# The Impact of Herd and Overconfidence in Unit Trust investment Decision in Malaysia

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## Abstract

The year 2006 was a much remembered year for members of the unit trust industry in Malaysia. Utusan Malaysia 6th and 7th of August 2006 and Chong (2006) reported a loss of RM600 million from Employee Provident Fund (EPF) saving invested in approved unit trust fund. EPF is a compulsory saving for workers in Malaysia, where they are allowed to withdrawal their saving from Account 1 which has more than RM50,000 to invest in approved unit trust fund. With the launching of Private Retirement Scheme (PRS) in July 2012 by our beloved Prime Minister with various tax incentives, investment decision in unit trust fund is utmost important. With this in mind, this paper intends to study how investors' behavior (herd and overconfidence) impact in investment decision in unit trust fund by using statistical method. It is focused in Peninsular Malaysia; 3 states from the west and 3 states from east Peninsular Malaysia.

***Keywords:*** Unit Trust Fund, Herd and Overconfidence

## Introduction

The shocking news which was agreed by Campbell 2006, where he said that household did not seem to be well prepared to meet these challenges as they make serious investment mistakes. And Gruber 1996 mentioned that household need to believe in their skill of fund manager.

It was not a surprise when Utusan Malaysia dated 6th and 7th of August 2006 and Chong et al. August 2006 reported a shocking new that RM600 million loss from EPF saving invested in unit trust.

Answering to this issue, President of Federation of Malaysia Unit Trust Manager, YM Tunku Dato' Yaacob Tunku Abdullah, in his press release on 8th August 2006, said that according to Standard and Poor as reported on 28th July 2006, the average return from Malaysia equity funds for 7 years is 24%, 5 years is 56% and 3 years is 26%.

Resulting from that our Prime Minister has asked EPF management to take actions to tighten the conditions for withdrawal.

## Statement of Problem

The studies of unit trust fund in Malaysia started in 1990s with Mohamed and Mohd Nasir (1995), Tan (1995), Leong (1997), Leong and Aw (1997) , Nawawi et at., (1999), Swee-Wah Low (2007) and Nurasyikin (2012). Their studies focus on the performance of the fund in the selection of fund. Studies by Arbi (1999), Shariff (2002) and Mohamed Sharif Bashir (2012) provided some insight into the performance of Islamic unit trust fund. While Fabian (2009) and Agnes (2010) said that knowledge of unit trust fund and selection criteria needs attention.

By studying the performance of the fund alone in selection of unit trust fund is very minute aspect in the selection of unit trust fund. As clearly said by Christopher (2011):

The phrase "Past Performance is not indicative of Future Result" is ubiquitous in finance industry but equity mutual fund investors don't believe it. Researches on unit trust in Malaysia were conducted using various methods based on performance of fund, yet none was based behavioral variables. With this in mind:

The statement of the problem is that the investment decision on Unit Trust fund based and investor's behaviors which are still unsubstantial in Malaysia and unknown in the sense that there is no well documented proof of its practice.

It is the intention of this study to fill this knowledge gap. It is imperative to study on how investor's behavior influence the investment of unit trust fund as this investment is for their tomorrow. With the coming of Private Retirement Scheme as an alternative or compliment to EPF saving, the study of investor's behavior influencing investing decision is indeed very timely.

## The Need to Study

It is very true to say that every investment has inherent risk-risk that investor has to face. As traditional finance always quote: High risk, high return. This may not be true in investing unit trust. In investing equity fund is a high risk, yet the return is below the benchmark rate. So, by looking at risk and return is to simplicity, and it only tells only a part of the complex story. In considering risk and return as the sole criteria in making selection of fund, creates halo effect and in 1990 Consumer Reports Survey of Mutual fund indicate that there were evidence that risk and returns alone were inadequate as the only explanatory variables.

The lack of clarity in understanding investor's behavior impact in investment decision is of considerable importance to academic research because of the implication to future returns.

Most financial advisors believe that, for this function, mutual funds should be evaluated on other attributes in addition to risk and return. But the process they follow of incorporating other attributes, especially qualitative attributes, is often ad hoc, and the overall evaluation process appears to be a "black box" to the investor.(Hakan Saraoglu, 2002) Fabian 2009 agreed that investors used different decision criteria in selection of fund, value and contribution of other attributes in mutual fund; investor's behavior demand attention. This was agreed by Chong et al., (2011) where they said investment decision would be affected with diverse variables and did not rely on a single integrated factor. Clearly this shows, there is a need to study investor's behavior impact in investment decision in unit trust investment.

## Research Question

Do investor's behavior (herd and overconfidence) has an impact in decision making in unit trust investment?

The specific research questions are:

1. What investor's behavior (herd and overconfidence) exist in the investing of unit trust fund?
2. What behavioral variables (herd and overconfidence) have an impact in decision making in investing of unit trust fund?
3. Which investor's behavior produce a better rate of return in investing unit fund?

## Objective of the Study

The ultimate objective of this study is to contribute towards improving the investment of unit trust fund in Peninsular Malaysia. Particularly, this research attempts to examine the impact of investor's behavior in the investment of unit trust fund. The specific objectives are:

1. To determine whether investor's behavior (herd and overconfidence) exist in investment decision in unit trust investment.
2. To identify behavioral finance variables which influence investment decision in unit trust investment.
3. To compare herd and overconfidence behavior in term of rate of returns in unit trust investment.

## Significance of the Study

Finding of the research will add knowledge and understanding of the subject and its application to the industry and society at large. This study should be significant in the sense that it will:

a) Support and enrich the study of behavioral finance in Unit Trust industry.
b) Generate greater awareness among investors on the importance of selection of unit trust fund especially with the launching of Private Retirement Scheme (PRS). (www.btimes.com.my/Current.News/BTIMES/articles/../index_html)
c) Allow the identification and framework of selection of Unit Trust Fund and takes into account of the complexity of it.
d) Provide a useful knowledge on factors that might have impact and contribute to the successful investment of Unit Trust Fund.

## Scope of the Research

This study will take on six states of Peninsular Malaysia as the setting and questionnaires will be distributed to the appropriate respondents.

## Research Gap

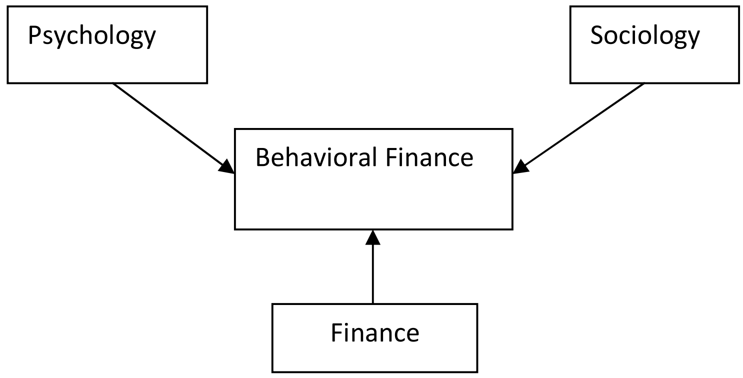
With this in mind, the behavior of investor is of major concern; I adapted the much needed area for my research by looking at behavioral finance (herd and overconfidence).

Hence to encapsulate the research gap in previous research, we can say that this study is based on behavioral finance (herd and overconfidence) in the impact on investment decision in unit trust investment.

## Theoretical Framework

Modern financial economics assumes that we behave with extreme rationality; but, we do not. Furthermore our deviations from rationality are often systematic. Behavioral finance relaxes the traditional assumptions of financial economies by incorporating these observable, systematic and very human departures from rationality into standard models of financial markets.

Behavioral finance uses model which some agents are not fully rational, either because of preferences or because of mistake belief. Mistaken belief because are bad Bayesians. According to Victor Ricciardi (2000), behavioral finance is an interdisciplinary subject as shown below:




Source: Victor Ricciardi (2000)

The above diagram demonstrates the important of the interdisciplinary relationship that integrates behavioral finance. In studying behavioral finance, traditional finance is the centre piece while psychology and sociology are the integral catalyst within the field of study. Psychology is the scientific study of behavior and mental processes, along with how these processes are affected by a human being's physical, mental state and external environment. Sociology is the systematic study of human social behavior and groups. This field focuses primary on the influence of social relationship on people's attitudes and behavior. Finance is a discipline concerned with determining of value and making decisions. The finance function allocates capital, including the acquiring, investing and managing resources.

Based on the theory above, Waweu (2008) has group various theory on behavioral finance in investment decision. Among them are:-

| Group | Behavioral Variables |
|---|---|
| Heuristic Theory | Representative<br>Overconfidence<br>Anchoring<br>Gamble Fallacy<br>Availability of Bias |
| Prospect Theory | Price Changes<br>Loss Aversion<br>Regret Aversion<br>Mental Accounting |
| Market | Price Changes<br>Market Info<br>Past Trend<br>Fundamental of underlying stocks<br>Over reaction of price change |
| Herding Effect | Buying and selling decision<br>Choice of fund to trade of other investors<br>Volume of fund trade by other investors<br>Speed of herding |

Initially, the goal is to explore all the theories in behavioral finance and their impact in the selection of unit trust. It is narrow down to two variables (herd and overconfident) because it is too big to undertake. The two variables are chosen because of the following reasons:

Retail investors are outcome oriented. (Suzanne 2012) When the outcome is not predictable, they just go to what is. They become aggressive and they herd and take an easier way out based on their confident. Secondly, there are 607 unit trust funds, 42 unit trust management companies and 49,530 qualified unit trust consultants in Malaysia according to www.fimm.com as at 29/01/2013. Psychologist Barny Schwartz has demonstrated that too much choice leads to reduced happiness and feeling of missed opportunity. In his book "The Paradox of Choice", choice no longer liberates but debilitates and sometimes demotivating.

Beside that overconfidence is a human trait and a human tendency to set unrealistic expectation. There is no shortage of overconfidence in the investment community.

According to Maxime Merli (2011), herd behavior is caused by the following determinants:

1. Gender
2. Sophistication
3. Individual Wealth

While Briony (2000), mentioned that overconfident is caused by the following determinants:

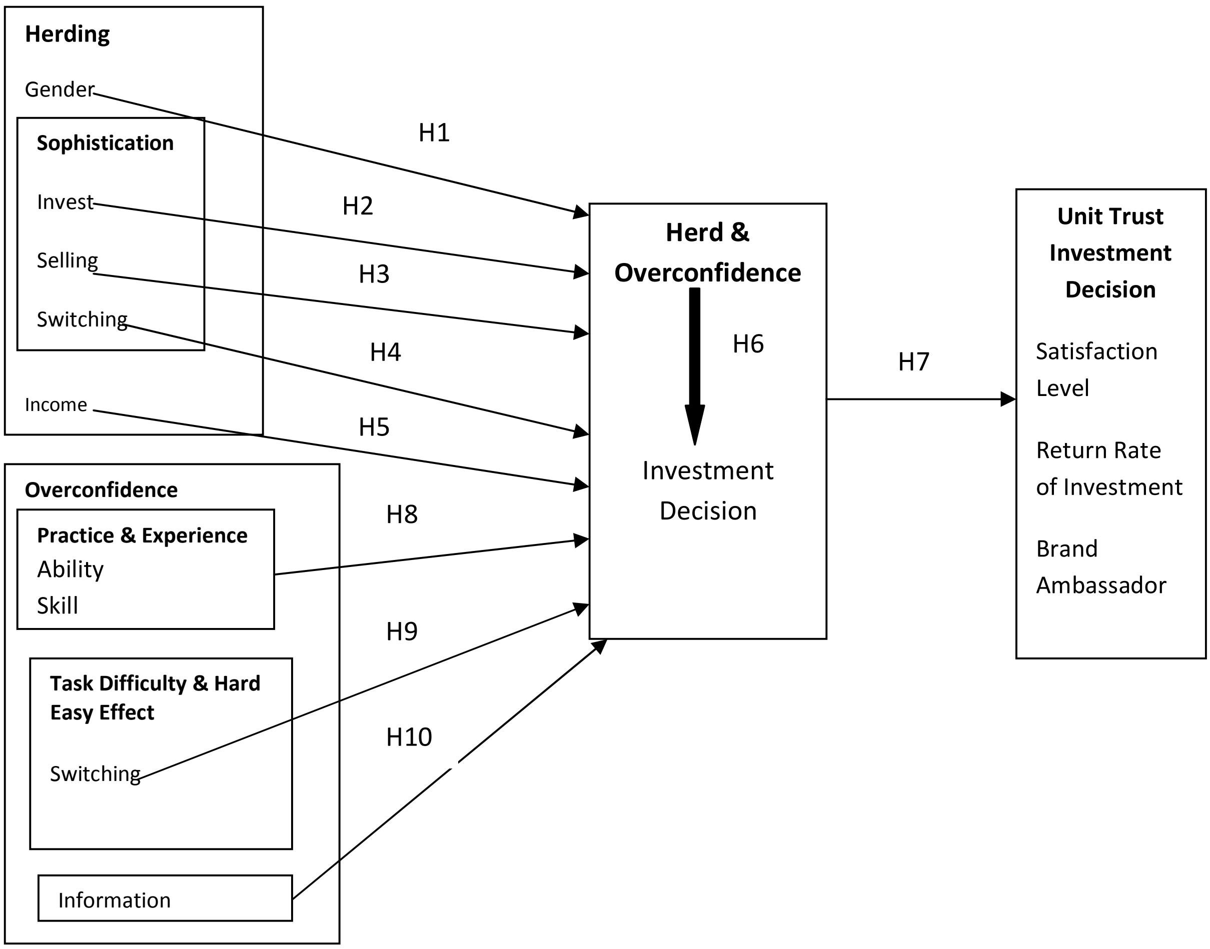
1. Task difficulty and hard easy effect
2. Information
3. Practice and expertise
4. Base Rate
5. The Locus of Uncertainty
6. Motivation and Self Presentation Biases
7. Individual Experience
8. Mood
9. Gender
10. Overconfidence in visual perception

With such a large determinants, the following determinants are picked for research:

Herd behavior-Gender, sophistication, individual wealth

Overconfident: Information, Practice and Expertise, Task difficulty and Hard Easy effect

With this theoretical frame work in mind, the research model is created. Below shows the research model:




Satisfaction level is measured through Service Quality Performance Measurement. The determinants according Parasuramam et al (1985) are: Reliability, Responsiveness, Access, Courtesy, Communication, Security, Knowing, Tangibles, Competence and Credibility. Only determinants of reliability, responsiveness, access and competence will be used to measure the satisfaction level. The return rate of investment is measured by fixed deposit rate and past performance of the fund. Brand ambassador is measured through whether the investors introduce new investors to what they invested.

## Hypotheses

Null Hypotheses

1. Gender has an impact on investment decision in investing Unit Trust Fund.
2. My investing decision in unit trust fund has positive relationship with unit trust investor's friend.
3. My selling decision in unit trust fund has positive relationship with my unit trust investor's friend.
4. There is a relationship between my switching of fund and other investors' decision to switch.

5. There is a relationship between income and investment decision in unit trust fund.
6. There is a strong relationship between behavior of investor (herd and overconfidence) and investment decision.
7. The behavior of investor (herd and overconfidence) has a negative relationship with investment decision.
8. There is a relationship between my investment decision in unit trust fund and my ability and skill.
9. Information received in unit trust fund investment has positive impact in my investment decision.
10. My confidence has a positive influence in switching of fund.

## Suggested Statistical Tool

Descriptive statistics are used to describe the respondents' personal information and the influence level of the behavioral variables in the investment decision. Correlation and multiple regressions will be used to show the relationship. Factor analysis will be used for exploratory purposes.

The purpose of the present study is to investigate how investor behavior (herd and overconfidence) has an impact in decision in unit trust investment. A field survey is chosen for this study. From the twelve states, only six states will be chosen for this survey. They are Kelantan, Trengganau, Pahang from the east cost of Peninsular Malaysia, Penang, Kuala Lumpur and Perak from the west coast of Peninsular Malaysia. As I am dealing with certain types of investor investing in unit trust fund, the formulae provided by Paul Andrew Bourne (2009) is very appropriate.

$$n = \frac{z^2 p(1-p)}{e^2}$$

Here:

n = the sample size

z = the number relating to the degree of confidence

p = an estimate of the proportion of people falling into the group in which I am interested in the population.

e = the proportion of error that the researcher decides to accept

Data that is collected for this study will be analyzed to answer the hypotheses. The Statistical Package for Social Sciences (SPSS)

## Expected Result

The researcher expected that the behavior had an impact on investment decision in investing unit trust fund in Peninsular Malaysia. On the comparative study, the researcher expects the investors on the western part of Peninsular Malaysia to be more influence by their behavior as they more expose to more information than the eastern side. Investors from Western Peninsular state will have a better knowledge than Eastern Peninsular counterparts.

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