

Conceptual framework on market factors affecting investor's sentiments and the effect of behavioral pitfalls on investment decision making

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Abstract: Behavioral finance means investors behavior while investment in financial markets. It explain how, why, and where the investors invest capital. This concept investigates and explains the multidisciplinary field of psychology and sociology of financial behavior. In this market the individual investor's decisions are affected by psychological factors while buying and selling of stock, which is influenced by the price. The behavior of individual investors are based on investing the amount of fund in stock market. Investor's sentiment is a major role in stock market. Sentiment means investors attitude and opinion about stock market. . Investors tend to become optimistic and pessimistic in their decision making because of familiarity biases or due to the tendency for sensation seeking. It has become very necessary therefore to identify and categorize these factors and also to understand their implication on investment decision making. In this study the conceptual framework on investor's sentiments and affected on behavioral pitfalls of individual investors while investing in stock market. This study mainly concentrates on market sentimental factors like herd behavior, macro-economic and risk and cost factors are affected by behavioral pitfalls such as active trading, familiarity biases and ambiguity aversion and their impact on investors decision making

Keywords: behavioral pitfalls, investment decision, market factors, sentiments, stock market

I. Introduction:

Over the last few decades, Investors behavior in capital market has been an interesting and most researched field, especially in relationship to behavioral patterns, style which may impact the stock prices. Behavioral finance theory has focused on the study of investor's rationality and stock market investment and also implication of cognitive process of investor's behavior [1]. Decision making is the complex task of every one, while investing in the securities in financial market. It is a mental activity and better insight in investors for future development of skills and ability of individual investors. Behavioral finance means the study of investor's behavior and its effects on while investing in stock market. Behavioral finance holds that investors tend to fall into predictable patterns of critical behavior. In other words, they make the same mistakes frequently. Specifically, many investors lose their portfolios by under diversifying; trading frequently; following the herd; favoring the familiar short-term thinking, and overconfidence. The rational market of investors are become irrational and they made mistake about investment decision. The main objective of this paper is to study the sentimental factors that are affected by individual investor's decision making and also affected by behavioral pitfalls.

Investor's sentiment means attitude and opinion about future cash operations and amount of fund while investing in different type of securities. In this concept, the investors tend to decline in to predictable pattern of destructive investors i.e., they make mistake for every time and it includes sentimental factors that affected by behavioral pitfalls of individual investors. The main aim of this paper is to provide a comprehensive view of market sentiment and ambiguity aversion, active trading and familiarity biases affected by individual decision making.

A study by Ebenezer Bennet et al. Suggest that the analysis of investor's sentiment affect the market factors in stock market. They carried out their study by selecting some market factors like internet led access to information and trading, risk and cost factors, best game in town, herd behavior, confidence level of institutional investor's performance factor, and the macro economic factors of 100 investors in Ghana. In this study investors attitude influenced rumors, intuition, herd behavior and media coverage of the stock [2]. There are two major things in behavioral finance such as limited arbitrage and investors sentiments. Investors sentiments are mainly concerned with two things a) Representativeness Heuristic, i.e. the tendency of people to think as a representative for some specific asset classes or process of probability and b) Conservatism which indicate people to a slower modernizing the models in the face of new evidence than is essential. These two results are overreaction and under reaction of investors in stock markets [3]. The relationship between the capital market

restructurings and amount of money invested by the investors. It was found that the educative reforms and attractive reforms were statistically significant but they had destructive effect over money invested by the investors at the Indian Capital Market [4]. The most of the investors anticipate the stock prices to move up to a level greater than their initial investments [5].

The retail investors frequently study their needs, goals, objectives and restrictions before taking decision about their investment. But it isn't possible for them to arrive upon an efficacious decision on investments. Their attitude is influenced by a variety of factors like get rich quickly strategy, online trading, dividend, investor awareness programme, stories of successful investors etc. A better knowledge about behavior procedures and outcomes is important for financial planners as knowing about investors' reaction to market movements would empower them while planning proper method of asset allocation for trades. [6].

This paper discusses the theoretical background of the context, and defines the various market sentiments and pitfalls among individual investors. The paper propose a conceptual model on how the market sentimental factors affect investor's decision making while affecting pitfalls. The paper will come up with its contribution to the theoretical background and the practical implications of the investors.

II. Review of Literature

The following are the select earlier research studies conducted in the area of Behavioral Finance in the context of investor's sentiments and market factors. The stocks become overpriced or underpriced during periods of high or low sentiment, which leads to foreseeable successive returns [7, 8].

III. Investor's sentiments

Behavioral finance has been a very provocative and sensitive topic in the field of finance. Since investors were considered to have a significant influences in the stock market while investing the amount of fund and decision making.

Behavioral finance theory explains that investors are not always rational, most of the time their behavior shows irrationality such as moods of investors, which have influenced the asset prices and the implication of portfolio selection on asset management. Investor's sentiments can lead to market bubbles and variation of price of security in the market. Investor's opinions attitudes and decisions are mainly influenced by emotions, risk and future cash flows. Behavioral theories concerned with the discounted value of future cash flows is reflected in the stock prices and investors are not always rational market participants. In classical finance theory, investors are always rational in respect of information and decision making. Whereas behavioral finance theory consists of the irrational sentiments of investors that have a great impact on stock prices [9]. Investor's sentiments in stock market defined as the overall attitude toward the particular financial market or security. Sentiments influence the movements of price of security in the market, if bullish market there is a rise in price and in a bearish market fall in prices. Investor's sentiments leads to belief about future cash flow and risk of the security. Sentiments of market leads to overpriced and underpriced stock [7]. A study Lixu Chi et al find the investor's sentiments and the relationship between return and volatility in the Chinese stock market. In this study, lack of experience and sentiments highly influenced the stock return. They found that, high sentiments leads to high stock return and low sentiments leads to low return in the market[10]. Schmeling explains the effect of stock return of 18 countries using consumer confidence as a proxy of investor's sentiments. The main conclusion of this study is when sentiment is high the stock return is lower and the when sentiment is lower, stock return tends to be high. The result main categories of stock are value of stock, small stock, growth stock [9]. The two aspects of investor's sentiments proxies for two steps. First approach, six indirect measure of investor's sentiments such as closed-end fund discount, New York Stock Exchange share turnover, number and first day initial public offerings returns, equity shares in new issues, and dividend premium. Second approach, business cycle proxies includes growth in consumer durables, nondurables, and services, and National Bureau of Economic Research recession variable. In this study sentiments effects on predictability of stock return and volatility depends upon firm characteristics and demand. They developed two approach such as top down and macro-economic. In this approach there are two assumptions in behavioral finance i.e. sentiment and limit to arbitrage .Top down approach mainly focuses on measurement of aggregate sentiments and effect on stock market return. Stock prices are also depend upon the sentiments of investors [11]. Sanjay Sehgal et al study the relationship between investor's sentiment and stock return. The main sentimental factors are market, economic and regulatory. This study is mainly based on survey of institutional investors and stock return. Economic factors that impact investor sentiment are real GDP, corporate profits, rate of inflation, level of interest rates and liquidity in the economy. market based factors are put call ratio, advance decline ratio,

earning surprises, *PIE* ratio and price to book value. The main findings are market returns highly influence the investor's sentiments. This study primarily concentrate on investor's behavior and stock market activity [12]. There are two measure of indicators of investor's sentiments. Direct measure are based upon the survey report. In this study direct and indirect measures are correlated and these indicators of sentiments are highly correlated to stock return [13]. Lixu Chi et al [10] suggest the study that high sentiments leads to high stock return and low sentiments leads to low return in the market.

There are different models available for analysis of investor's sentiments, such as qualitative approach and quantitative approach. Existing quantitative approach of investors sentiments measurement mainly focus on time serious of price return, trading volume, dividend premium, ipo volume volatility[11].In qualitative approach there are two types of investors, rational and irrational investors. DeLong et al suggest the Behavioral model of investors risk created by unpredictability of investor's opinion [14]

IV. Market sentimental factors

The market factors influencing the investor's decision making are: In a study by J. Hengelbrock, et al. [15], it was found that future stock returns over the intermediate and long term can be predicted by measuring investor sentiment. They suggested that smart investors' dependency on the trade information from indicators causes an instant market response.

4.1 Herd Behavior

Herding means similar thinking among individuals. It describe, if any experienced investors invest in any stock, other will do follow same category of investment. S. David et al [16] studied some of the forces which can point out herd behavior of investment. They pointed out that under certain situations, the managers blindly imitate the investment decisions taken by other managers while managing essential private information. While this behavior is ineffective from a social viewpoint, it can be rational from the perception of managers who are panicked about their standings in the labour market. Lihara et al [17] explain herding behavior in various classes of Investors on the Tokyo Stock Exchange. The money-flow instruments permitted the separation of the dimension of sentiment from the measurement of asset returns. Cheng, and Khorana (2000) discussed herding behavior as a method by which market participants base their investment decisions on collective arrangements alone, defeating their own opinions [18]. Hirshleifer et al [19] discuss that the existence of herding is based on the tendency of investors to follow the same information sources, interpreting the signals carried to the market in a regular way and, therefore, enhancing similar financial decisions. Consequently, when individuals have access to the same sources of information or interpret it similarly, correlated behavior forms happen.

Herding behavior can be influenced by the market's degree of sophistication [20], [21], [22], [23]. The Portuguese market is small in size and of low liquidity, which indicates to a type of behavior that may fluctuate from the major world markets, such as that of the USA. The absence of liquidity can influence behavior in the markets because, in some periods, it may not be possible to perform the anticipated action, especially when it comes to not replicating other investors.

4.2 Macro-economic

Chandra, V [24] stated macro-economic factors like rate of inflation, interest rate and strength of Indian economy influenced investor's attitude towards investing in variables. Mark and Protopapadakis found that there is a significant influence of inflation and money growth on the stock market returns. It is difficult to establish the impact on aggregate equity returns by real macroeconomic variables [25]. In a study carried out in Ghana on the attitude of investors, the main factors which influence investors' attitude are interest rate, unemployment rate and strength of an economy [2]. That market returns are directly related to inflation and interest rate [25].

4.3 Risk and Cost factor

Risk and cost factor studies two aspects of investor's attitude, firstly high risk involve high return and stability of involving the stock market.

Mark et al, [25] found that cost and risk factor is not influenced the investors optimism. The main factors influencing risk and costs are cost cutting at the operational level and techno logical advancement. Likewise they also recognize two influencing aspects of risk factor in stock market that affect the attitude of

investors. Firstly, investors believe that risk and return are directly proportional, Secondly, stability and the able governance of the government.

V. Behavioral pitfall

Researchers have identified a number of common investment mistakes and have scrutinized some significant patterns of negative investment behavior in their decision making. Investors sentiments in stock market are highly influence the psychological impact of the investors. The main pitfalls of investors are ambiguity aversion, active trading, and familiarity biases.

5.1 Ambiguity Aversion

Constantinos Antoniou et al [26] analyses ambiguity aversion and stock market participation of house hold investment equity market. In this study stock market participation are negatively related to ambiguity aversion. Increase in ambiguity is negatively related to stock market. Ambiguity aversion is another behavioral factor that has been theoretically linked to stock-market participation but thus far empirical tests of this prediction mainly concentrate on survey data, with mixed results. [27].Schneider's (1989) says The ambiguity refers to uncertainty when no probability is given [28].[29]proposed the concept of comparative unawareness hypothesis, according to which ambiguity aversion is created in ambiguous events versus less ambiguous events or in individuals with great knowledgeable baggage. This hypothesis has sustenance in the results of experimental studies, which exposed the existence of ambiguity aversion in conditions where the participants estimated simultaneously a situation with an ambiguous context and another with a clear and objective context.

5.2 Active Trading

Active trading as an investment strategy which seeks to take advantage of short-term movements in price, and often focuses on financial instruments in higher demand, such as currencies, stocks, options, and derivatives. One of the most speculative trading strategies is Active trading. An active trader, is not keen to expose investments to get impacted by short-term losses or miss the opportunity to gain in short-term. The active traders see an average long-term return not as an achievable expectation. The trader realizes that the profit potential in the markets should be looked upon to outperform the markets. Since the importance of short-term activity has increased the traders will be more active. Opportunity for good capital gains arises out of the market movements. The time frame within an investor looking for trends is determined by trader's style. [30] A earlier study demonstrates the pitfalls of active trading, it was found that active traders underperform in the market and active trading correlates with overconfidence.

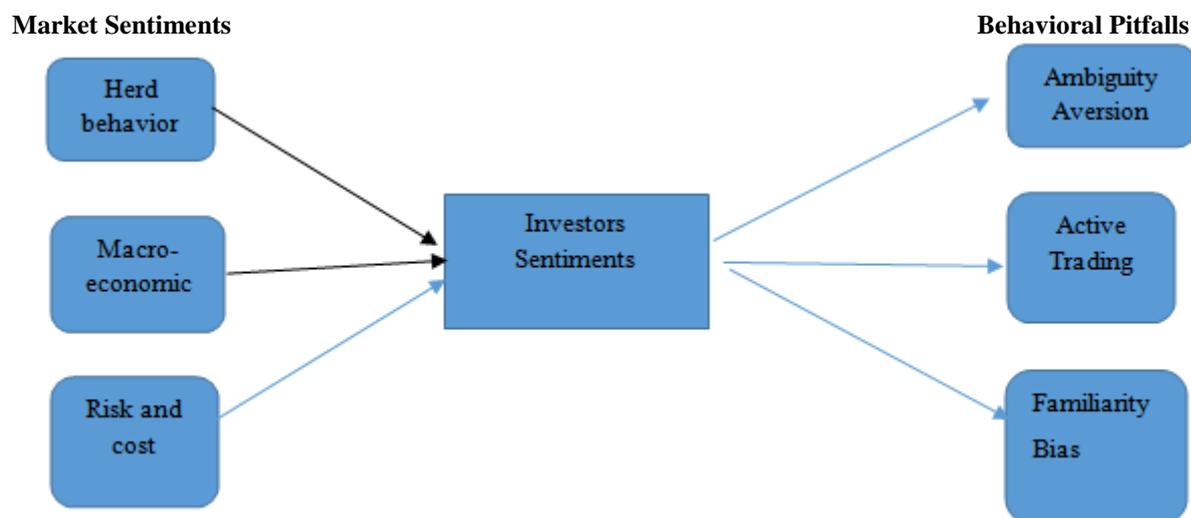
5.3 Familiarity Biases

In this bias, people prefer their familiar portfolio while investing from their own country, region, state and company. Investors prefer local and domestic stock within in their domestic portfolio they avoid foreign stock. [31] Describes asset price theory of investors which mainly focus on the familiar. In this work, investors mainly trade in securities with which they are familiar. Investors are mainly focus on familiar stock and they know parameters of stock return. Swedish investors of portfolio holding and their selected are mostly closely related to them, either professionally or geographically. In this study, they argue familiarity based investing allows investors to get high return [32]. Ivkovic et al [33] study that individual investors tend to concentrate on local stock and they earn high return on local stock. [34] Examined that, after eliminating own-company stock holdings, individual investors in Norway have overweight stocks in the industry in which they are employed despite the diversification shortcomings of doing and receive negative abnormal returns on the stocks they buy in their industry of employment. [35] Suggest that countries with higher rate of economic growth, controlling for a wide variety of factors affect the lower rate of familiarity biases. Ivkovic and Weisbenner [33], argue that individual investors do not receive superior returns on local stocks. H.Cao et al [36] find that familiarity biases on equilibrium asset prices and return.

The performance of geographically and occasionally stock of investments are going on debate, where as investors focus their familiar stock in equity portfolio, are the main implication of diversification of stock. The under diversification of investors force highly concentrate on local, familiar, domestic and company stock.

VI. Conceptual Framework

A comprehensive conceptual framework of the various biases is presented. It shows how the different biases originates and what are the different intermediate and final outcomes they lead to. It also shows the interactive relationships among the various pitfalls. The frame work is presented in the Fig. 1, in which depicts how market sentiments leads to investor’s sentiments and the behavioral pitfalls affecting decision making. This frame work was developed based on extensive literature review in the field of behavioral finance. The framework thus developed fills out the lack of literature among the three variables namely market sentimental factors, investor’s sentiments and behavioral pitfalls.



Source: Literature Review

Figure: 1. Conceptual framework depict the relationship between investors sentiments and pitfalls

VII. Conclusion

This paper present a comprehensive theoretical framework of the behavioral pitfalls and market sentiments that affect financial decision-making process. The strength of each pitfalls such as active trading, familiarity biases and ambiguity aversion is a function of investors sentimental factors like herd behavior, risk and cost and macro-economic factors. The proposed model has contributed to the theoretical background by filling out the voids in literature analyzing the impact on different types of investors and their behavior problems in decision making. The proposed model will give out interesting results when applied to the emerging economic market. Under some situations one pitfall may become more relevant than others. Additionally, several pitfalls may also be active. However, future researchers may work on the model developed in this paper and can include more constructs to make the model more efficient. The paper has important implications for both researchers and practitioners as it provides the base for developing theories applicable for a deeper understanding of the psychological processes involved in decision making. To conclude, behavioral pitfalls have been known to influence human judgments and price determination of stock market. The model has been conceptualized from the past literature and is yet at a conceptual stage. The model will be tested empirically during the course of time.

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