

„How Market Psychology Drives Investment Decision-Making”

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To those for whom the role of psychology in finance is self-evident, both as an influence on securities markets fluctuations and as a force guiding individual investors, it is hard to believe that there is actually a debate about the relevance of behavioral finance. Yet many academics and practitioners, residing in the "standard finance" camp, are not convinced that the effects of human emotions and cognitive errors on financial decisions merit a unique category of study. Behavioral finance adherents, however, are 100 percent convinced that an awareness of pertinent psychological biases is crucial to finding success in the investment arena and that such biases warrant rigorous study.

This chapter begins with a review of the prominent researchers in the field of behavioral finance, all of whom support the notion of a distinct behavioral finance discipline, and then reviews the key drivers of the debate between standard finance and behavioral finance. By doing so, a common understanding can be established regarding what is meant by behavioral finance.

BEHAVIORAL FINANCE: THE BIG PICTURE

Behavioral finance, commonly defined as the application of psychology to finance, has become a very hot topic, generating new credence with the rupture of the tech-stock bubble in March of 2000. While the term behavioral finance is bandied about in books, magazine articles, and investment papers, many people lack a firm understanding of the concepts behind behavioral finance. Additional confusion may arise from a proliferation of topics resembling behavioral finance, at least in name, including behavioral science, investor psychology, cognitive psychology, behavioral economics, experimental economics, and cognitive science. Furthermore, many investor psychology books that have entered the market recently refer to various aspects of behavioral finance but fail to fully define it. This section will try to communicate a more detailed understanding of behavioral finance. First, we will discuss some of the popular authors in the field and review the outstanding work they have done (not an exhaustive list), which will provide a broad overview of the subject. We will

then examine the two primary subtopics in behavioral finance: Behavioral Finance Micro and Behavioral Finance Macro. Finally, we will observe the ways in which behavioral finance applies specifically to wealth management, the focus of this book.

Key Figures in the Field

In the past 10 years, some very thoughtful people have contributed exceptionally brilliant work to the field of behavioral finance. Some readers may be familiar with the work *Irrational Exuberance*, by Yale University professor Robert Shiller, Ph.D. Certainly, the title resonates; it is a reference to a now-famous admonition by Federal Reserve chairman Alan Greenspan during his remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research in Washington, D.C., on December 5, 1996. In his speech, Greenspan acknowledged that the ongoing economic growth spurt had been accompanied by low inflation, generally an indicator of stability. "But," he posed, "how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"¹ In Shiller's *Irrational Exuberance*, which hit bookstores only days before the 1990s market peaked, Professor Shiller warned investors that stock prices, by various historical measures, had climbed too high. He cautioned that the "public may be very disappointed with the performance of the stock market in coming years."² It was reported that Shiller's editor at Princeton University Press rushed the book to print, perhaps fearing a market crash and wanting to warn investors. Sadly, however, few heeded the alarm. Mr. Greenspan's prediction came true, and the bubble burst. Though the correction came later than the Fed chairman had foreseen, the damage did not match the aftermath of the collapse of the Japanese asset price bubble (the specter Greenspan raised in his speech).

This paper studies the influence of feelings and emotions of investors on prices of financial instruments and also is a theoretical analysis which can be understood using the results emerging from this area. Theoretical basis is developed around research in economic psychology and decision making. This paper deals with recent progress in understanding how emotions affect investment decisions by investors, especially in risk and uncertainty. Also, the content of this work is to be an investigation of variations feelings, which are highly experienced people and influencing investors to make decisions and, therefore, lead to predictable patterns in the pricing of financial instruments. The paper concludes by suggesting a series of empirical and theoretical research directions.

The role of this presentation is to provide a baseline against which future research in behavioral finance can be built. It is discussed different views on human behavior of economists and psychologists. After differentiating their approaches will be developed and categorize the term "emotion" and will highlight the human factor influence on investment decisions. This paper aims to cover the full potential of behavioral finance and focuses on explaining certain forecasting models of investor behavior.

There are many features and qualities that investors should have in order to truly succeed in the financial markets. Ability to understand the internal workings of a company's fundamentals and the ability to determine the direction of a trend are some of the main features of the investors, but none of them is as important as mastering emotions and maintain discipline in trading.

Psychological aspect is very important investment decision and the reason is simple: an investor is often faced with moments where you have to make quick decisions. To do this, he must have a certain state of mind. The investor needs discipline to meet some predetermined trading strategies, knowing when to mark the profits and losses when to quit. Quite simply, emotions cannot stand in the way of investors.

Participants in these financial markets appear to be irrational and is as easy to see that people - both ordinary and professional people - believes that psychological factors play a role (Akerlof and Shiller, 2009). Evidence suggests that psychological factors were always higher in economic value. These factors are not necessarily "irrational", but it is how people process information and how they act on them. The contribution of psychology is to find regularities in individuals' perceptions and decisions that take into account economic behavior. Considering the history of human evolution, it uses its resources so as to accommodate the demands of a given situation. Such applications to judge probabilities and make decisions are often more than the investor capacity. Many proponents of behavioral finance argue that participants in financial markets are unable to think rationally. "The key to success is knowing the investor psychology" (E.Alexander 1993). While a statement is taken to the extreme significance as any professional investor should consider all mechanisms of financial markets. Someone may base an investment on fundamental or technical analysis. Others traded taking account of certain emotions and political trends, using privileged information or hope to be right and become rich overnight. All emotions investors are psychologically embedded in a massive wave that moves global financial markets. Most

people are giving their trading in a lot of time looking for profitable investments. Shortly after they were involved in a transaction or lose control and become agitated because of psychological pain caused by a loss or become overwhelmed by immediate gains. They revolve around an emotional roller coaster and lose the essence of winning - emotional management.

If the individual mind is not in line with financial markets, or ignoring changes in crowd psychology, it is virtually impossible for someone to gain financial markets. All winners professionals consider the importance of the psychological impact of an investment. All amateur ignore losers.

This early field of behavioral finance comes with a growing number of researchers that change results in variable and non-paradigmatic psychological models to help their understanding easier. Introducing psychological background in analyzing financial anomalies is far from being a negation of the rational economic paradigm. Will always be a tension between how the world should be based on rational theory, and how the world actually is based on behavioral trends. These two often interact and evolving theories in an unsuccessful attempt to keep up with the endless changes of human behavior.

Participated in market research users registered on its website, www.investEd.ro, website that offers people interested in investing an easy way to obtain all relevant information in capital market allows both beginners and professionals to understand the mechanism of capital market and develop their abilities. InvestEd provides members with a trading platform that can simulate virtual investment portfolios, they can buy and sell shares with money, and learning the basic principles of investment environment. Stock prices are taken from BSE, the data is taken over all respondents portfolios on the website invested and questionnaires were sent in 2010, members of the website verified the correlation of psychological factors in investment decisions taken at those moments. The work, in addition to the synthesis of knowledge accumulated so far on this subject, a new approach using data on emerging capital market in Romania. Scientific value is the asset allocation process more efficient by removing at least some of the influences of psychological factors on investment decisions. In behavioral finance, risk is perceived as a subjective construction influenced by how events are interpreted (Rottenstreich and Tversky, 1997; Weber, 2004). The risk is perceived differently by different people in different contexts (Deacon, 2001). An analysis of how people make investment decisions, confirms that probability events have little impact on

decision making (Capon and Prince, 1996). Other aspects are taken into account when investment decisions are uncertain and people are more influenced by perceived risk than objective risk. (Diacio, 2001). Perception of risk is an essential component in behavioral finance. Schleifer, 2001, states that risk perception is an important, but poorly researched, it is essential to understanding the stock market investment decision.

Perception of risk includes an assessment of uncertainty depending on the situation, control of this uncertainty and confidence in any estimates made (Sitkin and Weingart, 1995). It is therefore a combination of genuine uncertainty, lack of knowledge, and the severity of possible consequences (Fischhoff, letter, and Combs, 1978). Risk perception is actually a cognitive evaluation, but influenced by emotions such as fear, sorrow, and optimism (Loewenstein, Weber, 2001). As a cognitive evaluation, is likely many deviations (letter, 1985, 2001). One of these deviations particularly highlighted the blind trust in financial markets (Glaser, and Weber, 2004), which can be displayed in different ways. People tend to have much confidence in their knowledge than in reality. (Lichtenstein, and Phillips, 1982), might think that their skills are above average (Svenson, 1981), or be excessively optimistic (Weinstein, 1980) with the future. Being more experienced and familiar, those who take investment decisions tend to focus on their ability and successes, rather than situational factors. They will build their own judgment and past events and, in a situation they are asked to make a choice will not process all relevant information. As a result of excessive confidence, people are likely to underestimate the real risks and overestimate their ability to overcome unforeseen problems (Jemison, 1986; Shapira, 1987). The trend towards risk is defined as a tendency of behavior to take or avoid a specific area. It is closely related and often equated with actual risk taking. Sharma and Pelton (2009) have recently proposed a model developed by the propensity of risk. Trend toward risk is, in this model determined by three factors: perceived risk, attitude toward risk, and price knowledge. Those who are able to make decisions and avoid risk are more likely to participate and evaluate the negative and thus overestimate the probability of losses in relation to the likelihood of earnings. They need, therefore, more likely to win to tolerate exposure (Schneider and Lopes, 1986). Instead, policy makers and embrace risk are likely to participate and evaluate positive results likely overestimate the gains compared to the probability of loss (Brockhaus, 1980; Stallen, 1980). The distinction between risk avoidance and risk acceptance is quite similar to the distinction in theory (Higgins, 1998) between the emphasis on prevention (avoidance of negative outcomes) and focus on promotion (fight for positive

results). The trend towards risk is often measured by analyzing patterns of behavior observed. Risk tends to be relatively stable over time and can be taught in social or cultural groups. However, it is also changing and accounts people's ability to learn from experience and adapt to new situations making (Sitkin, 1992).

The trend towards risk can be also explained by the methods of handling risk situations. These models tend to persist over time. Those who are able to make decisions and have a high aversion to risk in the past, are likely to continue to take prudent decisions while policy makers with low aversion to risk in the past, are likely to continue to take risky decisions and adventurous (Kogan, 1964; Rowe, 1977, letter, 1972). However, a model assuming normal risk will not persist when it proved unsuccessful. Knowledge of results, reinforced by the positive and negative affect adjustment in different circumstances (Osborn, 1988). In contrast to the stability of the correct decisions, those decisions are wrong strategies will change permanently. Thus, negative results, leading to changes. However, changes are also influenced by success and failure, whether attributable to the actions of decision makers themselves or situational factors beyond their control (Einhorn, 1978). People tend to attribute their good results and failures attributed to others or circumstances. This results in an incomplete and partial awareness of events and a reliable overestimated. People with risk appetite are likely to buy risky financial products. They will have hazardous effects of these products during periods of economic boom and growth, whereas in periods of economic recession are likely to create problems when dealing with the effects of damage risky financial products.

Risk-taking is an important financial decision. This is mediated by risk perception, risk attitude and inclination to risk, and is modified by socio-demographic factors, personality and different situations. People who want the extreme, characterized by a high coefficient of extraversion, and open to new experiences are likely to bear any financial risks more and more, while anxious people with high conscientiousness and neurosis are likely to take fewer financial risks. Women, parents, and older people are less likely to take risks. Consumers and investors with a high degree of confidence in the future are more likely to take risks. Overestimated confidence and optimism are other psychological factors that lead people to take financial risks, with potentially disastrous consequences for their financial situation. Financial crises will be much more serious consequences for people who take risks. Capital market, investors traded companies listed action. A rational analysis suggests that investors traded only if they differ from each other, for example, need liquidity, and risk

perception with or knowledge. A general opinion is that these differences are not sufficient to explain the observed large volumes of stock market trading (Odean, 1999). One reason may be price action that companies are too small or too large. According to efficient market theory proposed in finance (Fama, 1970), where the action prices deviate from their fundamental value due to "noise" trader-s, rational investors will increase trading volume that, in the Finally, prices will correct. This operation is known as arbitrage. However, empirical observations question the validity of efficient market theory; include the idea that arbitrage is limited to cancel the noise impact investors. (DeBondt, 2008, Shleifer and Vishny, 1997). The arbitrageurs can follow noise even exotic investors to buy shares on market trends increasing, strengthening and confirming the price rather than countering it. Some market anomalies identified (deviations from the efficient market theory) can be represented by psychological factors governing the behavior of investors. Offering such an approach, we can represent the main goal of research in behavioral finance (Glaser, 2004). Next I argue that principles-based psychological research validated individual judgment and decision making by it, take account of rational behavior related to capital markets. In this regard, I propose explanations beyond overestimated investor confidence, which in behavioral finance, whoever it is often the explanation for anomalies in financial markets. As stated by Glaser (2004), overestimated the confidence investors tended to become explanation used in all situations (Zaleskiewicz, 2008), for a thorough discussion of how the principles of overconfidence can be found in Psychological Research responsible for market anomalies). Another reason for the dominance of one explanation is that it is not easy to identify the causes of observed behavior in stock markets. In contrast, laboratory experiments, to eliminate confusion plague interpretations of market observations. However, some experiments raise external validity. An effective approach would be to perform experiments that accurately simulate the behavior of investors in capital markets (Plot and Smith, 2008). It has been shown that several phenomena observed on stock markets, referred to as market anomalies (deviations from the efficient market theory in economics), can be caused by enhanced cognitive influences affective and social influences. There are several market anomalies identified (DeBondt, 2008). It is an open question whether this analysis can be extended to explain these anomalies. Another question is whether the proposed explanations are sufficient to explain the potential boom sites and crashes observed in the capital market. In analyzing the determinants of financial crises, some economists (Akerlof and Shiller, 2008, Galbraith, 1955/1997, Krugman, 2009) at least not deny that psychological factors play important roles.

We conclude that efficient market theory (Fama, 1970) gives a perfect capital market and an image not consistent with reality. Since the stock market crashes have such serious negative consequences for the real economy and people's welfare, future research should be less focused on denying efficient market theory.

To quantify the performance of investment was needed to determine individual portfolio returns and risks. These parameters can be calculated either based on previous developments of return (R_t) and average deviations ($R_t - R_{\text{mediu}}$), a development that is considered repeatable in future be based on estimates of probable states of return (R_s) and thus, possible deviations from a trend of return hoped.

Based on the closing values of the 80 investment portfolios on the BSE and the assumption that history repeats (and taking into account normal distribuție law of random returns), we determined the aspired annual return (as a simple arithmetic average of past returns daily) and annual risk (measured by dispersion deviations from the mean) for each portfolio. We also calculated the variance, standard deviation, market risk (which I used for deduction of volatility coefficient "beta" from the application SLOPE function) and specific. We note that to simulate a portfolio with 100% accuracy, we can get a return of 16.22% / year, assuming a risk of 18.23% / year. Repeating the same reasoning for each portfolio, we conclude that we can take investment decisions that generate benefits through diversification and can achieve the required return, but minimizing risk. In this paper studied the influence of feelings and emotions of investors on prices of financial instruments and also was considered a theoretical basis with which results can be understood in this emerging field. This paper deals with recent progress in understanding how emotions affect investment decisions by investors, especially in risk and uncertainty. The trend towards risk can be explained by the methods of handling risk situations. These models tend to persist over time. Those who are able to make decisions and have a high aversion to risk in the past, are likely to continue to take prudent decisions while policy makers with low aversion to risk in the past, are likely to continue to take risky decisions and adventurous. Risk-taking is an important financial decisions. This is mediated by risk perception, risk attitude and inclination to risk, and is modified by socio-demographic factors, personality and different situations. People who want the extreme, characterized by a high coefficient of extraversion, and open to new experiences are likely to bear any financial risks more and more, while anxious people with high conscientiousness and neurosis are likely to take fewer financial risks. Women, parents, and older people are less likely to take risks.

Consumers and investors with a high degree of confidence in the future are more likely to take risks. Overestimated confidence and optimism are other psychological factors that lead people to take financial risks, with potentially disastrous consequences for their financial situation. Financial crises will be much more serious consequences for people who take risks. It has been shown that several phenomena observed on stock markets, referred to as market anomalies can be caused by enhanced cognitive influences affective and social influences. It is an open question whether this analysis can be extended to explain these anomalies. In analyzing the determinants of financial crises, some economists at least, do not reject that psychological factors play important roles.

Efficient market theory gives a perfect capital market and an image not consistent with reality. Since the stock market crashes have serious negative consequences for the real economy and people's welfare, future research should be less focused on denying efficient market theory. Psychological factors influence the investment decision is exemplified by case studies of performance of portfolios, followed by recommendations for efficient allocation of money by eliminating, at least partially, influence the emotional factor. The conclusions of the research highlight a significant impact on its results of individual investment behavior. We chose a study involving market 80 people directly involved in trading activities, people in the investment environment both beginner and professional investors or capital market specialists. Detailed analysis of each portfolio was possible through www.invested.ro website. The results obtained show that the Romanian capital market investors are likely to be influenced by emotions.

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