Investment Management
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Lecture - 05
Investment Philosophies

Hello, there. So far, we have discussed about the basics of Investment Management and to wrap up the this module of Basic Concepts of Investment Management, we will discuss in today's session Investment Philosophies.

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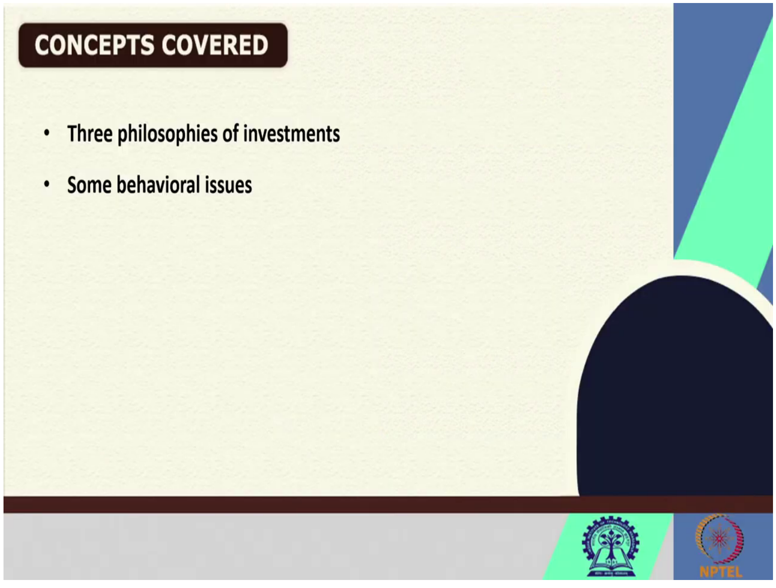

Basically, we are going to discuss in this session about different philosophies that an investor might wish to follow well when taking investment decisions and also, we will touch upon certain behavioral aspect of investments in brief.

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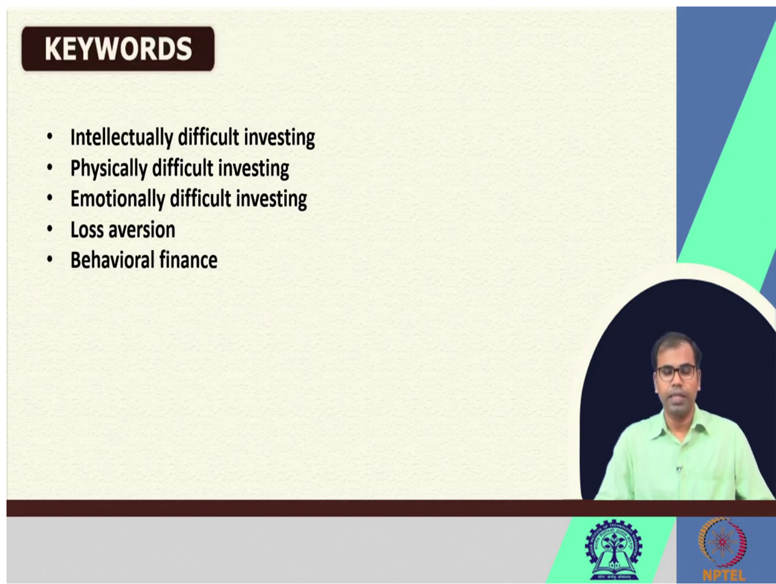

So, essentially, we are talking about investment management from an individual or small or retail investor's point of view.

Now, we know so far that to succeed in investment game we have to be following a process which starts with understanding the psyche, understanding the profile of investors and then according to their risk tolerance or risk bearing capacity their tax status we can figure out which type of assets we have to invest in.

And, as we have seen earlier there are multiple types of assets, financial securities that are available for investment we can pick one or more in the form of combination of those securities as it is suitable for the need of the investor and then we can move on to expect certain return or certain cash flows in future out of those investment.

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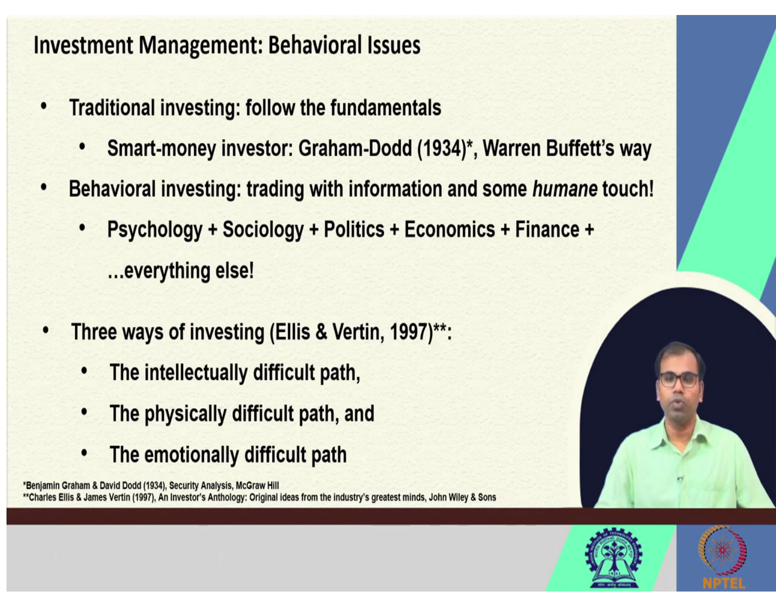

Now, to take on these decisions we have to follow certain approaches which will be more appropriate to the profile or to the characteristics of the investor and remember this investor could be us or we could be acting on behalf of our clients or certain other investors.

So, to start with if we know that traditionally investment is recommended or believed to be process which follow follows the fundamentals which means you know the typical smart-money investor as suggested by Benjamin Graham-Dodd in 1934 and has been successfully followed and replicated in some sense by Warren Buffett or people like him who have got a good hold on fundamentals and they have been able to generate a huge amount of wealth by following the typical approach of investment.

Now, off late research in finance and insights from practice have shown that there is an alternative approach to explain the investment process or investment management process as

such by way of explaining through behavioral investing. Which means, whenever we are going to buy or sell a security or a financial asset, we not only trade with information at hand which might come in the form of financial numbers or maybe the fundamental details of a particular asset or the company issuing those securities.

But also, we should keep in our mind while taking such decisions some humane aspect of the investment decision. And, this comes in the form of some sort of bouquet of psychology, sociology, politics, economics, finance and off-late technology and even everything else. All these things combined together provide us a big platform for playing with investment management tools in the form of behavioral investing approaches.

Now, I would not discuss in much detail about the behavioral investing at least at this point of time. We will discuss about different tools that we apply to understand the valuation of financial securities and how we can pick up those financial securities to be part of our portfolio.

And, then we will see what behavioral aspects can be used to explain certain anomalies or certain behavior of financial assets as such. Here we are going to talk about three ways of investing as highlighted in Ellis and Vertin in their 1997 work. They have highlighted three types of investment path which any investor would typically take. These are the intellectually difficult path, the physically difficult path and the emotionally difficult path.

Now, as the name itself suggests each of these three paths could carry certain characteristics and according to the profile of the investor or let us say risk bearing capacity or the resources that one have this the one of these paths can be taken up and implemented in their investment management journey.

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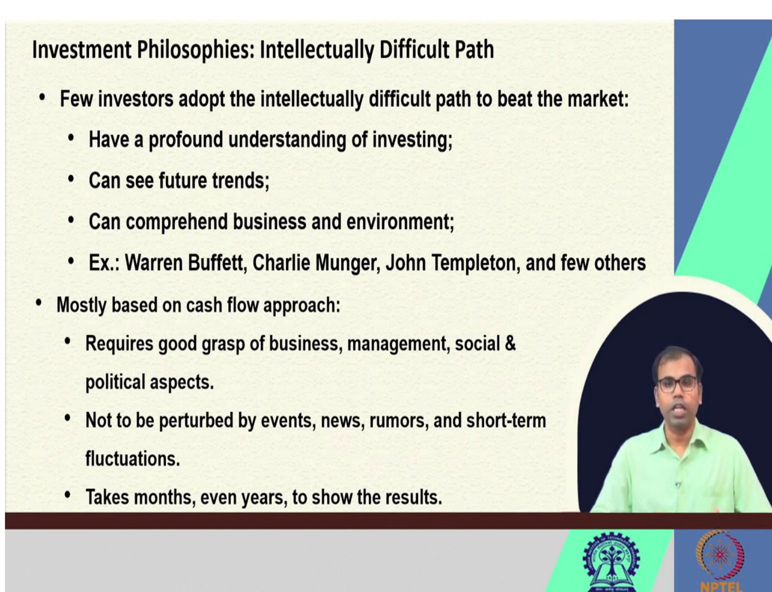

So, to start with I will let us talk about the intellectually difficult path first. What it implies is the approach where we are expected to have profound understanding of investing investment process. We should be able to or we should be capable of forcing the future trends and we should comprehend business and environment in detail.

You know people like Warren Buffett, Charlie Munger, John Templeton and others have shown that intellectually difficult path of investing is very rewarding. Very few investors have adopted intellectually difficult path and those who have adopted sustainably they have been able to beat the market.

Now, how does it work? So, mostly intellectually difficult path of investment works on the basis of cash flow approach which means whenever we are trying to make an investment decision, whenever we are planning to buy as financial security, we and if we agree to follow

intellectually difficult path, then we plan to understand how cash flow how much cash flow is going to be generated when we invest in such a business or such a project or such a financial security.

And, to do that it requires good grasp of business, management, social and political aspect. We should be able to absorb the information from all arena, we should be able to make sense of the information that we are receiving and we should be able to interpret the implications of those information on the finances of that particular security. We should also be not perturbed by events or news or rumors or short term fluctuations in the market, we should invest and relax.

It might take months even years to yield the result. So, if we invest today, it is not going to give us very good result or very good return for that matter, tomorrow or next year we have to wait for many months or maybe many years to see the benefit of intellectually difficult path of investing.

But the idea here is you need to understand the business properly, the investment structure, so that whenever you are making such an investment by following intellectually difficult path it should be rewarding at the end of the day. Now, that is about the insights being relevant for investment decision and that is how we follow intellectually difficult path of investing.

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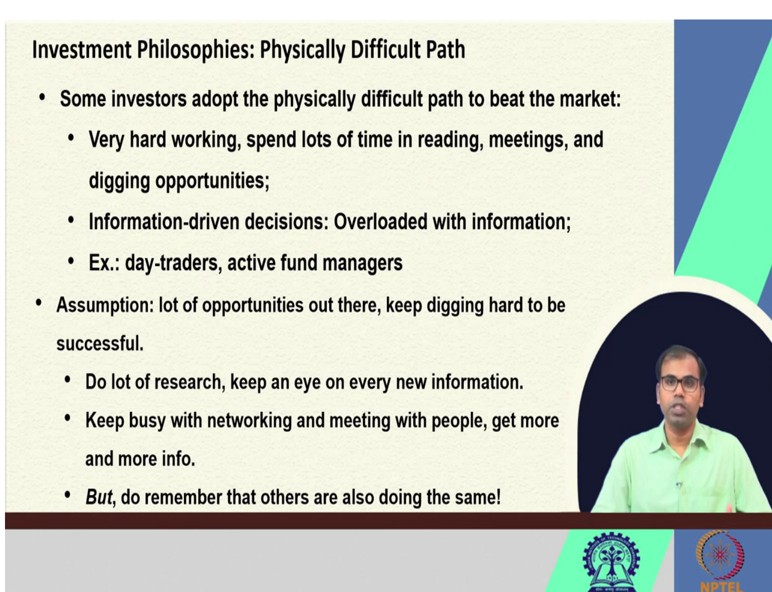

Now, second is physically difficult path of investing. What happens in physically difficult path of investing is, many investors follow this path where they are very hard working. They like to spend lot of time in reading, collecting, gathering information, meeting people, meeting relevant agents and figuring out the opportunities that might be available anywhere in the market.

So, you know they are the work force focused on gathering information, interpreting those information for a finding a suitable opportunity which might be beneficial, which might be able to give them abnormal return or which might help them to beat the market as they say it.

Most of the time their decisions are driven by information that they gather, many times it may so happen that they are overburdened with information. So, it might the decision making or

decision invest regarding to the investment can be slow, but they have to be active, they have to be actively gathering information and making sense out of it.

You we can relate this kind of activities or this kind of tendencies with those who are known as day traders or active fund managers. So, day traders are people who trade during a day. Basically, they do not hold any asset in the market for long; they just buy it at the right time and sell it most likely on the same day or next day probably. So, they are the day traders.

And, then we have active fund managers who are those people who are managing funds where lot of people, lot of investors have invested their money or pooled their money to invest in that fund. That fund is managed by these active fund managers who are very active in terms of changing the constituents of the portfolio. And, that is why they have to be constantly look looking out for information that might be relevant for their portfolio or for their investment.

Here it is assumed that there are lot of opportunities. So, when you put too much effort when you are really working hard, you are digging hard to you know get some abnormal profitable opportunities from those pools of opportunities out there, then you are bound to be successful.

Characteristics that they hold is basically they do lot of research; they keep an eye on every new information that might be coming in the market. Sometimes even the information that might not be relevant or suitable for the market movement. They keep busy with networking and meeting with people who might be active in the market or who might be related to the market.

They want to get more and more information, but also remember that others are also doing the same. So, the chances of getting a profitable opportunity or abnormally profitable opportunity is very low. So, such approach of investment is very tiresome, very demanding particularly in terms of effort that it might require to be really successful.

There are very few people who follow physically difficult path because it requires lot of expertise and the consistency in terms of putting the hard work, putting the effort in finding

the information that might be relevant for you know getting an opportunity that will be helping them earn substantial return over and over the market return.

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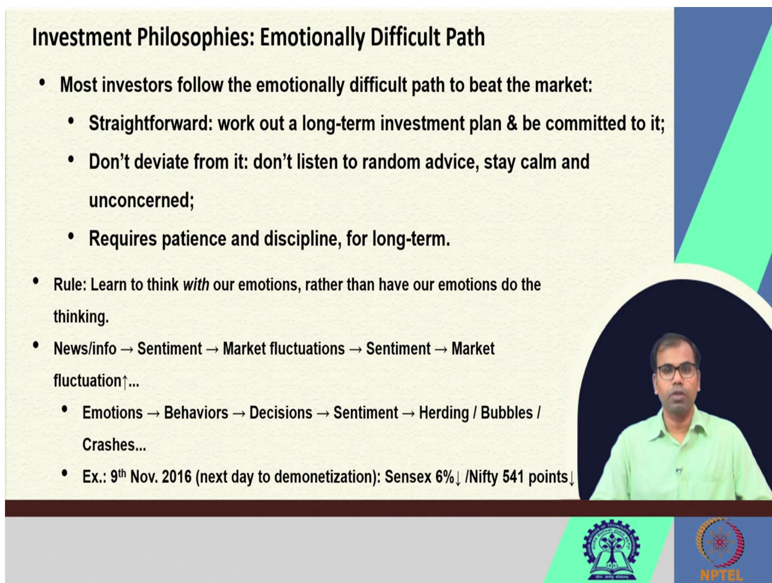

And, finally, there is this emotionally difficult path. Most of us try to follow this emotionally difficult path to outperform in the market. It is very straightforward. You know the whole idea is you work out a long-term investment plan and stick to it. Do not deviate from your original plan, do not listen to random advice, stay calm, unconcerned. Be patient, follow a disciplined approach.

For long-term, have some control. Make sure that you have your emotions under tap, so that you do not deviate from the original idea of your investment. Basic rule is we have to learn to think with our emotions rather than you know have our emotions to do the thinking.

Many a times we might see that there are lot of news or information coming in the market that might be changing that might be affecting the sentiment which will in return get reflected in market fluctuations which will again change our sentiment. Again, that will be reflected in market fluctuations and this will this process, this loop might keep on going.

And, that might really not be beneficial for investors, it might create some sort of bubble as well at some point of time. So, if you do not follow emotionally difficult path, then you are likely to be stuck in this loop where you might see that the prices of certain assets have been going up and it will keep on going in future as well.

So, the rule or the process is you have to have your emotions under control because emotions will lead to the behaviors, behavior will reflect in decisions, decision will affect the sentiments that might be you know evident in the form of herding, bubbles, crashes all these issues might erupt.

We can relate to some major economic events where people have been affected by certain biases, certain heuristics, certain emotions even though it might not be relevant for long-term valuation of those assets. For example, the demonetization when Sensex dropped 6 percent, Nifty dropped 540 plus points.

There have been several instances where we have seen the impact of emotions or impact of behaviors of market participants reflected in the valuation of the securities or value of the assets in the market.

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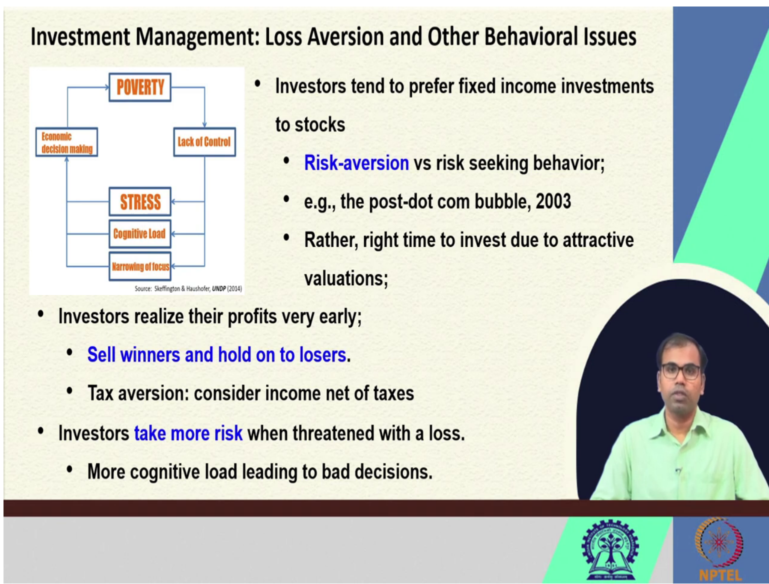

So, what are the what are certain examples of behavioral issues or behavioral aspect that we have to be careful about or we have to be aware of? Let us try to understand this. So, we have just discussed that there might be some sort of loop where sentiment might be affecting our decisions, decision might be reflected in the market, market might be affecting the sentiment further and this loop might keep on going.

If you look at the graph here, you see that let us say if we define poverty as someone facing a lack of resources. When you face lack of resource, you typically lose control over your decisions. Suppose, I am running out of time and I have to meet the deadline and I am running out of time. So, I have to take certain decisions which might have to be taken within a very limited time and it may so happen that I lose control and my decision might not be really rational.

So, we have to have we might be I might be under stress, lot of cognitive load, our focus is narrowed and that is why our decisions might not really be beneficial to myself and that is how we take bad decisions. And, once we take bad decisions, it will impact our lack of focus, lack of control, you know lack of resources.

So, suppose I am someone who is lacking economic resources and I have a very limited means of income. That limited income can be used for upgrading my skills, so that I can you know increase the source of income for myself, maybe I can go for a training and that training might help me get a better job and so, that my income will be increased.

But, another use of that limit limited income is to you know go for a party or maybe you know spend that money on something leisure and once I choose a wrong decision that will create further stress on the limb income that I have been receiving and subsequently I will keep on stuck in that loop and my decisions will be detrimental to my financial health and subsequently more difficult life as well.

So, there are certain behavioral biases that an investor should be careful about or at least should be aware of. So, for example, loss aversion. So, loss aversion in one such bias where we can say that individuals or investors in this context tend to prefer fixed income over stocks. If I want to have less risk, I want to carry less risk. I would not want to invest in stock market as we have discussed earlier.

So, I would rather invest in fixed income securities. So, that will show my risk aversion behavior rather than risk seeking behavior. And, that may happen that may propagate particularly when the times are very uncertain. You know like it happened in post dot com bubble scenario in the markets whereas, it may so happen that in such cases only in such scenarios only it is the right time to invest because of the lower valuation.

You know when the market is really down when the stock market is really down or for that matter any asset prices are really down, it is that time when we should enter. Because we know that the prices are really down because of some external factors maybe and if you buy at

that moment the prices will eventually go up and in the process, we might make money. So, risk aversion is one factor that we should be knowing of.

Many times, we also tend to realize our profits very early. What happens is we have hold certain set of stocks. Let us say I have stocks for company A, company B, company C and I realize that company A's stock has been doing really well, but company B and C are not doing so well.

And, tomorrow if I have to I have some requirement of funds I would rather sell A because it has been giving me good returns. So, I would rather sell it and keep on holding the stocks which I have been losing on. That is one bad economic decision that most of us usually take.

Tax aversion is another aspect of it because sometimes we face this income net of taxes and that is why we take decisions related to investment. Investors are typically take more risk when they are under certain scenario of loss or we can also call it under the situation of uncertainty because as explained earlier more cognitive load leading to bad decisions and that will propagate further cognitive load or lack of resources. And, that is why people usually take more risk when they are faced with losses or uncertain situations.

So, particularly if we have let us say certain amount of money to be invested in stock market and we lost a portion of it. Then we might end up buying more risky stocks with a hope that particular stock that we have just bought will make up for the loss that we already had. So, that is how we take on more risk when we are facing a loss situation.

And that is that might not really be a good idea for an investor particularly, if you are doing if you are not taking such decision on the basis of rational inputs or rational information or I would say calculated decisions.

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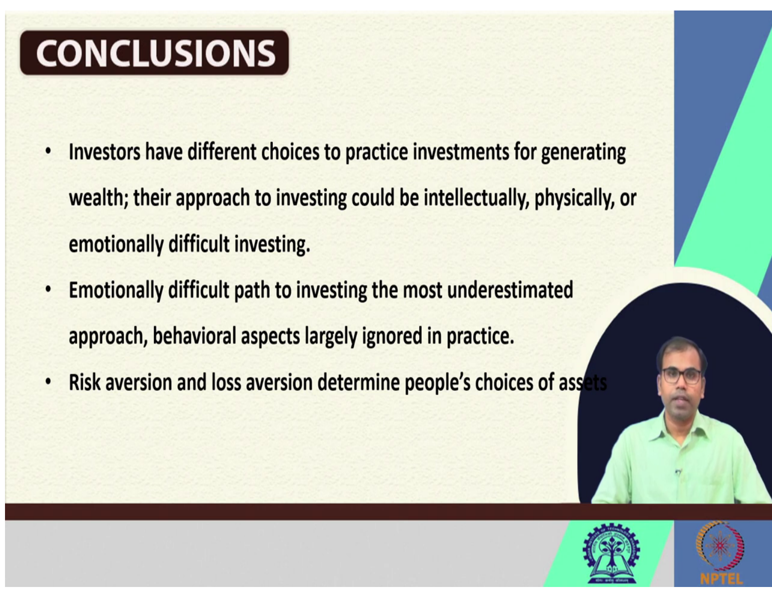

To summarize we know that investment as a process requires lot of inputs from different dimensions, different aspects starting with understanding the profile of the investors. And, once we try to understand the profile of the investors, we can decide about the type of assets that investors should be investing in. And remember that investor could be ourselves as well.

So, if I want to invest in certain assets certain financial securities, I know what type of investor I am and what kind of investment path I should be taking. As we have just discussed there could be intellectually difficult path, there could be physically difficult path and there could be emotionally difficult path.

Depending on our ability or our risk tolerance or the resources that we have or the investment horizon that we have, we can choose one or the other in path that should be used for or that should be implemented for our investment decisions. And these approaches typically aim to

create wealth for in future, so that we can generate more income in future by investing in a present time.

Most likely we observe lot of people, lot of investors following this emotional difficult path because it is more relatable and more you know beneficially long run. However, we also know that this is the most underestimated approach for investing because behavioral aspect is largely ignored in practice.

So, we as an investor we should be mindful of we should be aware of behavioral factors which might be affecting the investment decisions for an individual or investors. So, factors like risk aversion, loss aversion, mental accounting, all these factors, all these behavioral issues determine people's choices of assets.

And, that is why whenever we try to take decisions irrespective of the path that we adopt to have a successful investment management we should be able to take care of these behavioral issues, so that our investment is hopefully going to get wealth generated through a structured process.

Now, having discussed all these aspects of investment management as a process, the types of asset that we that that are available for investors to invest in and the technical as well as some behavioral aspect of investment management which are relevant for starting with investment management decisions, what are the issues or factors that we need to be knowing of in coming sessions?

So, from next session onward we will try to talk about the nuances of different assets that we have already shown. So, as you could recall we discussed about non marketable securities and marketable securities wherein we discussed about capital market securities, derivative market securities and investment company security. We have also discussed about money market securities.

So, to start with from next session onward we will discuss about one of these assets that we have seen. Let us say for example, the valuation of securities in capital market, let us say

equity valuation and bond valuation which we will start with and try to connect with the overall objective of generating wealth creating investment strategies for investors.

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With this I conclude this session.

Thank you very much.