What are the Approaches to Investment Decisionmaking?
We have seen above that stock market is thronged by investors pursuing diverse investment strategies. These may be subsumed under four broad approaches:

1. **Fundamental Approach**
The basic tenets of the fundamental approach, which is perhaps most commonly advocated by investment professionals, are as follows:
- There is an intrinsic value of a security and this depends upon underlying economic (fundamental) factors. The intrinsic value can be established by a penetrating analysis of the fundamental factors relating to the company, industry, and economy.
- At any given point of time, there are some securities for which the prevailing market price would differ from the intrinsic value. Sooner or later, of course, the market price would fall in line with the intrinsic value.
- Superior returns can be earned by buying under-valued securities (securities whose intrinsic value exceeds the market price) and selling over-valued securities (securities whose intrinsic value is less than the market price).

2. **Psychological Approach**
The psychological approach is based on the premise that stock prices are guided by emotion, rather than reason. Stock prices are believed to be influenced by the psychological mood of the investors.
When greed and euphoria sweep the market, prices rise to dizzy heights. On the other hand, when fear and despair envelop the market, prices fall to abysmally low levels. Since psychic values appear to be more important than intrinsic values, the psychological approach suggests that it is more profitable to analyse how investors tend to behave as the market is swept by waves of optimism and pessimism which seem to alternate. The psychological approach has been described vividly as the 'castles-in-the-air' theory by Burton G. Malkiel. Those who subscribe to the psychological approach or the 'castles-in-the-air' theory generally use some form of technical analysis which is concerned with a study of internal market data, with a view to developing trading rules aimed at profit-making. The basic premise of technical analysis is that there are certain persistent and recurring patterns of price movements, which can be discerned by analysing market data. Technical analysts use a variety of tools like bar chart, point and figure chart, moving average analysis, breadth of market analysis, etc.

3. **Academic Approach**
Over the last five decades or so, the academic community has studied various aspects of the capital market, particularly in the advanced countries, with the help of fairly sophisticated methods of investigation. While there are many unresolved issues and controversies stemming from studies pointing in different directions, there appears to be substantial support for the following tenets. Stock markets are reasonably efficient in reacting quickly and rationally to the flow of information. Hence, stock prices reflect intrinsic value fairly well. Put differently:

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\text{Market price} = \text{Intrinsic value}
\]

Stock price behaviour corresponds to a random walk. This means that successive price changes are independent. As a result, past price behaviour cannot be used to predict future price behaviour. In the capital market, there is a positive relationship between risk and return. More specifically, the expected return from a security is linearly related to its systematic risk. Stock price behaviour corresponds to a random walk. This means that successive price changes are independent. As a result, past price behaviour cannot be used to predict future price behaviour. In the capital market, there is a positive relationship between risk and return. More specifically, the expected return from a security is linearly related to its systematic risk.

4. **Eclectic Approach**
The eclectic approach draws on all the three different approaches discussed above. The basic premises of the eclectic approach are as follows:
- Fundamental analysis is helpful in establishing basic standards and benchmarks. However, since there are uncertainties associated with fundamental analysis, exclusive reliance on fundamental analysis should be avoided. Equally important, excessive refinement and complexity in fundamental analysis must be viewed with caution.
- Technical analysis is useful in broadly gauging the prevailing mood of investors and the relative strengths of supply and demand forces. However, since the mood of investors can vary unpredictably excessive reliance on technical indicators can be hazardous. More important, complicated technical systems should ordinarily be regarded as suspect because they often represent figments of imagination rather than tools of proven usefulness.
- The market is neither as well ordered as the academic approach suggests, nor as speculative as the psychological approach indicates. While it is characterised by some inefficiencies and imperfections, it seems to react reasonably efficiently and rationally to the flow of information. Likewise, despite many instances of mispriced securities, there appears to be a fairly strong correlation between risk and return.

The operational implications of the eclectic approach are as follows:
- Conduct fundamental analysis to establish certain value 'anchors'.
• Do technical analysis to assess the state of the market psychology.
• Combine fundamental and technical analyses to determine which securities are worth buying, worth holding, and worth disposing of.
• Respect market prices and do not show excessive zeal in ‘beating the market’. Accept the fact that the search for a higher level of return often necessitates the assumption of a higher level of risk.

What are the Qualities for Successful Investing?
We are now at the turning point. Since, we are aware of all the investment avenues by this time, so we need to be a successful investor in the long run. HWE must answer the question “What are these qualities that will make us fulfill our dream.”?

Let’s now discuss the same.
1. You are realistic
2. You are intelligent to the point of genius; or else
3. You are utterly dedicated to his craft
4. You are disciplined and patient
5. You are a loner

Can You Commit any Errors While Managing Your Investment? What are They!
Yes, investors appear to be prone to the following errors in managing their investments. Some of the common ones are listed as:
• Inadequate comprehension of return and risk.
• Naïve extrapolation of the past.
• Cursory decision-making.
• Simultaneous Switching
• Misplaced love for cheap stocks.
• Over diversification and under-diversification.
• Buying shares of familiar companies
• Wrong attitude toward losses and profits.
• Tendency to speculate.

Let’s discuss them one by one.

Inadequate Comprehension of Return and Risk
You have to answer to some crucial questions before you invest. What returns can one expect from different investments? What are the risks associated with these investments? Yet investors often have nebulous ideas about risk and return.

Many investors have unrealistic and exaggerated expectations from investments, in particular from equity shares and convertible debentures. One often comes across investors who say that they hope to earn a return of 25 to 30% per year with virtually no risk exposure or even double their investment in a year or so. They have apparently been misled by one or more of the following: (a) tall and unjustified claims made by people with vested interests; (b) exceptional performance of some portfolio they have seen or managed, which may be attributable mostly to fortuitous factors; and (c) promises made by tipsters, operators, and others. In most of the cases, such expectations reflect investor naïveté and gullibility.

By setting unrealistic goals, investors may do precisely the things that give poor results. They may churn their portfolios too frequently; they may buy dubious ‘stories’ from Dalal Street; they may pay huge premiums for speculative, fashionable stocks; they may discard sound companies because of temporary stagnation in earnings; they may try to outguess short-term market swings.

Vaguely Formulated Investment Policy
Often investors do not clearly spell out their risk disposition and investment policy. This tends to create confusion and impairs the quality of investment decisions. Ironically, conservative investors turn aggressive when the bull market is near its peak in the hope of reaping a bonanza; likewise, in the wake of sharp losses inflicted by a bear market, aggressive investors turn unduly cautious and overlook opportunities before them. If you know what your risk attitude is and why you are investing, you will learn how to invest well. A well articulated investment policy, adhered to consistently over a period of time, saves a great deal of disappointment.

Naïve Extrapolation of the Past
Investors generally believe in a simple extrapolation of past trends and events and do not effectively incorporate changes into expectations. As Arthur Zeikel says:” People generally, and investors particularly, fail to appreciate the working of countervailing forces; change and momentum are largely misunderstood concepts. Most investors tend to cling to the course to which they are currently committed, especially at turning points.”

The apparent comfort provided by extrapolating too far, however, is dangerous. As Peter Bernstein says: “Momentum causes things to run further and longer than we anticipate. The very familiarity of a force in motion reduces our ability to see when it is losing its momentum. Indeed, that is why extrapolating the present into the future so frequently turns out to be the genesis of an embarrassing forecast.”

Cursory Decision-Making
Investment decision-making is characterised by a great deal of cursoriness. Investors tend to:
• Base their decisions on partial evidence, unreliable hearsay, or casual tips given by brokers, friends, and others.
• Cavalierly brush aside various kinds of investment risk (market risk, business risk, and interest rate risk) as greed overpowers them.
• Uncritically follow others because of the temptation to ride the bandwagon or lack of confidence in their own judgment.

Simultaneous Switching
When investors switch over from one stock to another, they often buy and sell more or less simultaneously. For example, an investor may sell stock A and simultaneously buy stock B. Such action assumes that the right time for selling stock A is also the right time for buying stock B. This may not often be so. While it may be the right time to sell stock A, it may not necessarily be the right time to buy stock B. Alternatively, while it may be the right time to buy stock B, it may not necessarily be the right
time to sell stock A. Hence, when you contemplate switching you should first sell (if you feel it is the right time to do so) or buy (if you feel it is the right time to do so) and make the other deal at an appropriate time.

**Misplaced Love for Cheap Stocks**
Investors often have a weakness for stocks, which look apparently cheap. This is revealed in the following behaviour: · They buy a stock that is on its way down because somehow a falling share looks like a good bargain.

- They tend to ‘average’ down. This means that they buy more of the same stock when its price falls in a bid to lower their average price.
- They like to buy a stock that is quoting low as they feel comforted when they buy 1000 shares of a company that is quoting at Rs 10 rather than 100 shares of accompany that is quoting at Rs 100.

**Over-Diversification and Under-Diversification**
We have seen a number of individual portfolios, which are either over-diversified or under-diversified. Many individuals have portfolios consisting of thirty to sixty, or even more, different stocks. Managing such portfolios is an unwieldy task. As a result, the impact of a good idea is negligible. Perhaps as common as over-diversification is under-diversification. Many individuals do not apparently understand the principle of diversification and its benefit in terms of risk reduction. A number of individual portfolios seem to be highly under-diversified, carrying an avoidable risk exposure.

**Buying Shares of Familiar Companies**
Investors are often tempted to buy shares of companies with which they are familiar. Medical practitioners, for example, may prefer to buy shares of pharmaceutical companies. Perhaps they believe in the adage “a known devil is better than an unknown God” and derive psychological comfort from investing in familiar or well-known companies. Those who have such tendencies, however, must realise that in the stock market there is hardly any correlation between the fame of a company’s product and the return on its equity stock.

**Wrong Attitude Towards Losses and Profits**
Typically, an investor has an aversion to admit his mistake and cut losses short. If the price falls, contrary to his expectation at the time of purchase, he somehow hopes that it will rebound and he can break even. (He may even buy some more shares at the lower price in a bid to reduce his average price.) Surprisingly, such a belief persists even when the prospects look dismal and there may be a greater possibility of a further decline. This perhaps arises out of a disinclination to admit mistakes. The pain of regret accompanying the realisation of losses is sought to be postponed. And if the price recovers due to favourable conditions, there is a tendency to dispose of the share when its price more or less equals the original purchase price, even though there may be a fair chance of further increases. The psychological relief experienced by an investor from recovering losses seems to motivate such behaviour. If we put differently, the tendency is to let the losses run and cut profits short, rather than to cut the losses short and let the profits run.

**Tendency to Speculate**
The tendency to speculate is common, particularly when the market is buoyant and ecstatic. Try to resist this. You may find it difficult to follow this advice. Yet, in the long run you are likely to be better off if you refrain your speculative instincts.

**Notes**