Beating equity fears

Address people's aversion to ambiguity

VIDYA MAHAMBARE

The BSE Sensex rose over 17 per cent in the year ending March 31, outperforming other asset classes. This is not a one-off. The equity market has delivered around 12 per cent returns per year in the last five years and close to 15 per cent in the last 10 years. Despite this robust performance, why do Indians shun equity?

Investment choices are an outcome of our differential attitudes to gains and losses. People tend to avoid participating in the stock market because they are not comfortable with uncertain outcomes.

Uncertainty has two dimensions — risk and ambiguity. Risk arises when there are a number of possible outcomes with known probabilities while ambiguity arises when the probabilities and/or outcomes are unknown. For instance, if we know there is a 70 per cent chance that this investment will provide 15 per cent return and a 30 per cent chance it may end up in a loss, the risk involved in investing in the product is known.

However, when it is not possible even to estimate the probabilities, it is an ambiguous situation which is the case when one invests in equities. A large number of studies show that people tend to be more ambiguity averse than risk averse, famously known as the Ellseberg paradox.

Given the ambiguity aversion, people tend to see the past performance and what makes them nervous is that in the last 10 years the Indian equity market fell sharply in three financial years — in 2009, 2012 and 2016. What if, this would be repeated next year? What makes things worse is that investors often fall in the trap of 'narrow bracketing' — evaluating an investment as a standalone rather than maximising the overall portfolio risk-return.

What can be done to help people overcome ambiguity aversion? First, the product design — a product which preserves investors' original capital say in a safe asset and invests only the return earned on a safe asset into the market may appeal ambiguity averse individuals. It can be a kind of a transitional product, which helps investors see their overall portfolio in one go and, thereby, overcome narrow bracketing.

Second, it is known that ambiguity averse individuals suffer from myopic loss aversion. They have a tendency of frequently evaluating their decisions, and even any notional loss makes them nervous. In this situation, people prefer to sell their investment even at a loss rather than continuing with a future unknown outcome. Therefore, the advertising of equity-related products should not only promote the fact that they provide higher returns over time, but also focus on preventing people's uneasiness about ambiguity. Third, under ambiguity aversion people either tend to take decisions quickly or delay taking one for a long time. That means, the communications need to be precise and impactful.

There are many financial decisions where we encounter ambiguity. One of the reasons for the low uptake of health insurance is that it is difficult to convince a perfectly healthy individual about its welfare gains. In an on-going research on why chit funds continue to be popular even in urban areas, several participants tell us that , unlike insurance, their savings are not wasted if an emergency does not materialise *ex-post*.

If a large section of households is to benefit from investing in the equity market, a complementary communication strategy needs to be chalked out to help them deal with decision-making under ambiguity, rather than merely focus on potential returns.

The writer is Professor - Economics, Great Lakes Institute of Management, Chennai