the more risk and less liquidity the investor can accept in the portfolio. While the investment in stock and bonds can be risky in the short run, time has a moderating effect on market risk.

- Tax concerns: Besides an individual's overall tax rate, the tax treatment of various types of asset classes is also a consideration in security selection and portfolio construction. Some types of investment such as provident fund or new pension schemesmay be tax exempt or tax deferred..

- Unique needs & preferences: Each investor, whether individual or institutional, may have specific preferences or restrictions on which securities and asset classes they can invest. Ethical preferences, such as prohibiting investment in securities issued by companies in the manufacturing or distribution of tobacco, alcohol, defence, firearm producers and environmental harmful products are not uncommon.

- Legal & regulatory restrictions: In addition to financial market regulations that apply to all investors, more specific legal and regulatory constraints may apply to particulartype of investor. Trust, corporate, and qualified institutional investors are restricted by law from investing in particular types of securities and assets. Other Constraints such as investment constraints faced by specific investor category or organization or institution in order to adhere to their bylaws.

INVESTOR CATEGORIZATION:

- Private Investor
- Institutional Investor
- Independent Investor

- Risk Averse
- Risk Tolerant

INVESTMENT STYLES: An investing style, also commonly referred to as the investment philosophy or investment strategy, is the Investor's approach to building portfolios. It sets the overarching investment discipline and identifies certain qualities or characteristics the manager is look for when analyzing potential investments. The investment style defines howthe investor will achieve the portfolio's investment goals.

- **Active Investing**: involves being more aggressive in investment approach to beat the market / index and hence would entail higher returns by taking higher risk. It involves extensive fundamental and /or technical analysis and micro and macroeconomic factors influencing the investment are closely monitored. The objective of active investing is in outperform the market.
- **Passive Investing**: has a long-term focus and ignores short-term market ups and downs. This is thus a more cost-effective way to invest and avoids short-term temptations or setbacks in price. A good example of passive investing is buying an index fund wherein the fund manager switches holdings based on changing composition of the index being tracked by the fund.
- **Bottom-up**: style involves choosing stocks based on the strength of an individual company, regardless of what's happening in the economy as a whole or the sector in which that company lies.
- **Top down:** style involves choosing assets based on a big theme like economy boom or slump.
- **Value Investing** is focused on buying a strong firm at a good price which is currently undervalued.
- **Growth Investing**looks for firms that have high earnings growth rates, high return on equity, high profit margins and low dividend yields.
- **GARP Investing:** Growth at a reasonable pricing style is combination of growth and value investing. These investors are looking for companies with the potential to generate superior earnings growth, but are also very conscious of the valuation.
- **Contrarian Investing**looks tochoose assets that are out of favor. They determine the market's consensus about a company or sector and then bet against it.
- **Market cap based Investing**style looks to invest in stocks based on it's market capitalization matching their risk profile and investment objective.
- **Diversification:** Investment style focuses on reducing concentration risk by investingin various asset classes in order to take benefits of performance various assets at different economic situation.
- **Style-neutral Investing** aim to remain neutral to any particular styles with a blend of value and growth characteristics. Even within this grouping there can be variations. There are those investors which aim to maintain an even balance over time and not exhibit any style bias and then there are style-neutral investors which actively allocate between the styles and will implement style tilts over time, depending on market conditions.

TYPES OF RISKS:

- Investment Risk
- Systematic Risk/Market Risk
- Unsystematic risk

- Country Risk
- Currency Risk
- Reinvestment Risk
- Interest rate Risk
- Liquidity Risk
- Volatility Risk
- Political, regulator/Policy Risk
- Information Risk
- Business & Technology Risk

INVESTMENT PRODUCTS:

There is a plethora of investment avenues, each associated with varied risk-return trade- offs. Every investment avenue is distinct in its characteristic, which makes the investment decision fascinating. The investor thus needs to carefully analyze each of its characteristics and build a basket of assets that suits his risk profile and complies with his objectives and goals. Hence, investment decision making is a fascinating task to the investor.

Investment products are primarily divided into following categories:

- Fixed Income Products
- Variable Income Products
- Derivatives
- Structured Investment Products
- Alternative Investment Products

FIXED INCOME PRODUCTS:

Fixed Income Investments offer a fixed rate of return with the interest getting accumulated over a predetermined period of time at regular interval. Because the returns in fixed income investments are reliable, it is particularly popular amongst the retired investors. This category also includes the likes of Money market instruments, bonds and bond funds, Post Office Savings Schemes, Government schemes, Bank FDs and RDs, Corporate securities,exchange-traded funds (ETF).

Money Market Instruments

Investment in money market funds take the direct brunt of any increase in interest rates and are therefore best suited for short periods investment like upto 90 days. They generatea steady income and include treasury bills, commercial papers, short term certificates of deposits, banker's acceptances etc. These are considered as risk free investment instruments and hence returns are low.

Bonds & Bond funds:

Bonds are long term debt securities issued by government, governmental agencies, municipalities or corporations. These institutions issue bonds in order to raise funds for specific project or general purpose. These debt securities are characterized by face value (the amount due at maturity) and coupon rate (annual interest payment by the issuer). Returns are capped todecided coupon rate and money is at risk only if the institution goes bankrupt.

Bond / Debt funds invest in instruments like government bonds, corporate bonds andrelated securities. These are low risk, low return, stable investment platform that do not invest in volatile stock markets.

Exchange traded Funds:

These are funds that are listed and traded on the stock exchanges. Nifty, S&P, BSE Sensex are some of the indexes these funds associate with. ETFs can be traded in the cash market on a day to day to basis with Gold ETF being one of the popular choices among its offerings.

Government Schemes:

There are various fixed income schemes launched by Government of India through Post office and Banks wherein Government acts as a guarantor and controls the feature like time horizon, interest rate, minimum / maximum investment amount etc. hese schemes includes:

1. Public Provident Fund (PPF)
2. Senior Citizen Savings Scheme (SCSS)
3. SukanyaSamriddhiYojana (SSY)
4. KisanVikasPatra (KVP)
5. National Savings Certificate (NSC)
6. NPS &Atal Pension Yojana (APY)
7. Sovereign Gold Schemes etc.

Certificate of deposits:

CDs are offered by banks, NBFCs and credit unions that provides an interest rate premium in exchange for the customer agreeing to leave a lump-sum deposit untouched for a predetermined period of time. Almost all consumer financial institutions offer them, although

DERIVATIVES:

Derivatives are not themselves equity interest or debt securities, but rather represent right or obligation related to equity or debt securities. These are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, commodity, security, or index. Even small market movements can dramatically affect their value, sometimes in unpredictable ways. Derivative contracts have several variants. The most common variants are forwards, futures, options and swaps.

The following three broad categories of participants - hedgers, speculators, and arbitrageurs trade in the derivatives market.

STRUCTURED INVESTMENT PRODUCTS:

Structured products refer to combinations of individual financial instruments, such as bonds, stocks and derivatives. Structured investments usually combine a debt security with exposure linked to the performance of an underlying asset, such as equities, interest rates, options, commodities or currencies. There is no single structure in Structured Products. Structured

investments are typically originated and offered by investment banks and come in a variety of forms, the most common being senior unsecured notes of the issuer.

Structured products are not homogeneous—there are numerous varieties of derivatives and underlying assets—but they can be classified under the following categories:

- Interest rate-linked notes and deposits
- Equity-linked notes and deposits
- FX and commodity-linked notes and deposits
- Hybrid-linked notes and deposits
- Credit-linked notes and deposits
- Constant proportion debt obligations (CPDOs)
- Constant proportion portfolio insurance (CPPI)
- Market-linked notes and deposits

Most structured products have a fixed maturity and may pay an interest rate or coupon rate. Structured products also frequently cap or limit the upside participation in the referenced asset, particularly if the security offers principal protection or an enhanced rate of interest.
They can be used as:

- an alternative to a direct investment
- a part of the overall asset allocation
- a risk-reduction strategy in a portfolio

Challenges of Structured Investment products

- Not liquid: It's not easy to sell Structured Products – it is not liquid. If one is able to sell it, it would have been sold at a discounted price.
- No daily pricing or net asset value: The pricing of an SP is, at the most, gained through a best-guess approach. This increases the risk of investors who are technical in nature.
- Structured Products are an unsecured debt from investment banks: This will affect your credit as an investor, which will basically affect and roll out in all of your other investments on loan.
- Extremely complex nature: Its complexities leave room for a lot of error. It is hard to determine the number versus number scale between getting Structured Products and getting each product inside it individually, so there is still no actual proof in numbers that one is better than the other.

VARIABLE INCOME PRODUCTS:

Variable-income securities are a type of investment where there is no assurance that all of the money invested will be recovered, and the amount of any potential returns will not be guaranteed or known in advance. It is even possible for these returns to be negative, evento the extent where the money initially invested may be lost entirely. Equity and equity Mutual funds are considered as most common form of variable income products.

Equities:

Equities, also sometimes called stocks or shares, represent ownership in a company. Of the major asset types equities, bonds, property and cash, history has shown that equities have the highest potential to deliver strong returns over the long-term.

The return is uncertain at inception and is subject to factors specific to a company, sector and/or country, and regional or global economic and business cycles. Unlike debt, equity carries no legal obligation for repayment and has an unpredictable and variable cash flow for investors. Therefore, equity is broadly understood as a riskier investment than debt, and it consumes more economic capital.

Investor can invest in common stock through Primary Market or secondary market. Primary market is a place where securities are issued by the company for the first time to general public for raising funds in order to fulfill the long term capital requirement. While secondary market is a place where existing shares are traded amongst investors.

Equity Mutual Funds:

In a managed equity mutual fund, after investigating the prospects of many companies, the fund's investment adviser will pick the stocks of companies and put them into a fund. Investors can buy shares of the fund, and their shares rise or fall in value as the values of the stocks in the fund rise and fall. Investors may typically pay a fee when they buy or sell their shares in the fund, and those fees in part pay the salaries and expenses of the professionals who manage the fund.

Fund manager invest in companies as per the objective or theme of the fund. There are various types of equity mutual funds:

Investment Strategy-based Categorization

Theme and Sectoral Funds – An Equity Fund might decide to follow a specific investment theme like an international stock theme or emerging market theme, etc. Also, some schemes might invest in a particular sector of the market like BFSI, IT, Pharmaceutical, etc. **Focused Equity Fund** – This fund invests in a maximum of 30 stocks of companies having market capitalization as specified at the time of the launch of the scheme. **Contra Equity Fund** – As the name suggests, these schemes follow a contrarian strategy of investing.

Market Capitalization-based Categorization

Some schemes might decide to invest in companies with specific market capitalizations only. Here are the common types:

- **Large-Cap Funds** – which typically invest a minimum of 80% of their total assets in equity shares of large-cap companies (the top 100)..
- **Mid-Cap Funds** – which usually invest around 65% of their total assets in equity sharesof mid-cap companies (101-250th placed companies according to market capitalization).
- **Small-Cap Funds** – which typically invest around 65% of their total assets in equity shares of small-cap companies (251st and below placed companies according to market capitalization). This is a huge list and more than 95% of all companies in India fall into this category. These schemes tend to offer great returns but are also highly volatile.

- **Flexi Cap Funds –** which usually invest around 65% of their total assets in equity shares of large-cap, mid-cap and small-cap companies in varying proportions. In these schemes, the fund manager keeps rebalancing the portfolio to match the market and economic conditions as well as the investment objective of the scheme.

Tax Treatment – Based Categorization

- **Equity Linked Savings Scheme (ELSS)** – ELSS Funds is the only equity scheme which offers tax benefits of up to Rs. 1.5 lakh under Section 80C of the Income Tax Act. These schemes invest a minimum of 80% of its total assets in equity and equity related instruments. Further, these schemes have a lock-in period of 3 years.

Investment Style-based Categorization

- **Active Funds** – These schemes are actively managed by the fund managers who handpickthe stocks that they want to invest in.

- **Passive Funds** – These schemes usually track a market index or segment which determines the list of stock that the scheme will invest in. In these schemes, the fund manager has no active role in the selection of the stocks.

TYPES OF SCHEMES

1. Balanced /Hybrid Funds

Balanced funds make strategic allocation to both debt as well as equities. It mainly works on the premise that while the debt portfolio of the scheme provides stability, the equity one provides growth.

2. Equity Diversified Funds

A Diversified funds is a fund that contains a wide array of stocks. The fund managerof a diversified fund ensures a high level of diversification in its holdings, thereby reducing theamount of risk in the fund

a. Flexicap/ Multicap Fund: These are by definition, diversified funds. The only difference is that unlike a normal diversified fund, the offer document of a multi- cap/flexi-cap fund generally spells out the limits for minimum and maximum exposure to each of the market caps.

b Contra fund: A contra fund invests in those out-of-favour companies that have unrecognised value. It is ideally suited for investors who want to invest in a fund that has the potential to perform in all types of market environments as it blends together both growth and value opportunities. Investors who invest in contra funds have an aggressive risk appetite.

3. **Index fund**: An index fund seeks to track the performance of a benchmark market index like the BSE Sensex or S&P CNX Nifty.
4. **Dividend Yield fund**: A dividend yield fund invests in shares of companies having high dividend yields. Dividend yield is defined as dividend per share dividend by the share's market price.

Equity Linked Tax Savings Scheme

ELSS is one of the options for investors to save taxes under Section 80 C of the Income Tax Act. They also offer the perfect way to participate in the growth of the capital market, having a lock-in- period of three years. Besides, ELSS has the potential to give better returns than any traditional tax savings instrument.

5. Sector Funds

These funds are highly focused on a particular industry. The basic objective is to enable investors to take advantage of industry cycles. Since sector funds ride on market cycles, they have the potential to offer good returns if the timing is perfect.

6. Thematic Funds

A Thematic fund focuses on trends that are likely to result in the 'out-performance' by certain sectors or companies. In other words, the key factors are those that can make a difference to business profitability and market values.

7. Arbitrage Funds

Typically these funds promise safety of deposits, but better returns, tax benefits and greater liquidity. Pru-ICICI is the latest to join the list with its equities and derivatives funds.

This fund is aimed at an investor who seeks the return of small savings instruments, safetyof bank deposits, tax benefits of RBI relief bonds and liquidity of a mutual fund.

Arbitrage fund finally seeks to capitalize on the price differentials between the spot and the futures market.

8. Cash Fund

Cash Fund is an open ended liquid scheme that aims to generate returns with lower volatility and higher liquidity through a portfolio of debt and money market instrument.

The fund will have retail institutional and super institutional plans. Each plan swill offer growth and dividend options.

9. Exchange Traded Funds

An Exchange Traded Fund (ETF) is a hybrid product that combines the features of an index fund. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

ETFs can be bought and sold like any other stock on an exchange. In other words, ETFs can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day.

Following types of ETF products are available in the market.

- Index ETFs - Most ETFs are index funds that hold securities and attempt to replicate the performance of a stock market index.
- Commodity ETFs - Commodity ETFs invest in commodities, such as precious metals and futures.
- Bond ETFs - Exchange-traded funds that invest in bonds are known as bond ETFs. They thrive during economic recessions because investors pull their money out of the stock market and into bonds (for example, government treasury bonds or those issues by companies regarded as financially stable). Because of this cause and effect relationship, the performance of bond ETFs may be indicative of broader economic conditions.
- Currency ETFs - The funds are total return products where the investor gets access to the foreign exchange, spot change, local institutional interest rates and a collateral yield.

ADVANTAGES OF MUTUALFUND

- Professional Management: The funds are managed by skilled and professionally experienced

managers with a back up of a Research team.

- Diversification: Mutual Funds offer diversification in portfolio which reduces the risk.
- Convenient Administration: There are no administrative risks of share transfer, as many of the Mutual Funds offer services in a demat form which save investor's time and delay.
- Higher Returns: Over a medium to long-term investment, investors always get higher returns in Mutual Funds as compared to other avenues of investment.
- Low Cost of Management: No Mutual Fund can increase the cost beyond prescribed limits of 2.5% maximum and any extra cost of management is to be borne by the AMC.
- Liquidity: In all the open ended funds, liquidity is provided by direct sales / repurchase by the Mutual Fund and in case of close ended funds, the liquidity is provided by listing the units on the Stock Exchange.
- Transparency: The SEBI Regulations now compel all the Mutual Funds to disclose their portfolios on monthly basis. The NAVs are calculated on a daily basis in case of open ended funds and are now published through AMFI in the newspapers.
- Other Benefits: Mutual Funds provide regular withdrawal and systematic investment plans according to the need of the investors. The investors can also switch from one scheme to another without any load.
- Highly Regulated: Mutual Funds all over the world are highly regulated and in India all Mutual Funds are registered with SEBI and are strictly regulated as per the Mutual Fund Regulations which provide excellent investor protection.
- Economies of scale: The way mutual funds are structured gives it a natural advantage. The "pooled" money from a number of investors ensures that mutual funds enjoy economies of scale;
- Flexibility: There are a lot of features in a regular mutual fund scheme, which imparts flexibility to the scheme.

DRAWBACKS OF MUTUALFUND

- No guarantee of Return
- Diversification – A mutual fund helps to create a diversified portfolio.
- Selection of Proper Fund – It may be easier to select the right share rather than the right fund. For stocks, one can base his selection on the parameters of economic, industry and company analysis.
- Cost Factor – Mutual Funds carry a price tag. Fund Managers are the highest paid executives. While investing, one has to pay for entry load and when leaving he has to pay for exit load.
- Unethical Practices – Mutual Funds may not play a fair game. Each scheme may sell some of the holdings to its sister concerns for substantive notional gains and posting NAVs in a formalized manner.
- Taxes – When making decisions about your money, fund managers do not consider your personal tax situations.
- Transfer Difficulties – Complications arise with mutual funds when a managed portfoliois switched to a different financial firm.

References:

1. Mutual Fund Handout by ICAI
2. Investment in Mutual Funds by SEBI.

ALTERNATE INVESTMENT OPTIONS

There is no uniform definition of alternative investments or definitive list of alternative assets. Alternative investments are sometimes viewed as including any investment that is not simply a long position in traditional investments. It includes investments in:

1. COMMERCIAL REAL ASSETS: Commercial real estate investing includes making equity or debt investments in multi-family residential, land, office, industrial, retail, hotel properties, natural resources, infrastructure and other more specialized assets like intellectual property. Investors can gain exposure to commercial real estate through indirect route in two ways;

Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs). Both are types of companies that invest in real estate and whose shares are traded on exchanges.REITs invest in real estate directly, either through equity stakes in properties or through mortgages. They must distribute 90% of their taxable income to shareholders and thereby qualify for lower corporate tax treatment.

Apart from these, investor can participate through **real estate mutual funds.** Real Estate Funds are sector funds that invest in securities of companies from the real estate sector. In other words, these funds provide the capital to the real estate company to develop a property. If the sector grows, then the fund makes good returns. A real estate fund might invest in real estate companies or REITs (Real Estate Investment Trusts) based on the investment objective of the fund among other factors.

Advantages of Investing in Real Estate Funds:

a. Flexibility: Real Estate Investment Funds allow you to invest in the real estate sector without burning a hole in your pocket. You have the flexibility to choose the amountthat you want to invest.
b. Alternative to buying property: These funds offer a great alternative to buying an investment property. You can benefit from the growth of the real estate sector without buying a property.
c. Diversification: These funds are a blessing for investors with limited available capital who want to gain exposure to the real estate sector.
d. Liquidity: When you invest in a real estate property, your investment has very low liquidity since selling the property takes time. This is where real estate funds offer an advantage since they are highly liquid and allow you to liquidate your investments when the markets are high.
e. Stability: When you invest in a property, if there is a downturn in prices in your locality for any reason, then you can suffer losses. However, with real estate funds, these fluctuations are balanced out since the fund invests in multiple properties spread across different areas.
f. Protects against Inflation: When an economy goes through inflation, the prices of property rise and the rents increase too. This, in turn, leads to an increase in the

value of the units of a real estate fund. Hence, these funds are great protection against inflation.

2. HEDGE FUNDS:

Hedge funds represent perhaps the most visible category of alternative investments. Hedge funds are investment pools that are typically privately organized and invest principally in publicly traded assets, such as stocks, bonds, currencies, commodities, and derivatives. Unlike traditional investment pools, such as mutual funds, they can use leverage and sell short. The hedge fund category includes managed futures funds.

Hedge funds are a heterogeneous group with over twenty distinct strategies within four broad strategy groups:

• Equity Hedge Strategies: Their main objective is to seek long-term capital appreciation while maintaining low net exposure to the overall stock market or individual industry groups.

• Event Driven Strategies: These concentrate on the profit potential created by major corporate events, such as mergers, acquisitions, restructurings, bankruptcies or liquidations.

• Macro Strategies: These primarily trade in the most liquid markets in the world, such as currencies and government bonds, typically betting on macroeconomic events such as changes in interest rate policies or currency devaluations. They rely mostly on an assessment of economic fundamentals.

• Relative Value Strategies: These seek to profit from the relative mispricing of related assets, e.g. convertible bonds and the common stock underlying the conversion option; options and futures and their underlying reference assets; debt instruments of the same issuer or of different issuers with different maturities or yields.

3. PRIVATE EQUITY:

These are negotiated investments in privately held companies at different stages of maturity undertaken with the objective of improving their profitability and growth prospects and then reselling them at a higher price in the future. Private equity includes the common stock, preferred stock, and (in some cases) debt securities of firms that are not publicly traded and that have equity-like risk exposures.

• **Venture Capital:** These firms provide risk capital for starting, expanding and acquiring companies. Most are quite specialized, often investing in a single field, such as telecommunications or health care.

• **Leveraged Buyouts:** Leveraged buyout firms specialize in financing the purchase of established mature companies that are generating cash-flow (used to service the debt). Investing in these funds allows directionally long exposure to equity.

• **Mezzanine Capital:** These funds provide an intermediate level of financing in leveraged buyouts below the senior debt layer and above the equity layer

• **Distressed Investing:** This includes i) the purchase of companies that are distressed or outof favor, for low multiples of cash flow and/or low percentages of asset value; or, ii) the acquisition of quality companies with excessive leverage or those that are going through bankruptcy that require restructuring.

4. STRUCTURED PRODUCTS

Structured products are instruments created to exhibit particular return, risk, taxation, or other

attributes. These instruments generate unique cash Lows as a result of partitioning the cash Lows from a traditional investment or linking the returns of the structured productto one or more market values.

The category of structured products varies from rather simple financial derivatives that are often classified as traditional investments (e.g., credit default swaps) to more complex derivatives, such as collateralized loan obligations, that are usually classified as alternative.

Collateralized debt obligations (CDOs) and similar instruments are among the best -known types of structured products. CDOs partition the actual or synthetic returns from a portfolioof assets (the collateral) into securities with varied levels of seniority (the tranches).

Credit derivatives, another popular type of structured product, facilitate the transfer of credit risk.Most commonly, credit derivatives allow an entity (the credit protection buyer) to transfer some or all of a credit risk associated with a specific exposure to the party on the other side of the derivative (the credit protection seller). The credit protection seller might be diversifying into the given credit risk, speculating on the given credit risk, or hedging a preexisting credit exposure.

5. GOLD & OTHER COMMODITIES:

Gold is an excellent alternative investment avenue which provides liquidity, stability and safety. Apart from investment vehicles listed below, investor can invest in Gold through Sovereign Gold Bonds (SGB) issued by Reserve Bank of India. SGBs are government securitiesdenominated in grams of gold. They are substitutes for holding physical gold. Investors haveto pay the issue price in cash and the bonds will be redeemed in cash on maturity.

Benefits by investing through SGB compared to physical gold: The quantity of gold for which the investor pays is protected, since he receives the ongoing market price at the time of redemption/ premature redemption. The SGB offers a superior alternative to holding gold in physical form.

Investors can gain exposure to commodities through numerous investment vehicles. Many of these instruments have only recently become widely available to both individual and institutional investors.

a. **Exchange-Traded Funds:** Commodity-based exchange-traded funds (ETFs) provide investors with a low-cost means of gaining exposure to commodities. These securities represent claims to individual commodities, groups of commodities, or indices tracking commodity prices.

b. **Exchange-Traded Notes**: Commodity-based exchange-traded notes (ETNs) are non-interest-paying debt instruments that are similar in purpose to commodity-based ETFs. Although the basic purposes of commodity-based ETFs and ETNs are comparable, investors should be aware of some important differences. Because ETNs do not hold the underlying asset or a derivative contract on the underlying, the payoff to an ETN depends on the creditworthiness of the issuer of the ETN. Second, the gains and losses on ETFs and ETNs receive different tax treatment in many jurisdictions

c. **Mutual Funds:** Commodity-based mutual funds provide easy access to commodities in a form that is familiar to the typical investor. Commodity-based funds typically use derivative instruments that are based on commodity indices to build their exposure to commodities

d. **Structured Notes:** Commodity-linked notes are popular with investors wishing to gain exposure to commodities without having to bear all of the price risk inherent in commodities.

Commodity-linked notes combine the security of a fixed-income instrument with an exposure to commodities, generally in the form of an option or futures contract tiedto a commodity index.

e. **Derivative Contracts:** Futures and options contracts with commodities as the underlying asset provide investors with a way to allocate funds to individual commodities and baskets of commodities (commodity indices). Commodity indices consist of passive, rebalanced, long positions in baskets of commodity futures.

f. **Swaps:** Commodity swaps are over-the-counter agreements to exchange cash flows in which the cash flows depend on a notional (principal) dollar amount and changes in commodity prices..

g. **Commodity Pool Operators and Commodity Trading Advisers**: An investor can gain an actively managed exposure to commodities by investing with a commodity pool operator(CPO) or by hiring a commodity trading adviser (CTA).

h. **Equities of Commodity-Based Companies**: A common way to gain commodity exposure is to invest in the equity of a company whose main product is a commodity.

i. **Direct Investment in Physical Commodities**: Investing directly in physical commodities is generally considered not feasible for investors because of the costs associated with trading, insuring, and storing the commodity.

6. ART

The role of art is changing and it is no longer just appreciated for its aesthetic value and the expression of its lofty ideals. It is now also viewed as an investment. Art is a heterogeneous product, artworks are unique. Loyalty to an artist is low and the perceived value of the product very much depends on art dealer's taste.

Factors affecting price are intertwined can be divided into four groups:
1) the work of art,
2) the artist,
3) the market and
4) the macroeconomic environment.

The art market is driven by the following attributes:

• Art is a heterogeneous asset. There are few pieces of art of a specific author traded each year despite the number of fairs and auctions in the market.
• Market transparency is low.
• There are large differences in expertise between buyer and seller.
• There is low liquidity.
• Transaction costs are far higher than other markets.
• There are psychological benefits of owning arts, which are not calculated in the case of owning other financial assets.
• The art market has a much weaker equilibrium process than other securities.
• For dead artists, elasticity of supply is equal to zero.
• The inventories of stocks can be substituted by other securities, but each individual workof art is unique.
• Monopolies with art does exist – mainly for owners of art.
• The equilibrium price is unknown, so an objective evaluation (for example the present value of future cash flows) is often impossible.

7. ANTIQUES

The antiques market has some unusual characteristics that can make investing in them a unique adventure. There are no formal, publicly-available benchmarks in the antiques market such as the Nifty or BSE and relevant market data for specific antiques can be difficult to find, even with the internet as a search tool. The general cycles in the antiques market tend to be very long, and antiques are very illiquid relative to most stocks, bonds or currencies. Furthermore, an antique may require restoration, preservation, transaction orinsurance costs well beyond the costs for "paper" investments with comparable values.

Purposes of Investing in Alternative Investments:

There are three key reasons for adding alternative investments to a well-diversified portfolio.

1. **Reduced Risk through Diversification.** A primary goal of alternative investing is to reducerisk through diversification. One of the distinguishing features of most alternative investments is their lack of correlation with the major traditional asset classes of public equities and public fixed-income assets. A portfolio containing a variety of alternative assetsmay offer reduced risk without a proportionate reduction in expected return.
2. **Enhanced Return through Alpha.** A second major goal of alternative investing is to enhance the expected return of a portfolio by acquiring alternative assets that offer reasonable expectations of alpha—that is, superior risk-adjusted returns. Alternative investing has a track record of offering opportunities, including hedge funds and private equity that can enhance the risk-adjusted returns of well-diversified portfolios through alpha.
3. **Avoiding Obsolescence.** The asset classes viewed as appropriate for institutional investing have changed dramatically over time. Institutional investors who are the last adopters of institutional-quality asset classes will find that prices have adjusted such that the greatest opportunities have been missed. In a similar vein, those asset allocators who are last to embrace change are likely to yield disappointing performance. In other words, those who wait to invest in alternative assets until they have become so mainstream as to be considered to be traditional may suffer from a "last-mover disadvantage."

References:

1. An introduction to Alternative Investments by AR Capital
2. An introduction to Alternative Investments by CAIA Association
3. Alternative Investment: A Primer for Investment Professional by CFA Institute Research Foundation.
4. Commodities as an Investment by The Research Foundation of CFA Institute
5. www.rbi.org.in**Session**

1. **Behavioural skills for wealth management**
2. **Marketing of Financial Products**
3. **Understanding Investor Psychology**

Understanding how the mind can help or hinder investment success

Behavioural finance holds out the prospect of a better understanding of financial market behaviour and scope for investors to make better investment decisions based on an understanding of the potential pitfalls.

This guide focuses on the latter issue. Advisers can learn to understand their own biases and also act as a behavioural coach to clients in helping them deal with their own biases.

Why bother with behavioural finance?

What is behavioural finance?

Behavioural finance has been growing over the last twenty years specifically because investors rarely behave according to the assumptions made in traditional financial and economics theory.

Behavioural finance studies the psychology of financial decision-making.. In other words, behavioural finance takes the insights of psychological research and applies them to financial decisionmaking.

Traditional vs. behavioural finance

Behavioural finance has been growing over the lasttwenty years specifically because of the observation that investors rarely behave according to the assumptions made in traditional finance theory.

Established financial theory focuses on the trade-off between risk and return. However, behavioural finance suggests investors are overconfident with respect to making gains and oversensitive to losses. Research in psychology has documented a range of decision-making behaviours called biases. These biases can affect all types of decision-making, but have particular implications in relation to money and investing. The biases relate to how we process information to reach decisions and the preferences we have. *1*
The following sections discuss the key biases and their implications for investors and advisers.

Overconfidence

Psychology has found that humans tend to have unwarranted confidence in their decision making. In essence, this means having an inflated view of one's own abilities. This trait appears universal, affecting most aspects of our lives. Researchers have asked people to rate their own abilities, for example in driving, relative to others and found that most people rate themselves in the top third of the population. Few people rate their own abilities as below average, although obviously50% of all drivers are below average. Many studies– of company CEOs, doctors, lawyers, students, anddoctors' patients – have also found these individualstend to overrate the accuracy of their views of thefuture. *2*

Overconfidence and investing

Overconfidence has direct applications in investment,which can be complex and involve forecasts of the future. Overconfident investors may over estimate their ability to identify winning investments. Traditional financial theory suggests holding diversified portfolios so that risk is not concentrated in any particular area.'Misguided conviction' can weigh against this advice,with investors or their advisers 'sure' of the good prospects of a given investment, causing them to believe that diversification is therefore unnecessary. In this simple way,investors overestimate their own abilities and overlook broader factors influencing their investments *3*.

Too much trading

Investors with too much confidence in their trading skill often trade too much, with a negative effect on their returns.

Advisers and overconfidence

Advisers need to consider the potential for overconfidence in themselves and their clients. Clients can be counseled against trading too much. Advisers should consider carefully the outcomes of past investment decisions, making an honest assessment of what went well and what did not.

1How behavioural biases affect investment behaviour
Shefrin, Hersh, 2000. *Beyond Greed and Fear: Finance and the Psychology of Investing.*
Chapters 1-3.

2 Barber and Odean (1999), 'The courage of misguided convictions' *Financial Analysts*

Journal, November/December, p47.
Professors Brad Barber and Terry Odean studied US investors with retail brokerage accounts
3 Werner De Bondt (1998), 'A Portrait of the Individual Investor,' *European Economic Review.*

Lessons can be learned for future decisions. and found that more active traders earned the lowest returns.*4*

Skill and luck

Overconfidence may be fuelled by anothercharacteristic known as 'self-attribution bias'. In essence, this means that individuals faced with a positive outcome following a decision, will view that outcome as a reflection of their ability and skill. However, when faced with a negative outcome, this is attributed to bad luck or misfortune. This bias gets in the way of the feedback process by allowing decisionmakers to block out negative feedback and the resulting opportunity to improve future decisions.

4 Brad Barber and Terrence Odean (1999) 'The courage of misguided convictions' *Financial Analysts Journal*, November/December, pp 41-55.

Attitudes to risk and reward

Established financial theory focuses on the trade-off between risk and return. Risk from this perspective means variability of outcomes and riskier investments should, broadly speaking, offer higher rates of return as compensation for higher risk. Financial advisers often ask clients to complete a risk attitude questionnaire to establish their attitude to risk, and consider issues such as investment time horizon and wealth levels to establish risk tolerance. Risk tolerance drives the types of investments they recommend for the investor.

Fear of loss

Behavioural finance suggests investors are more sensitive to loss than to risk and return. Some estimates suggest people weigh losses more than twice as heavily as potential gains. For example, most people require an even (50/50) chance of a gain of £2,500 in a gamble to offset an even chance of a loss of £1,000 before they find it attractive.*5*

5 Montier, James (2002) *Behavioural Finance* Wiley p21-22.

Loss aversion

The idea of loss aversion also includes the finding *6* that people try to avoid locking in a loss. Consider an investment bought for Rs 1,000, which rises quickly to Rs 1,500. The investor would be tempted to sell it in order to lock-in the profit. In contrast, if the investment dropped to Rs 500, the investor would tend to hold it to avoid locking in the loss. The idea of a loss is so painful that people tend to delay recognising it. More generally, investors with losing positions show a strong desire to get back to break even. This means the investor shows highly risk-averse behaviour when facing a profit (selling and locking in the sure gain) and more risk tolerant or risk seeking behaviour when facing a loss (continuing to hold the investment and hoping its price rises again).*7*

The disposition effect

Professors Shefrin and Statman developed the idea of loss aversion into a theory called the 'disposition effect', which indicates that individuals tend to sell winners and hold losers. In later research, Professors Barber and Odean tested this idea using data from a US retail brokerage. They found that investors were roughly 50% more likely to sell a winning position than a losing position, despite the fact that US tax regulations make it beneficial to defer locking in gains for as long as possible, while crystallising tax losses as early as possible. They also found that the tendency to sell winners and hold losers harmed investment returns.

Advisers and loss aversion

Advisers have a key role in helping clients deal with loss aversion and contain their desireto sell winners and hold losinginvestments. The adviser can help the client evaluate whether the investment still has good future prospects and whether it is still suitable for the client's circumstances.

6 Barber and Odean (1999) p42.

7 Daniel Kahneman and Amos Tversky (1979) 'Prospect Theory: An anaysis of decision making under risk' *Econometrica* 47:2, pp. 263-291.

The problem of inertia

Regret avoidance

Inertia means that people fail to get around to taking action, often even on things they want or have agreed to do. A related issue is a tendency for emotions to sway you from an agreed course of action – 'having second thoughts'. The human desire to avoid regret drives these behaviours. Inertia can act as a barrier to effective financial planning, stopping people from saving and making necessary changes to their portfolios. A fundamental uncertainty or confusion about how to proceed lies at the heart of inertia. For example, if an investor is considering making a change to their portfolio, but lacks certainty about the merits of taking action, the investor may decide to choose the most convenient path – wait and see. In this pattern of behaviour, so common in many aspects of our daily lives, the tendency to procrastinate dominates financial decisions.

Overcoming inertia with an autopilot

In recent years behavioural researchers have designed 'autopilot' systems to counteract inertia. For example, in the realm of retirement planning it has been observed that many individuals fail to join their company pension plan, possibly as a result of inertia. Changing the pension scheme so that employees are automatically enrolled in the scheme, while retaining a right to opt out, tends to boost take up rates considerably. In effect, the automatic enrolment approach puts inertia to a positive use. Automatic enrolment is planned for use in the UK's new pension regulations, due to be implemented in 2012.

Individuals in pension plans are also often found to be saving at low rates that are unlikely to generate the levels of retirement income the individuals would hope for. A study*8* found that asking members to precommit to future increases in their pension contributions was an effective way of raising contributions. of the plan, the participants were saving more, on average, than the other groups of employees.

7 Richard Thaler and Cass Sunstein, 'Nudge: Improving decisions about health, wealth and happiness'(2008), pp. 112-115.

8 Richard Thaler and Cass Sunstein, *Nudge: Improving decisions about health, wealth and happiness* (2008), pp. 112-115.

Advisers and inertia

Savings schemes, pound cost averaging and automatic portfolio rebalancing are autopilot approaches that can be used to help clients overcome inertia and meet their financial goals.

Autopilot approaches to investing

Autopilot approaches can also have relevance in investing, such as taking a disciplined approach to portfolio rebalancing, or a commitment to regular monthly savings. Such disciplined approaches – often called 'commitment devices' by behavioural economists – can help investors avoid biases like overconfidence and promote rational investor behaviour. In terms of rebalancing, using a regular schedule for guiding decisions can help investors to avoid being swayed by current market conditions, recent performance of a 'hot' investment or other fads. It results in a regular strategy that sells out of markets or investments that have recently outperformed and adds to markets or investments that have lagged. Regular investing, the process of 'pound cost averaging, also helps as the investor tends to accumulate more units or shares of an investment when markets are low than when they are high.

Constructing portfolios

Framing

Finance theory recommends we treat all of our investments as a single pool, or portfolio, and consider how the risks of each investment offset the risks of others within the portfolio. We're supposed to think comprehensively about our wealth. Rather than focusing on individual securities or simply our financial assets, traditional financial theory believes that we consider our wealth comprehensively, including our house, company pensions, government benefits and our ability to produce income. However, human beings tend to focus overwhelmingly on the behaviour of individual investments or securities. As a result, in reviewing portfolios investors tend to fret over the poor performance of a specific

asset class or security or mutual fund. These ‘narrow’ frames tend to increase investor sensitivity to loss. By contrast, by evaluating investments and performance at the aggregate level, with a ‘wide’ frame, investors tend to exhibit a greater tendency to accept short-term losses and their effects.

Mental accounting

Our psychological self thinks about money and risk through ‘mental accounts’ – separating our wealth into various buckets or pools. We often base these pools on goals or time horizon (such as ‘retirement’ or ‘school fees’). Accounts can also vary in risk tolerance, investing some in risky assets for gain while treating others more conservatively.

Advisers, framing and mental accounting

Behavioural finance suggests that advisers could derive an advantage from developing an awareness and understanding of framing and mental accounting. The adviser could focus on the particular mental accounts the client has and the objectives and risk tolerance of each one. It may not be possible to establish a single overall tolerance for risk. Rather, the client may have a different risk tolerance for their pension, ISA and so on. Advisers should counsel clients to evaluate their financial assets with the widest ‘frame ‘ possible and avoid focusing on individual securities or instruments.

Investors pay less attention to the relationship between the investments held in the different mental accounts than traditional theory suggests. This natural tendency to create mental buckets also causes us to focus on the individual buckets rather than thinking broadly, in terms of our entire wealth position.

Behavioural portfolio theory

In some early versions of portfolio theory, economists suggested that most investors seek to balance security with the small chance for big winnings. Thus portfolio allocations should be based on a combination of ‘insurance’ (protection against losses) and ‘lotteries’ (small odds of a large gain). Behavioural economists Shefrin and Statman formalised this approach in their behavioural portfolio theory based on mental accounts. They view behavioural portfolios as being formed of a layered pyramid, with each layer a separate mental account. The base layers represent assets designed to provide ‘protection from poverty’, which results in conservative investments designed to avoid loss. Higher layers represent ‘hopes for riches’ and are invested in risky assets in the hope of high returns.

Source: Adapted from Statman (1999) ‘Foreign Stocks in Behavioural Portfolios’ *Financial Analysts Journal*, March/April 1999, p14.

Hopes for riches	Lottery Equities
Protection from poverty	Cash Bonds Insurance

This idea explains why an individual investor can simultaneously display risk-averse and risk-tolerant behaviour, depending on which mental account they’re thinking about. This model can help explain why individuals can buy at the same time both ‘insurance’ such as gilts and ‘lottery tickets’ such as a handful of small-cap stocks. The theory also suggests that investors treat each layer in isolation and don’t consider the relationship between the layers. Established finance theory holds that the relationship between the different assets in the overall portfolio is one of the key factors in achieving diversification.

Advisers understand the critical importance of portfolio diversification. However, behavioural finance research suggests investors sometimes struggle to apply the concept in practice.

Naïve diversification

Evidence suggests that investors use ‘naïve’ rules of thumb for portfolio construction in the absence of better information.9 One such rule has been dubbed the ‘1/n’ approach, where investors allocate equally to the range of available asset classes or funds (‘n’ stands for the number of options available). This approach ignores the specific risk-return characteristics of the investments and the relationships between them. Investors might understand the importance of diversification, but not knowing exactly how to achieve it, go for a simple approach. The twist here is that despite the apparent behavioural bias, recent research has shown investors using naïve ‘1/n’ techniques can sometimes do better than the investors

who construct portfolios using sophisticated computer models.*10*

9 Bernartzi, Shlomo and Richard H. Thaler. 'Naive Diversification in Defined Contribution Savings Plans.' *American Economic Review* 91(1), (2001): 79-98.

10 DeMiguel, V., L. Garlappi and R. Uppal, 2009, 'Optimal versus Naive Diversification: How Inefficient is the 1/N Portfolio Strategy?' *The Review of Financial Studies* 22.5, 1915-1953.

Managing diversification

Advisers and diversification

Advisers have an important role to play in helping clients achieve effective diversification and avoiding a concentration of risks in particular investments, no matter how familiar they are. They should caution clients that familiarity is not a substitute for a good spread of investments. One of the more common aspects of naïve diversification is the tendency for some households to hold extreme portfolio allocations. On the one hand are aggressive investors who only hold all-equity portfolios. On the other hand are ultra conservative investors who are reluctant to hold anything other than bonds. Many such investors need the help of an adviser to ensure a balance of risk and return in portfolios.

Investing in the familiar

Investors have been documented to prefer investing in familiar assets. Investors associate familiarity with low risk. This manifests itself in home bias – high portfolio weights in assets from an investor's own country. Institutional and individual investors around the globe tend to bias portfolios towards familiar local markets and away from international markets. In these cases, the danger is one of inadequate diversification.

In the UK in recent years, the familiarity of property may have caused many investors to underestimate the risks involved, although recent market falls may have changed this perspective.

Researchers have documented a number of biases in the way in which we filter and use information when making decisions.*11*

In some cases, we use basic mental shortcuts to simplify decision-making in complex situations. Sometimes these shortcuts are helpful, in other cases they can mislead.

Anchoring

Decisions can be 'anchored' by the way information is presented. In a non-financial example, participants' responses to questions with numerical answers, such as 'How many countries are there in Africa?' were apparently affected by the value shown on a 'wheel of fortune' that was spun in front of them prior to answering. The wheel value provided an anchor that while irrelevant to the question still influenced the answers given.

In the financial sphere, values such as market index levels can act as anchors. Round numbers such as 8,000 points on the Nifty50 Index, seem to attract disproportionate interest, despite them being numbers like any other.

Using – or misusing – information

Availability bias

Some evidence suggests that recently observed or experienced events strongly influence decisions. Psychologists refer to this as the 'availability bias'. Researchers found that individuals were likely to overestimate the chances of being in a car crash if they had seen a car crash on a recent journey. The recent memory made the prospect more vivid –available – and therefore more likely. To give a financial example, investors are more likely to be fearful ofa stock market crash when one has occurred in the recent past.

11 *Shefrin* (2000) Chapters 1-3.

Representativeness bias

The notion of 'representativeness bias' reflects the case where decisions are made based on a situation's superficial characteristics (what it looks like) rather than a detailed evaluation of the reality. Another way of putting this would be saying that decisions are made based on stereotypes. A common financial example is for investors to assume that shares in a high-profile, well-managed company will automatically

be a good investment. This idea sounds reasonable, but ignores the possibility that the share price already reflects the quality of the company and thus future return prospects may be moderate. Another example would be assuming that the past performance of an investment is an indication of its future performance.

Using – or misusing – information

Investors also suffer from representativeness bias when they evaluate fund managers. Investors are often drawn to a manager with a short track record of beating market averages over a few years. Meanwhile they show less interest in a manager with a much longer track record that has exceeded averages by only a small margin. Statistically, the manager with the long-term track record has the stronger case to make about skill. But we tend to look at the manager with the short-term track record, and believe that the record of superior performance will continue.

Conservatism bias

'Conservatism bias' describes the idea the decision maker clings to an initial judgement despite new contradictory information. Or they only partially adjust their view in light of the new information. Taking the example above, investors who buy shares in a highprofilecompany may be slow to adjust their view of the company's prospects even after the company's profitability deteriorates.

Advisers and checklists

Various biases act on our decision-making. Advisers can use checklists to identify potential investment pitfalls, such as:

• Am I, or my client, being anchored by an irrelevant factor, or being affected by the way the issue is framed?
• Am I, or my client, respondingto an available memory, orjudging based on superficial similarity?
• Am I, or my client, being tooconservative in updating views based on recentchanges in information?

Group behavior

The biases discussed so far relate to individual decision making. An important question is how these and other biases affect decisions made by groups. Agroup situation may counteract a particular bias or it may strengthen it. Equally, the group situation couldcreate new biases.

Two heads are better than one?

We typically use groups to make decisions in order to benefit from the range of knowledge and experiencein a group. However, a desire for social acceptance may encourage individuals with conflicting views to fall into line. Or, those with opposing views may start to doubt their own convictions.

Crowds vs. groups

Evidence suggests that crowds – groups of unrelated individuals – are often able to identify correct answersto problems. This is typified in the 'ask the audience feature of the *Who Wants To Be a Millionaire* quiz show. The benefit of the audience is that the rangeof knowledge and experience is diverse and that individuals give their opinion independently of theopinions of others. The research suggests the majority opinion of the audience is correct over 90% of the time.*12*

12 *Behavioral Finance and Investment Committee Decision Making, CFA Institute Conference Proceedings Quarterly*, Arnold S. Wood, December 2006, Vol. 23, No. 4: 29-37, p. 32.

This provides some guidance for effective decision making in committees. Firstly, we need to make sure the committee is appropriately diverse – two headsaren't better than one if both the heads think the same way. Secondly, individuals on the committee must be encouraged to give their own opinions rather than fall into line with the views expressed by one or a few dominant individuals such as their boss.

Decision-making in groups

Effective decision-making in groups requires making sure that the group comprisespeople with diverse experience and perspectives. The grou should be run in a manner tha allows individuals to expresstheir views freely and not feelpressure to fall into line withother views expressed.

The behavioural biases discussed in this guide are thought to be deep-seated aspects of human decision-making processes. Many of them serve uswell when making day-to-day choices. But they may

be unhelpful in achieving success when thinking about long-term financial decisions such as investing. We are unlikely to find a 'cure' for the biases, but if we are aware of them and their effect, we can possibly avoid the major pitfalls.

Awareness for adviser and client

Initially, advisers could develop an awareness o the different biases and the influence they have on investing behaviour. Advisers may also wish to understand the biases that will affect their clients and think about how to reduce their adverse influence Advisers do a fact-finding exercise with clients, looking at their circumstances and objectives. This exercise involves some form of risk tolerance or risk attitude questionnaire. Behavioural finance would suggest a widening of the review to include othe aspects of behaviour. Certainly questions about risk should not simply focus on risk versus return, but also on the client's tendency towards overconfidence in rising markets and undue loss aversion in falling markets. The adviser could also assess the client's decision-making style to understand their proneness to regret, for example.

Managing the biases

Some commentators suggest the source of a client's wealth will be an important driver of their decision making style. A self-made entrepreneur may be risktolerant, but require a hands-on approach to managing their investments. Someone with inherited wealth may be more risk averse and passive.13

Audit trails, feedback and framing

A clear understanding of why particular investment decisions have been taken can help mitigate the effects of behavioural biases. Some investors and ,advisers formalise their investment objectives and requirements in an investment policy statement which acts as another type of commitment device. As markets move and emotions take hold, this record can help prevent making snap judgements. A more rational evaluation can take place about whether individual or market circumstances have changed warranting a change of strategy.

Framing is also a valuable adviser tool. Portfolio discussions should always be framed in terms of long-term goals and the client's total wealth picture. Evaluations of individual investment holdings are useful, but should be considered secondary. In thinking about risk, the approach suggests that clients and advisers should respond to market downturns by reviewing long-term risk and return characteristics of stocks. Such 'wide framing' may help offset the natural tendency to be loss averse.

13 Michael M. Pompian (2009) Diagnosing Behavioral Investor Types, Morningstar Advisor. http://advisor.morningstar.com/articles/article.asp?s=0&docId=16139&pgNo=0

Advisers might consider enhancing their client advice by:

- Evaluating clients' decision making styles
- Developing formal investment policy statements
- Using behavioural checklists

More generally, investors may be able to use feedback to mitigate behavioural biases. Careful consideration of the outcomes of past decisions should help individuals learn to control and work around unhelpful decision-making biases.

Checklists

There has been considerable interest in recent years in the use of checklists in decision-making. In some complex circumstances, such as commercial aviation or surgery, checklists are used to aid decision-making under pressure. A checklist takes expert knowledge and distils it into a series of brief statements that guide actions. Use of checklists could help in financial planning in an effort to avoid the behavioural pitfalls. The list can check for common behavioural biases, such as overconfidence, availability and representativeness biases, as well as anchoring and conservatism.

The devil's advocate

Individuals tend to decide on a course of action and then look for evidence to confirm that course. This

neglects the case against the action. It can be useful to build into a decision-making process the consideration of ‘why we should not do this’ or ‘what could go wrong’. This could be a part of any checklist, or if there are several people involved in the investment process, one could be assigned a formal role as ‘devil’s advocate’ challenged to argue against the proposed course of action.

Mitigating the biases

In this guide we have discussed the field of behavioural finance and its implications for investing and financial planning. There is a range of deep-seated behavioural biases, which, although they might serve us well in various circumstances, tend to detract from investment success. These biases can affect the decisions we take on particular investments and the way we construct portfolios. Individual investors can fall prey to the biases, but as a part of human nature, professional investors and advisers are also vulnerable. We cannot cure the biases, but we can attempt to mitigate their effects. Using techniques such as feedback, audit trails for decisions, checklists, and ‘devil’s advocates’ can help us take decisions in a more rational manner and improve the chances of investmen success.

Understanding our brains

One emerging strand of research is the field of neuroeconomics. Medical imaging technology now allows us to look at brain activity as decisions are being made. This helps us to understand the nature and reasons for certain behavioural biases. A recent study demonstrated that individuals with brain lesions that impaired emotional decision-making were more likely to behave as rational investors than individuals with normal brains.*14* Other imaging studies have confirmed that the rational parts of our brain are in tension with the emotional or limbic sections of our brain. This line of enquiry offers the possibility of understanding and improving decision making.

Better investing

We hope this guide has provided you with a useful insight into the research on behavioural finance. As humans, we are effective decision-makers, but with flaws that can cause problems in realms such as investing. An understanding of the nature of these flaws can help us avoid these problems and invest better.

14 Shiv, Loewenstein, Bechara, Damasio and Damasio, 2005. ‘Investment Behavior and the Negative Side of Emotion’ *Psychological Science* 16, 435-439.

Bibliography and further reading

If you want to explore behavioural finance in more detail you might find the following books of interest.

For a more detailed but accessible introduction to behavioural finance try:

Shefrin, Hersh, 2000.*Beyond Greed and Fear: Finance and the Psychology of Investing*.

For a more general discussion of the role of behavioural economics consider:

Thaler, Richard and Sunstein, Cass, 2008. *Nudge: Improving Decisions about Health, Wealth and Happiness.*

For a fascinating review of the recent research from the emerging field of neuroeconomics, read: Zweig, Jason, 2007. *Your money and your brain.*

By Alistair Byrne With Stephen P Utkus *Courtsey : vanguard.co.uk*