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Emergence of Behavioral Finance and Value Investing as A Tool for Wealth Creation in Financial Markets

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Abstract

Investment can be done in two ways – concentration or diversification. Concentration means managing patient and permanent capital for a long period of time. Successful investors buy when prices are low and sell when prices are high. However, investors are often faced with the dilemma of whether everyone agrees with their decision, since such a situation does not seem to exist. As a result, investors buy at a high price in the hope of selling at a higher price, but unfortunatelythey end up selling at a lower price.The extensive review of literatures inferred that there is a lack of conceptual understanding about Value Investing among the individual equity investors. Hence this study has been undertaken to differentiate a Value Investor from an ordinary investor.

Key Words: Behavioral Finance, Equity, Financial Markets & Value Investing.

1. Introduction

The theory currently accepted in academic finance is called standard finance or traditional finance. A viable portfolio is a group of stocks that has the highest expected return based on the expected risk level. Another key theme that reflects the value of the security or the market value and the current value of the stock or bond is the so-called efficient market hypothesis, in which investors have all the information about stocks already traded. The preface states that stocks are traded at a reasonable price. Therefore, it is believed that investors should own the whole market instead of trying to get ahead of the market.

It is a proven truth that investment in equity shares assumes an important place in the capital market and is expected to yield a higher rate of return than other form of investments. The investment decision of an investor may be in the form of subjective risk criteria or objective risk criteria. Traditional finance theories such as Modern Portfolio Theory (Harry Markowitz, 1952[1]) and Capital Asset Pricing Model (Jack Treynor,1962[2]) were based on the assumptions that investors behaved rationally. The investors updated their beliefs by engrossing any new information flooding the market. Hence, their decisions were rational and the markets also behaved in an efficient manner providing all the information to the investors.

The Capital Asset Pricing Model (CAPM) was introduced by Jack Treynor in 1962 and then by William Sharpe[3] in 1964. This theory was based on Markowitz's first work. Sharpe, Markowitz and Merton Miller received the 1990 Nobel Prize in Financial Economics. Fischer Black & Scholes. M[4] (1973) later developed another version of CAPM called Black CAPM or Zero-Beta CAPM.

Traditional financial theories had their limits. In 2004, Fama and French[5] argued that CAPM had failed in the empirical tests, indicating that the use of the model was incorrect.Decision – making involves complexities and cannot be made on the basis of incomplete information from unreliable sources. It is the process of choosing between the alternatives. An optimum investment decision, hence, plays a vital role in wealth maximization.

Financial theory was built on the premise that investors are rational. The individual and the collective rationality of investors make the market efficient. However, in reality, individual investors are not rational and markets are not efficient. Every investor is different due to various factors like socio – economic background, education, age, gender etc., Recent research indicates that certain psychological factors are the cause for such a situation. These findings led to behavioral finance - a study of the psychological impact of financial practitioners on their behavior and its subsequent impact on the market.

2. Investor Behavior

The cost of entering the stock market has dropped significantly and more and more people are investing in stocks.Also, the awareness of individuals while saving for their post – retirement has enhanced that they want to make a defined contribution to the schemes in order to secure their future. Evidence suggests that investors prefer to diversify their portfolio in order to reduce risks. They prefer to invest in avenues which are more familiar than in those which are unknown. However, investors diversify their portfolios in a naive fashion.

Rational models of investing predict that there should be very little trading in order to avoid risks. The most prominent reason for excessive trading is over confidence. This proves to be a more apt behavioral explanation for investors who trade more with an assumption that they have abundant and reliable market information.

The behavior of investors depends on whether they want to reap benefits in the short run or long run. The investing class who is hungry for quick bucks has grown in recent times This has created chaos in the market due to the short – sightedness and unpredictable behavior of these investors. Hence, it becomes necessary to manage the investors' perceptions and control the volatility of stock prices through understanding the behavior of investors.

3. Emergence of Behavioral Finance

While exploring the concept of behavioral finance, traditional finance remains at its core. However, behavioral aspects of psychology and sociology are important stimuli in this area of research. Therefore, those who study behavioral finance should have a basic understanding of

psychology, sociologyand financial concepts in order to be familiar with the general concept of behavioral finance.

Behavioral finance seeks to better understand the investor's rational ways, ie emotional processes and the extent to which they influence decision making. Basically, behavioral finance seeks to explain why funding and investment should be from a human perspective. As the field develops and becomes more complex, there is much debate about the true definition and meaning. This evolutionary process continues because many scientists have such diverse and extensive educational and professional backgrounds. Finally, Behavioral Finance explores the psychological and social factors that influence economic decision-making.

Shefrin, Hersh and Meir Statman[11] (2000) specified that when psychological aspect influences the investor's decision-making process, this is known as behavioral finance research. He identified four themes underlying behavioral finance: heuristics, framing, emotion, and market impact.

Kahnemann and Smith[12] (2002) discussed the relationship between financial economics and psychological decision-making and coined the term "behavioral finance". Barberis&Thaler[13] (2003) examined the effects of emotional judgment on financial markets and showed that the market is divided between rational and irrational investors. Rational investors make decisions based on emotional law, which upsets the balance of the market, while rational investors' rationality prevents these irrational investors from adjusting the price deviation from the underlying value.Richard H. Thaler[14] also won the Nobel Prize for his contributions to Behavioral Economics during the year 2017. His work was based on how human qualities influence individual economic decisions and how they affect the market as a whole.Behavioral Finance is a unique combination of financial theories and psychology. This theory has become a contradiction to the traditional Capital Asset Pricing Model and Efficient Market Hypothesis.

4. Stock Investing Styles

Investing styles in stocks can be roughly divided into two categories: fundamental investments and technical investments. Fundamental investors research financial details and other company-related information to acquire stocks, while technical investors research price patterns, trends, mathematical models, and charts to acquire stocks.The main aim of the Technical Investor is to make quick money in the market whereas the Fundamental Investor aims at making long – term gains. The Fundamental Investing style can be further divided into sub – styles and involves detailed studying of various company related information or economy - related information. The investor uses a combination of these to formulate his own investing style using his independent decision to pick stocks.

There are two popular styles of fundamental investing namely Growth Investing and Value Investing. Growth Investing refers to the investment in companies which have a lot of potential to grow in the long – run. These stocks are available at high valuations and are available for a “premium”.

Value Investing is investing in stocks which are available at less than their intrinsic value. Value Investing is a real form of investing where an investor finds good company stocks at a bargain. It may be noted that stocks are available at a bargain but they are out of fashion and the investor chooses the best among the available stocks. Very soon the market recognizes the potential of such stocks and they get re- rated and start bringing gains in the long – run. This method of investing is the safest as an investor buys stocks at low valuations and safeguards his interests. On the other hand, investing in growth stocks seems to be risky. Value investing is essentially a long – term investing strategy where at least a time horizon of five years is required while investing in stocks.

5. Value Investing Philosophy

The market replicates human nature as well as the underlying fundamental values. Behind every transaction, there are many human minds who bring in their optimism, pessimism or over confidence while they trade in the market. Also, psychologists believe that individuals behave in an aggressive manner when they are in a group than when they are alone. This behavior leads to highs and lows in the market and the prices of stocks are traded either above or below their true net worth. Under such circumstances, value investors follow a strict emotional discipline by studying the historic fundamentals of stocks and how they have traded in the market so that they can gauge their performance in the future.

This stock analysis process will determine the true or intrinsic value of such stocks. Stocks that trade significantly above their long-term intrinsic value will ultimately decline to that value, and if the stock is below that value, they may eventually return to their long-term intrinsic value. However, both fundamental and technical analysis can be used because fundamental analysis helps investors identify healthy companies they are investing in, and technical analysis helps investors understand when to get in and out of their stocks.

6. Finding the Value of Stocks

Assuming the intrinsic value of a particular stock to be Rs.100, a value investor would search for stocks trading at Rs. 70. If the risk factors are acceptable, then value investors would buy the stocks at Rs. 70 and wait patiently for the intrinsic value to return to Rs 100. If the stock's intrinsic value is Rs. 100, then the sell zone is everything above Rs.100. Considering the margin of safety, the buy zone would be Rs. 70 or less. When a stock returns to its original value, the decision to sell undergoes more subtle changes than the decision to buy.Because of the optimistic bias, the stock may sell for more than Rs. 100.

7. Intrinsic Value of a Stock

Intrinsic value is defined as the real value of a company in terms of tangible and intangible factors, based on a basic sense of real value that encompasses all aspects of the business. In short, this is the true value of a company.

To understand this situation, value investors analyze how a stock trades in the market over a period of time. Value investors use quantitative instruments to determine the intrinsic value of a stock. A quantitative model helps a value investor to screen and downsize the stocks which require a detailed analysis.

The intrinsic value of a stock is determined by the following factors:

- **Book Value**

  Benjamin Graham favors buying stocks that trade below book value because they are definitely cheaper. However, in the absence of cheaper stock, it is difficult to build a stock portfolio of less than book value.

- **Return on Equity**

  If all other conditions are the same, investors value companies with high returns, earnings, and cash flows versus companies with low returns, earnings, and cash flows. Value investors should incorporate this information into their valuation model using an average 10-year RoE that includes the last two market cycles. Fundamental analysis is used to adjust the number of stories to numbers that help investors predict the future more accurately.

- **Relative Price Earnings**

  Price-to-earnings ratio seeks to understand how stocks have traded against the market throughout its history. By analyzing long-term PE multiples and PE folds for the market and calculating long-term averages and long-term averages, investors should obtain numbers that reflect the relevant historical trading performance of the stock. Information can be obtained.

8. Calculation of Intrinsic Value of a Stock: Benjamin Graham Calculator

Benjamin Graham[17] has given the formula for calculating the intrinsic value of a stock which is as follows:

$$V^* = \frac{EPS \times (8.5 + 2g) \times 4.4}{Y}$$

where V* = Intrinsic Value

EPS = Earnings per Share

G = Growth rate of the company

Y = 10 years' Government Bond Rate

9. Understanding Financial Statements and Ratios

To understand the financial health of a company, one has to study and understand thoroughly the financial statements. This is a part of Fundamental Analysis. A better understanding of financial statements brings to light the not-so-obvious aspects of the company. A company has three main financial statements: balance sheet, income statement and cash flow statement. The company's balance sheet represents assets and liabilities, while the earnings statement reflects the company's profits, and the cash flow statement describes the cash flow in and out of the company.Alternatively, to understand the financial position of the company, an investor can make use of financial ratios, which are ready made tools to interpret what is happening in a company. In order to put a company's ratios in perspective, one can compare them with the industry and peers' ratios. However, the investment decision of an investor goes beyond financial ratios.

A company is financially strong when the assets are more than its liabilities. To understand the balance sheet strength, an investor has to look at the debt- equity ratio. The thumb rule says that debt- equity ratio should not exceed one. The next important ratio is the Return on Equity which tells us about the income generated by a company through equity. Higher Return on Equity Ratio is desirable. The Operating Margin Ratio tells us how much profit the company is able to make it through its core operations. A higher ratio is a good sign for the company.

Similarly, Earnings Per Share is a good measure of a company's growth. Good companies have higher earnings per share ratio and vice versa.

10. Application of Value Investing

All value investors have their roots in Benjamin Graham. Graham was born in 1894 and is considered the father of value investing. He developed the idea of buying stocks below intrinsic value to reduce risk, and is firmly convinced that stocks trade at prices that do not reflect intrinsic value. Graham's technology influenced Warren Buffett, whose value investing strategy has been around for decades.

Investors need to do a thorough research of the company before investing in undervalued stocks that are actually more valuable than they are currently trading. They don't have to be crazy because of their pretty proportions and the recent drop in prices.The outcome of a decision taken after critically analyzing the stocks may not always be correct. Investors continue to feel that there is uncertainty whether such stocks where they have invested is good or not. Mathematical equations or any software does not come to the rescue of the investors. It is not as simple as to feed a few numbers into software and determine the best stocks to invest in. Common sense and critical thinking skills play an important role in stock selection. Hence, value investing, which is considered as an art comes as an aid to investors.

Value investors are trying to buy stocks in companies that they believe the market is undervalued. In general, value investors choose stocks that are lower than the average price return ratio or price to book value ratio or higher dividend yield.Value investors focus on cheap stocks by calculating the ratio of market prices to some indicators of basic value such as earnings and assets. Therefore, value investing is a proven approach that has produced higher returns than the market average with a safety margin, which allows the investment to withstand adverse and uncertain market conditions. Such high returns on value stocks over the long term are called "value premiums".

11. Conclusion

Any investment should improve the financial health and well – being of the investor. It is up to the investor to rectify smaller mistakes in the beginning rather than to suffer in the long – run. This study has two aspects – one being financial and the other being psychological. A prudential investor always combines his financial intellect with balanced psychology. Value Investing brings in more discipline while making investment decisions. It is considered as a conservative yet long – term strategy. In the context of growing Indian Stock Market, Value Investing is an ideal investment strategy for investors who want to reap higher returns in the long – run.

Value Investing has been proved as an investment strategy to amass wealth in the stock market. All successful value investors have one thing in common. They all invest different amounts in different stocks at different times and make extraordinary profits. But they have made remarkable progress on their own.Value investing is a long - term strategy that will not be implemented immediately and investors will have to wait for years to get their share of the investment back.Value investing is a method that is not enough to use mathematical formulae to select the correct stocks that match the criteria of interest. Like all investment strategies, it takes patience and perseverance to stick to the investment philosophy, even if one loses money from time to time.

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