PGIM
India Mutual Fund

Watch out for over-simplifying investment decisions

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Wikipedia defines bias as a disproportionate weight in favor of or against an idea or thing. It also goes on to mention that biases can be innate or learned. In my experience this is true. Bias is at play in all decision making including investment decisions. The most difficult part for an investor is to identify the bias and overcome it so that the investment decisions work in favour of financial well being.

In any area of life that is perceived complex, human beings tend to search for a clear and simple solution. There are areas where it is possible to simplify and a solution thus found covers most probable outcomes. On the other hand, there are some areas that by construct are complex and uncertain. In such cases oversimplification may not be the best idea. Unfortunately investment is one such area which is complex and uncertain. No one can predict the future of markets and time it to perfection.

In global markets there is an investment adage saying ‘sell in May and go away’. The hypothesis is that investors should exit in May and buy back in November when the markets correct. Simple as it may sound, it doesn’t cover the aspects like whether there is scientific evidence for the same, if it is so effective why do investment legends not advocate the same? Should you be selling quality holdings? Over the long run does this strategy deliver any significant outperformance? Just following this simple method is unlikely to create any wealth. But those searching for simplifying the complex world of investments can fall for it.

Investors sometime create simple rules for identifying mutual fund schemes too, like investing in top 3 schemes by performance on a 1 year basis. Now this is oversimplification bias at work. Returns of a scheme are an outcome of the portfolio construct. Returns alone do not tell you the entire story. To correctly analyse the scheme, one has to figure out the risk adjusted returns, the source of returns, whether they have come from a single stock or from a huge exposure to a single sector etc. Investors in the past have paid a heavy price for such oversimplification.

The other way some investors simplify the process of choosing a scheme is by looking at the size of the scheme. For some reason the thought process is, bigger the better. While data analysis of the past decade throws a completely different picture, especially on the equity side. If you look at top 5 performing schemes on an annual basis, smaller size schemes have done better than their larger peers.

We also come across investors who follow some large well known investors. The moment the large investor adds a stock they also buy the same stock. The thinking is that if the large successful investor is buying it then there is something in the stock. Now this simple hack doesn’t account for the fact that the large investor can also get it wrong, he is not going to publicly tell when he is selling the same stock and the stock may just be a small portion of his portfolio. In a majority of cases we see that such simplification is counterproductive.

How do you beat the oversimplification bias? By acknowledging the fact that some areas are complex and uncertain. Second step is to decide whether the investment decisions are part of circle of competence. Does one have enough perspective on things that are crucial and will impact the outcomes. If not then it is better to outsource the job. Biases can also be overcome through solutions that are based on defined parameters. Our Dynamic Advantage Asset Allocation Facility and Age Linked Investment Facility are two such solutions. The former helps investors with the process of buying low and selling high, while the latter helps investors create a glide path to retirement. In case you wish to know more about them please connect with your MFD, RIA or visit us on pgimindia.com

For now, I will not delve into topics of geo-politics, state of the economy or the likely outcome of US elections in this communication. Reason being, the mantra to success is to always try and control the controllable. For an investor, spending less than earnings, investing those savings into a diversified portfolio, taking the help of a qualified and good advisor and sticking to the financial plan is what is controllable. Everything else will remain less important in the long run. Did I just oversimplify? No. This part is really simple.