Heuristic and Herding Bias on Property Investment Decision

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Abstract

Behavioral finance is the development of science which combines psychological and financial science. This studies the relation of emotional and cognitive deviation, thus affecting individual behavior. The decision made based on estimation that have been made, however was influenced by cognitive behavior associated to the individual. The effect of cognitive causes investment decision that is made investors will be irrational as heuristic and herding behavior. Heuristic is a decision behavior based on information that they have. Herding is a behavior that imitate other persons, not by conviction or information that they holds. Therefore, the purpose of the research is to analyze whether heuristic-driven bias or herding behavior influences property investment decision. The sample study was 100 prospective investors or investors in Surabaya. This data is analyzed using SEM Partial Least Square (PLS). The results showed that heuristic behavior (representativeness, anchoring, gambler's fallacy, and availability bias) significantly influences the investment decision. On the other hand, overconfidence and herding did not significantly influence the investment decision.. Both bias heuristic and herding behavior more inclined to occur on men compare to women. While the representativeness, anchoring, overconfidence, gambler's fallacy and herding are dominated by experienced investors than inexperienced investors.

Keywords: Heuristic, Herding, Behavior Finance, Investment Decision

1. Introduction

Traditional financial theory about Efficient Market Hypothesis (EMH) assumes that investors are rational. They will make a rational decision to follow financial basic rules based which are investment strategy and risk-return consideration from all available information [1]. However, EMH failed to explain behavior in market [2]. Investors sometimes make investment decisions that follow their psychological factor such as emotion, feeling, mood, fantasy and sentimental [3], therefore the result of decision be bias. Thus, doing research about investors’ behavior in property sector is needed, due to weak-form efficient real estate market condition.

Property is a financial product. It is offered in market as one of investors’ choice of diversification portfolio financial product. However, real estate market has a lack of liquidity higher than equity and bond markets. The collecting cost, processing information, as well as real estate trading costs are higher than trading cost of stocks and bonds. Therefore, directly or indirectly, cognitive factors and psychological factors of investors will influence investment decision-making process in those markets. Investors tend to behave irrationally in decision process [4]. Cognitive aspects and bias on investor psychology associated with what is trusted and what is chosen. Therefore, behavioral finance theory as a model of cognitive psychology research will try to explain the relationship between market and investors’ behavior, including in property market [5].

In general, property market in Indonesia has shown a declining development. In first quarter of 2015, average residential property sales were 26.6% based on Bank Indonesia survey in Jakarta, Bogor, Depok, Tangerang and Bekasi (Jabodetabek) also in Bandung and Surabaya. However, limited land in urban areas made developer to change sales strategies type of residential property horizontal to vertical such as more affordable apartment. Because of 50% of Indonesia’s population aged under 30 years old, the predicted demand for residential properties is still high. It is expected to realize on a property purchase in short and medium term [6]. Under these conditions, investors will change their cognitive and psychological aspects, so their behavior affect the decisions.

Shiller [7] stated behavioral heuristic or rule of thumb influence investment decision because the decisions are made based on information that they have. Investors tend to use several heuristic to solve complex problems, even if it was implemented properly; heuristic information processing will reduce search time and task completion [8]. Even, Hogarth [9] admits the importance of heuristic, yet experience factor and feedback should reduce bias due to financial behavior.
Another behavior found in research is herding behavior [10]. The behavior tends to mimic actions performed by others. Investors follow the decision of others at the time of deciding. Herding can happen to both irrational and rational investors [11] [12] [13]. When property prices increase very fast and are followed by price movements in stock and commodity markets, there will be a speculative bubble. That market is influenced by herding behavior of market participants. Herding is one of the key elements of behavioral finance. The investors’ fault at aggregate level will reflect in asset prices. Whereas, individual investors’ behavior does not affect market price at all. Investors who do not act collectively and do not commit the same psychological mistakes at the same time will be able to neutralize market situation. Therefore, market will still be efficient.

This empirical study will examine heuristic and herding behavior’s influence to investment decisions by investors [14] [15]. The previous study of behavioral finance more focused on research concepts. Therefore, this study will be analyzed empirically and divided into some analysis. Second section discusses the literature on heuristic and herding behavior. Third section discusses research methods. Fourth section takes up empirical test heuristic and herding behavior’s influence to investment decisions making. Investment products selected are residential properties which are landed houses and apartments in Surabaya, East Java, Indonesia. In the analysis part of this research, discussion covers analysis from the result of the empirical test. At the end of this study, there will be conclusion and recommendation for further research.