

## A CONCEPTUAL FRAMEWORK ON EMOTIONS AND INVESTMENT DECISIONS

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### ABSTRACT

*Most of the theories in security market are based on the notion of rational investment decision behaviour from investors. But it has been observed that it is not the case always. A new area of research has come up which recognizes the psychological element in financial decision making and thus challenging the traditional models. This new area of study is known as behavioural finance and in the changing socio-economic and technological context; it is high time to study this new area of knowledge. The objective of this paper is to know, To what extent literature restricted the role of investor emotions in investment decision making. In our study it has been proved that the emotions play a vital role in investment decisions and building long-term wealth requires counter-emotional investment decisions—like buying at times of maximum pessimism or resisting the euphoria around investments that have been recently outperformed. But unfortunately, as the study shows that investors as a group too often let emotions guide their investment decisions. In the end, by anticipating and understanding the series of emotions that you may experience, you'll be better equipped to tolerate and benefit from market fluctuations. And we have included some important suggestions which will help the investors to avoid emotional influence on investment decisions.*

**Keywords:** Investor Behaviour, Emotions, Investment Decisions

### INTRODUCTION

Investors of the stock market are rational and they efficiently respond to new information regarding the stock market products. In other words, investors' decisions in the market fully reflect the effects of any information revealed. There are no chances of abnormal returns in the market in the long run, even if the assets prices are not properly valued, they will come to reasonable price level through arbitrage (Fama,1988). Various empirical investigations conducted during 1980 revealed that market is not efficient as explained by efficient market hypothesis (EMH) of traditional finance theories, because of certain anomalies of the market like small firm effect. Thus traditional finance theories of neoclassical finance ignore the importance of investors' behaviour in the decision making. Due to this ignorance, the

investors' behaviour is not covered within the frame work of traditional finance. Sometimes, the investors make irrational decisions and do not behave rationally because of their limitations of capacity to process the information (Simon, 1986). Study of Kahnman and explains that representativeness and anchoring heuristics are sometimes present in the decision making of investors in an uncertain situation where the investors use their judgment in order to facilitate the process of dealing with vague and complicated information. The heuristics mentioned here may lead to some cognitive biases due to employing wrong judgment. They also proposed that prospect theory which is well known in the behavioural studies due to discussion of psychological attitude of investors should be used to understand the psyche based investors behaviour. The prospect theory replaced the traditionally used theory of utility maximization. The prospect theory holds that attitude of investors is not consistent when dealing with prospects of gain or loss, but will be opposite in these prospects. This inconsistency in the behaviour of investors is against the hypothesis of neoclassical finance which states that Investors attitude is consistent in profit or loss prospects. This prospect theory ultimately became the cause of rendering Nobel Prize to them in 2002. To study the financial markets, the researchers have adopted the use of behaviour approach in order to overcome the lacking of traditional neoclassical finance approach. The basic difference between prospect theory and traditional finance theory is that investors who prospect profits or gains tend to become risk averse in order to stabilize their gains but become risk takers in the prospects of loss, whereas according to traditional theory of finance investors are all the time risk averse. There are many investment products which are available for investment to investors in the stock market ranging from bonds to options. These products vary with regard to risk factor involved and the return. Investors choose the investment products which have matching to their risk tolerance. Moreover, investor make up their mind regarding risk factor involved in any investment based on the financial information they receive from different Channels/ Sources. Moreover, knowledge of investors regarding financial market and their past experience contribute a lot towards the risk assessment in various products.

Investors who have experienced loss in the past formulate new investment decision having kept in mind their past experience. These factors along with some other factors constitute the risk aversion and risk perception of the investors. After formulating risk attitudes the investors formulate their potential returns from that investment. Low return products are accepted if the risk attached with them is low and high risk products are selected if risk premium associate with risk level is offered to investors. Investors will invest in those products which offer the return suitable with the risk level of those products. The aim of behavioural finance is to analyses the phenomena of market keeping in view the psychological factors involved in the behaviour of investors.

### **Investor Behaviour**

Even though the fundamental investment rules and principles remain the same, investment climate and investor behaviour change from time to time and place to place. Individual investor behaviour in the capital market is factored by their income, education, reading habits, cognition levels, etc. Investor perception differs with respect to alternative investment avenues, assets and market segments in the securities market. The track records of companies and of the promoters have a telling influence on investment decisions. The investment

motives also vary through capital gains, dividends, bonus, rights, tax benefits and other relevant factors.

Economists have developed behavioural models to explain the decision-making process of individuals. The interdependence of the inherent risk and uncertainty about any course of action are provided by the theory of games. Game theorists call the stock market a 'Positive sum game'. But the money game of the stock market may not yield uniform returns to all its participants. There are various investment avenues. When one investment opportunity is chosen, other opportunities may be given up. So, opportunity cost of an investment is the possible income from the next best alternative. Rational decision-making demands technical knowledge and practical experience. Investor behaviour approaches investing as a rational decision - making process in which the investor attempts to select a portfolio of securities. Rational investors form rational expectations about asset returns, motivated by the maximising principle. They collect available and relevant information for making decisions. Some investors make decisions on inadequate information and such decisions may go wrong.

### **STATEMENT OF THE PROBLEM**

Market participants have for a long time relied on the notion of efficient markets and rational investor behaviour when making financial decisions. However, the idea of fully rational investors who always maximize their utility and demonstrate perfect self-control is becoming inadequate. During the recent years, examples of market inefficiency in the form of anomalies and irrational investor behaviour have been observed more frequently. By understanding the human behaviour and psychological mechanism involved in financial decision-making, standard finance models may be improved to better reflect and explain the reality in today's evolving markets. Our purpose is to describe and conduct a research on what factors, investing characteristics, and decision-making processes affected individual investors which are given in the Literature. Emotions can wreak havoc on an investor's ability to build long-term wealth. Why did investors sacrifice nearly two-thirds of their potential return? Driven by emotions like fear and greed, they engaged in such negative behaviours as chasing the hot manager or asset class, avoiding areas of the market that were out of favour, attempting to time the market, or otherwise abandoning their investment plan. Great investors throughout history have understood that building long-term wealth requires the ability to control one's emotions and avoid self-destructive investor behaviour.

### **REVIEW OF LITERATURE**

Literature suggests that major research in the role of emotions in individual investment behaviour has been done by behavioural scientists such as Weber (1999), Sheller (2000) and Shefrin (2000).who strongly advocated that stock market is governed by the market information which directly affects the behaviour of the investors. Several studies have brought out the relationship between the demographics such as Gender, Age and risk tolerance level of individuals. Of this the relationship between Age and risk tolerance level has attracted much attention.

Rajarajan V (1998, 2000 and 2003) classified investors on the basis of their demographics. He has also brought out the investors' characteristics on the basis of their investment size. He found that the percentage of risky assets to total financial investments had declined as the investor moves up through various stages in life cycle. Also investors' lifestyles based

characteristics has been identified. The above discussion presents a detailed picture about the various facets of risk studies that have taken place in the past. In the present study, the findings of many of these studies are verified and updated.

Annaert et al. (2005), indicate the impact of information asymmetric problem on investor behave, this is another subject in behavioural finance field. Most of these researches are pay close attention to behavioural finance, especially in financial products choices (investment) and behave of individual investor invest related.

Jennifer Reynolds-Moehrle (2007) "An empirical investigation of analysts and investors reactions", this study empirically compares earnings predictability, forecast revision behaviour, and the earnings response coefficients before and after the disclosure of hedging activity. The findings indicate that analysts' forecast accuracy increased and that unexpected earnings were incorporated into subsequent earnings forecasts to a greater extent subsequent to disclosure of sustained hedging activity. Additionally, the findings indicate an increase in the earnings-return relation in the hedging activity period.

Prentice R (2007) investigated the difficulties in ethical decision making and found that decisions that have an ethical aspect are subject o various biases in how people see the situation and how they tend to behave. He described many of the cognitive biases and decision heuristic that can create ethical traps. Insights presented by him can assist the well intentioned to do the right thing in difficult situations.

Mittal M and Vyas (2008) explored the relationship between demographic factors and the investment personality exhibited by the investors. Empirical evidence suggested that factors such as income, education and marital status effect an individual's investment decisions. Further the results revealed that investors in India can be classified into four dominant personalities namely casual, technical, informed and cautious.

Nicolosi G (2009) analyzed individual investors learning behaviour from two prospective, the first being based on the relation between trade performance and trading behaviour and presented strong evidence that individual investors learn from their trading experiences. Further they posit that not only do excess portfolio returns improve with account tenure, but they also found that trade quality significantly increase with experience and concluded that individual stock investors do learn, and they consequently adjust their behaviour and thus effectively improve their future investment performance.

Nagpal S and Bodla B.S (2009) attempted to bring out the life style characteristics of the respondent through an empirical analyses and their influence on investment performances and found that in-spite of the phenomenal growth in the security market and quality IPOs, the individual investors prefer less risky investments. They also found that investors are on a trap of some kind of cognitive illusion such as over confidence and narrow framing. They considered multiple factors and seek diversified information before executing some kind of investment transaction. They further concluded that financial dailies, TV channel and peer groups can play a pivotal role in making investment decisions and also psychographics play an important role in determining investment behaviour and preferences of individual investors.

Kannadhasan K (2010) Investigated on the role of behavioural finance in investment decisions and found that human decisions are subjected to various cognitive illusions. The susceptibility

of an investor to a particular illusion is likely to be a function of various psychological variables, and the investor has to take necessary steps to minimize or avoid illusions for influencing their investment decision making process.

Collard S (2010) has done survey on investors investment behaviour and she has found that when individuals are faced with complex decisions such as pensions fund investment choices, there is strong evidence that individuals do not behave according to economic theories, instead they use a range of psychological strategies and are influenced by them in number of ways. That may result in decisions that are less than optimal in terms of providing them adequate income on retirement.

Love D.A (2010) investigated the impact of demographic shocks on optimal decisions about savings, life insurance and most certainly assets allocation and found that marital status transition could have important effects on optimal house hold decisions particularly in the cases of widowhood and divorcee. His empirical evidence shows that divorce and widowhood have particularly strong effects on allocations and that these effects differ significantly by gender age and number of children.

Singh R (2011) has done research on Behavioural finance: As a Kaleidoscope view and has explored the relationship between investor psychology and investment decision taken by them. He found that psychology is having enormous impact on investment choice; almost all investors consciously or unconsciously take these factors into consideration though they call them by different names. He has also pushed behavioural finance into the direction of biological metamorphism.

Shanmngasundaram V (2011) has done the research on the impact of behavioural dimensions of investors in Capital market and has found that investor decisions are influenced by Psychological factors as well as behavioural dimensions and this Psychological effect is created by the fear of losing money, sudden decline in stock indices and lack of confidence about their decision making capability.

Based on the review of the available literature on investor Emotions about investment decision making it is quite clear, that investor's demographics and psychographics effect the investor's investment decisions. Researchers have indicated that the validity of widely used demographics as determinants of risk tolerance and risk perception is noteworthy as the relationship between socio-economic status differences including gender, age, income level, net assets, marital status, educational level and investment decision or portfolio choice. With regard to the financial risk tolerance literatures, there is much interest in the demographic determinants and risk attention (involving three risk types: risk aversion, risk moderate and risk seeking) is particularly focused on age, gender, education level, income level, marital status, the number of dependents and net assets. (Mittal M. and vyas 2008) younger investors have different attitudes toward financial decisions than elders, risk tolerance decreases with age (Wallach and Kogan, 1961; McInish, 1982) gender is the third most powerful determinant of investment, after age and income are considered (Bajtelsmit and Bernasek, 1996) there is positive relation between male and risky investment choice and negative relationship between female and riskless choice (Bajtelsmit and Bernasek, 1996) women investors have a distinct financial decision-making style that differs significantly from men (Worley, 1998) Increasing educational level attainment is associated with increased levels of risk tolerance as well indicated by (Baker and Haslem 1974) individual investors with university or college

education are more likely to invest in risky asset (Garble 2000) the level of education has its impact on person's ability to accept risk, (Worden 1996), a positive pattern between income and financial risk tolerance has been observed (Schlarbaum 1975) unmarried person are more risk tolerant than married individuals because they have less responsibilities than married people (Roszkowski et al., 1993) Investment decisions related to ethical aspects are subject to various biases (Prentice R 2007) human decisions are subjected to various cognitive illusions (Kannadhasan K 2008) investor decisions are influenced by Psychological factors and the Psychological effect is created by the fear of losing money, Sudden decline in stock indices and lack of confidence about their decision making capability (Shanmngasundaram V 2009) Physiological profiling is the most important aspect which need to be taken care for various investment avenues that individual investors learn from their trading experiences ( Nicolosi G 2009).

### **Significance of Emotions in Decision Making**

Emotions are best when they are left "out" of the decision making process. Due to the fact that humans are emotional creatures, it would be foolish and unwise to advocate people to "get rid of their emotions". This is both unnecessary and unhealthy, for we all have emotions for a reason.

However, there are times when our emotions must be kept in balance. One such example of this is when we have to make decisions, particularly critical decisions. History shows that when people mix their emotions with decision making, they tend to make bad decisions, which in turn lead to severe consequences.

In general, when you have a decision to make, and you're emotional about it, it is best not to make the decision based on the dominant emotion you have at that moment, because this will generally lead to you making a decision that ends up hurting you in the long run. There is a time for emotions, but emotions should never play a factor in the decisions you make in life, for disaster usually follows.

### **Logical Decision**

Warren Buffet, one of the top investors in the world, is famous for saying that "emotions should be left out of the investing process." He feels that if you are going to be emotional when it comes to investing in the stock market, you should not be putting your money in it. Why does he feel this way? The answer to this question is the same for why you should not be emotional when making any kind of critical decision.

Any decision you make in life should be based on "logic" not "emotion." Decisions made based on logic are decisions that are often right, though not always. They tend to be right because they are based on all available data, not your "perception" of data.

### **Problems Faced By Investors**

Investors have been attracted to the capital market by the potential for rapid growth and high returns. However, they have been highly discouraged by the operating inefficiencies and lack of reliability of market institutions and infrastructure. Investors face numerous problems in the capital market. There has been acute shortage of reliable information on the capital market network. Investors feel that the media is not friendly to them. Frequent change in the norms by the Regulators for new issues cause worries. Rigging of prices - as in the case of M S



Shoes issue – before floating of new issues is yet another problem. Manipulation of high premium on new issues is a similar problem. Besides, certain promoters manipulate and inflate the costs of the projects several times. There has been undue delay in refunding the application money, issue of allotment letters and in the issue of share certificates. Because of the absence of any mechanism to check the performance of companies which come out with public issues, a number of companies vanish into thin air after the issue. Investors in up-country regions lack accessibility to Stock Exchange, Stockbrokers and collection centres of commercial banks.

Hence, the primary market has a serious problem to mobilise the potential savings of the public. Only less than 10 per cent of the financial savings are routed through the capital market. The most important problem faced by investors in the secondary market has been delay and non-payment of dues or non-delivery of shares by brokers. Similarly there is undue delay in transfer of shares by companies, mostly due to bad delivery. The investors also experience delay in payments of dividends on shares and interest on debentures. Rights issues and bonus issues very often result in the problem of odd lots. The stock market lacks liquidity as it is flooded with untradeable scrip's, thousands of which are quoted below par. Besides, most of the stock exchanges are in metropolitan cities and so, many up-country investors miss the market very often

### **SUGGESTIONS**

We all want to make decisions to achieve what we believe will be best for us, and there are many theories about how we 'should' rationally make these decisions. However, there is substantial evidence that the decisions we do make are not the ones that these theories predict we would. Studies by psychologists and economists suggest that there are limits to the amount of information we are willing or able to process. This leads to individuals using 'heuristics' or 'rules of thumb' to help make better decisions. Many of these 'heuristics' lead to decisions that are almost as good as those reached using the best rational option, and often require far less effort. Unfortunately heuristics reduce the information that individuals feel it is necessary to seek out before they make their decisions, and can often develop into habits that don't easily fit changing situations.

They don't provide the right answer in every situation. Additionally, people will continue to use heuristics that have resulted in good outcomes in the past. This tends to lead to a degree of overconfidence in the outcomes of decisions when the particular heuristic is used.

- **Avoid Self-Destructive Investor Behaviour:** Chasing the hot-performing investment category or making major tweaks to your long-term investment plan can sabotage your ability to build wealth. Instead, work closely with your financial advisor to outline your long-term goals, develop a plan to achieve them and set the expectation that you will stick with that plan when faced with difficult periods for the market.
- **Understand That Crises Are Inevitable:** Crises are painful and difficult, but they are also an inevitable part of any long-term investor's journey. Investors who bear this in mind may be less likely to react emotionally, more likely to stay the course, and be better positioned to benefit from the long-term growth potential of stocks.

- Don't Attempt to Time the Market: Investors who understand that timing the market is a loser's game will be less prone to reacting to short-term extremes in the market and more likely to adhere to their long-term investment plan.
- Be Patient: Though periods of short-term volatility for stocks are to be expected, it is crucial to bear in mind that historically stocks have rewarded patient, long-term investors.
- Recognize That Short-Term Underperformance Is Inevitable: Almost all great investment managers go through periods of underperformance. Build this expectation into your hiring decisions and also remember it when contemplating a manager change.
- Disregard Short-Term Forecasts and Predictions: Don't make decisions based on variables that are impossible to predict or control over the short term. Instead, focus your energy toward creating a diversified portfolio, developing a proper time horizon and setting realistic return expectations.

## CONCLUSION

“Individuals who cannot master their emotions are ill-suited to profit from the investment process.” Benjamin Graham. Father of Value Investing “You make most of your money in a bear market; you just don't realize it at the time.” Shelby Cullom Davis. So far above study reveals that most investors are emotional and maximize money flows at the wrong times - a sure-fire way to reduce potential returns. Strategies that eliminate the emotional response to investing should produce returns that are significantly greater than those indicated by the typical investor responding to the market rather than proactively investing in the market. Diplomat, during extreme periods for the market, investors often make decisions that can undermine their ability to build long-term wealth. It is important to understand that periods of market uncertainty that can create wealth-building opportunities for the patient, diligent, long-term investor. Taking advantage of these opportunities, however, requires the willingness to embrace and incorporate the wisdom and insight offered in these pages. History has taught us that investors who have adopted this mindset have met with tremendous success. Whenever investor has to make an investment decision, he should first evaluate all the available information regarding the fundamentals of the company and only after consulting an investment expert he should make an investment decision and he should not let his emotions guide his investment decisions.

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