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REVIEW ARTICLE

PSYCHOLOGY OF INVESTMENT IN DYNAMIC MARKET SITUATION

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ABSTRACT

Investment is often regarded as a rational process of decision making for maximizing profit and minimizing losses. This article tries to emphasis that an investment process is not a strategic, methodological or a rational process but is based on emotional responses of individual investor given a volatile platform. An entire field of study known as Behavioral finance studies the emotions behind economic decision-making. Behavioral finance is a combination of economics, psychology, game theory to model decision making by individuals. Understanding Investor psychology helps in making sound and rational decisions. The last 10 years have been difficult for investors. The US Subprime mortgage crisis, the Satyam corporate accounting fraud saga and its aftermath, business and investor caution have led to poor and volatile returns from stock market. Investing methods that seemed to have worked well for many years have seemingly made investors lose faith in the stock market due to its volatile nature. This article should help the investor prudence by understanding the whole process of the functioning of stock market, understand the market cycles of good times and bad times, investor reaction towards economic and business cycles, identifying investment opportunities and managing risks. This should reiterate that understanding investor psychology offers best defensive stance and the awareness of past market cycles should not throw the investor into surprise. It is intended to help ~~us~~ investors make better choices. We make choices based on what we see, hear and with pre-conceived notions which we have accumulated and demonstrated over our lifetimes. This should be a thoughtful article for improvement and for recognition of false confidence and making better investment decisions through awareness.

INTRODUCTION

Stock markets are an organized and regulated financial market where securities such as bonds, promissory notes, shares, derivatives, commodities, currency and interest rate futures etc. are bought and sold at prices governed by the forces of demand and supply. And stock exchanges basically serve as (a) Primary Markets where Governments, Municipalities, Corporate and other incorporated bodies raise capital from prospective investors and channelize it into productive ventures. (b) Secondary Markets is where an investor can sell their securities to other investors for cash through online stock broking and thereby reducing the risk of investment and help in maintaining liquidity in the system. Stock Exchanges impose strict rules, listing requirements and other statutory requirements that bind all listed and trading parties. In Older exchanges trades were conducted on the trading floor of the exchange itself by shouting orders and instructions which was called Open Outcry system. On modern exchanges, trades are conducted over telephone lines or through online connections. Buying a share of a company is considered to be an investment in its future. The most common basic characteristics of a stock market world-wide are its unpredictable nature. Investing in stocks is a risky affair where an investor can lose as easily as one can make it. Even the most experienced investor will also fail to gauge the direction or trend of the market. The stock market offer Risk & Reward. The basic features of stock market where huge volume of shares get traded daily include the following:

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Gains and Losses

Stock market is a Zero-Sum game, one investors profit will be another investors loss. It offers no guarantee of making money in stock market. Similarly, the opportunity offered in terms of returns unlike fixed investment instruments, savings deposits etc it offers scope for unlimited profit/loss.

Diversification

Stock market offer a gamut of opportunity across various sectors, an investor can spread his investment among shares of many companies and safeguard his portfolio value. The advantage of diversification is that the loss in one or two companies is absorbed by rest of picks in the portfolio.

Stock categories

In any country, the investors focus on stocks according to their risk taking ability. Accordingly stocks are categorized as Blue chip companies where they offer dividends and maintain steady prices. The long term investors pick Growth stocks which offer greater scope of long term price appreciation. There are mutual funds and investor who pick the stock based on cyclical movements like those of automobiles, real estate which fluctuates with economic expansions and slowdowns. Conversely, defensive stocks whose value is maintained during economic contraction or slowdowns such as food and beverage manufacturing companies.

Market Indicators

Financial and technical indicators are a watch out for investors to make investment decisions. Price Earnings, dividend policy, company's quarterly earnings etc are monitored. Technical indicators like the market watch, gainers & loser for the day, 52 week high/low, market trends etc. are looked into for decision making by investors in any of the world markets.

Market Trend

The presence of Bulls & Bears in the market bring volatility into the system, there is always a tug of war between Bulls & Bears or each other waiting to dominate the other, during such a stage market moves in a sideway direction. Usually the market participants become cautious and delay in taking decisions when there is unclear trend in the market.

Phases of Booms and Busts

Sometimes market zooms upside and the market participants display Bullish tendencies. In the year 2000's ~~when~~ with the advent of internet revolution, Dotcom companies ruled the roost, and the marked soared to new heights. As soon as the dot-com bubble crashed, then some US$5 trillion in market value was wiped out. Eight years later we emerged from one of the worst recessions. After good recovery from market lows, we witnessed another crash due to panic selling, fear and Bear gripping the market which happened in 2008 US Sub-prime mortgage crisis. In Indian market, the Satyam Computer's Accounting fraud case in 2009 took place which shook our stock market when it came crashing to a new low. This phenomenon happens in all major markets worldwide. History keeps repeating itself. Efficient markets are based on the assumption that investor take rational decision to maximize gains and minimize their losses, but investor emotions often cloud their decision-making ability and prevent them from taking rational decisions. Just like any other Economic cycle or Business cycle, the investor's too undergo different stages in their journey when making investment decision on their own. From the above cycle, the Investor should understand the range of emotions he may experience and take key learning's from such experiences, he can make a conscious investment decision and can tame the emotional roller coaster in a volatile market. It can also give him a greater grasp or understanding of how emotions are affecting his own investment decision. It will also help in managing own investment portfolios as well as predict the next step for the broader market. Modern economics & financial theories have been developed keeping rational investor's general assumptions. A rational investor generally considers all the available information before decision making. But Behavioral finance brings a new dimension to rational investors who include their Emotions in their decision making process which is evident and displayed in the form of market anomalies, market booms, bubbles & crashes. As our world is mostly a subjective one in which formulas is rarely a solution to a problem. We seldom know the outcomes from the decisions we take and the risky judgments dominating our life and livelihood. The decisions that are expected to have a high probability of delivering positive outcomes may commonly prevail, but it is scary to think about the possibility of unexpected, negative consequences can have an indelible impact on how we treat similar choices under similar circumstances. Volatility is regarded as an important yardstick in investment decision making. Volatility is said to be the difference between the current price to its average past prices of an asset. It is generally believed that risk is directly related to the volatility of the asset class, more the volatility higher the risk. It measures variability around its central tendency. The relation of Volatility and Risk has become increasingly important to financial decision makers. Frequent and wild fluctuations in stock market cause uncertainty in the minds of investors affecting their confidence. Risk averse or cautious investors may shy away from the market due to volatile price fluctuations in stock market. Along with retail investors we also have market participants, financial practitioners, researchers, regulators & policy makers. High intra-day volatility is likely to scare investors and sometimes lead to market panic conditions with huge sell off seen in the market. The regulators and policy makers keep implementing policies that can smoothen information flow and ensure boundary with the help of circuit breakers, margin implication, and exposure limits etc. Also any after market information or announcements will get reflected in the opening prices of shares or index. Significant economic or political developments induce price fluctuations and its extent is dependent on the severity of the information. Even in other emerging capital markets like Indonesia, Brazil, South Korea, Mexico exhibit high volatility.

A stock market becomes dynamic when all the participants via. Individual retail investors, institutional investors such Mutual Fund house, Banks, Insurance companies & Hedge funds, and also publicly traded corporations trading in their own shares, conglomerate with each other. It is a well known fact that stock market is one of the most important sources for capital raising, this allows businesses to be listed, raise additional capital for expansion, acquisition by selling shares of ownership of the company in a public market. It offers liquidity to investors to sell shares which are an attractive feature of investing in stocks, compared to other less liquid investments. Often companies actively increase liquidity by trading in their own shares. The dynamics of economic activity is reflected through the prices of shares and other assets. If the stock market is in an uptrend then the economy is said to be an up-and-coming economy. Infact, stock market is often considered as one of the main indicator of a country's economic strength and development. Rising stock prices generally tend to be associated with increased business investment and vice versa. Share prices also have an influence over the wealth of the households and their consumptions. The Central Banks tend to keep monitoring the behavior of the stock market and ensure smooth operation of economy's financial functioning system. Stock exchanges act as a clearing house wherein they collect and deliver the shares, guaranteeing payment to the seller of a security thereby eliminating risk to an individual buyer or seller and protect from counterparty defaults in transactions. These smooth functionalities of an exchange facilitate economic growth with lower cost and enterprise risks promote the production of goods and services as well as employment in the economy. The disintermediation process has opened plethora of opportunities wherein a portion of funds involved in saving and financing, flows directly to the financial markets instead of being routed via traditional banks of lending and depositing operations. The general interest of the public in investing in the stock market, either directly or through MF, Insurance route has been an important component of the financial system across economies. In all developed economies such as Europe, US, Japan and in other developed nations the trend has been that the savings has moved away from traditional bank deposits to more riskier securities such as shares, commodities, derivatives etc.

Depending on the behavior of market participants, any positive or up trends in the stock market is referred to as Bull Markets and a negative or down trends are referred to as Bear Markets. Over-reaction may occur so that excessive optimism may drive prices unduly high or excessive pessimism may drive prices unduly low. There's a debate amongst the Economists whether financial markets are “generally” efficient. According to one interpretation of the efficient-market hypothesis (EMH), only changes in basic fundamental factors, such as margins, profit/loss, dividend, stock splits, mergers & acquisition etc ought to affect share prices beyond short term, while other researchers have proved that psychological factors may result in exaggerated stock price movements and have demonstrated that people are predisposed to seeing price patterns and make their investment decision. Sometimes, the market often seems to react irrationally to economic and financial news, even if that news is a rumor or not have real effect on the fundamental value of securities itself. The stock market may be swayed in either market direction depending upon press releases, euphoria, panic. Crisis in financial markets affect humans worldwide. At the Opening bell of the stock market, there can be either an upside opening, or downside or the market can stay neutral and give a range bound movement as previous day’s closing rate. But in the course of a day, the volatility in the market cause a huge trading swings when buyer and sellers bargain for a price leading to better price discovery. The factors that influence the market fall under below categories. If investor learns to predict the changes in the factors that drive stock prices, and it will help investors foresee changes in the direction of the stock market.

Government Policy

The governments keep a track on the performance of fiscal and monetary policy to steer the economy in the right direction. Measures such as imposing a ban on short-selling during market crash is an attempt to stop traders from driving the prices too low. When RBI announces its Interest Rate changes to control the money supply, it affects the stock market accordingly, when the interest rate is cut and money supply is increased putting more money in the hands of consumers which in turn drives up the stock prices. And increasing interest rates makes borrowing expensive and puts a downward pressure on the economy driving down the stock prices.

Speculation

Traders speculate in the capital market hoping for a favorable reward given the risk taking ability. It exposes to a considerable risk in anticipation of a large gain. In 1990’s when internet was revolutionized, all internet stocks soared high, the buying was based on speculation with very little rationale for decision making. When the dot-come bubble burst, the stocks came tumbling down due to speculation activity.

International Interest

The presence and fund buying activity of Foreign Institutional Investors (FII’s) influence the stock market to a greater extent. When an economy has a conducive investment environment, the FII’s flock and invest in the market taking up the index levels. On the other hand if the FII’s exit and divert their funds by pulling out from the one economy to another economy. This weakens the currency in the domestic economy & the markets hampering stock performance.

Supply and Demand

Market movement take place due to the balance and imbalances between supply and demand factors. When an investor faces with a financial constraint, he may not invest or he may liquidate the stocks in hand, on the other hand some may get new job, appraisal at work etc has reason to invest in the market, hence may push down the prices and few may push up the prices of stocks. Buying the stock increases the demand and selling the stock increases the supply. In stock market there is always a mis-match between buyers/sellers and demand/supply factors making the market more volatile.

Company Fundamentals

Investors keep a track of the stock they invest. They keep an eye on the news related to the company in which they invest, news relating to Quarterly/Year financial performance, bonus and dividend announcement, new product development that can cause investors to flock stock market and drive up the prices. And reporting profit that is lower-than anticipated or reporting loss has the opposite effect, driving stock prices lower. Any disappointing news from one company can impact other stocks in the same sector. Similarly positive news form single large company increases investor confidence and may pull buyer into other companies in same sector. Stock market crashes occur when the external economic events combine with crowd behavior and investor psychology where selling by some or all market participants drives the investors to sell. Stock prices decline dramatically across a significant cross-section of a stock market resulting in erosion of shareholder's wealth. One can witness a minimum of double digit percentage losses in a stock market index which are driven by panic over several day. When there is a stock markets crash, investors feel the pain. The listed companies may no longer raise funds through IPO's quickly and may have to cut back on growth and expansion plans. When business leaders become cautious, the economy faces recession threat with high inflation and unemployment, investors panic about the market condition and dispose the stocks from portfolio without regard to their inherent value, and then majority wants to follow out of nervousness leading to market crash where stock prices dwindle. By its nature, a crisis is a time of uncertainty. It could be months before one know's whether markets are crashing because of irrational fear or because of real economy problems. Crashes are very quick but the recovery takes much longer. Financial panics don't last forever and it is during crashes the assets trade at a very attractive prices. When economic slowdown looks imminent then investors move from riskier to safer investments avenue such as Gold, Govt . Bonds, Debt funds etc.

Investor Emotions dominate the market pricing. The emotional component of investors plays a major role in dynamic market behavior. Here the mix up of emotions of fear and greed is the main driver which is unfortunately counter-productive for most investors as it leads to poor investment performance. We know that the stock market goes through cycles just like the weather goes through Winter, Spring, Summer and Autumn. When the market goes up during a rally, it will also come down during a correction. Similarly, after every correction, it will go back up again. Although stock markets go up and down, it goes higher over time. Over time, it makes higher highs and higher lows, leading to a long term uptrend. And over time it makes lower lows and lower highs, leading to short or long term down trend. Investors behave irrationally when they fail to correctly process all the available information while making their investment decision. Even if investors decide to buy or sell without taking into consideration the economic fundamental, the impact on shares would be still limited. Only when the large groups irrational behavior displaying particular patterns do price deviation occur. The patterns of overconfidence, overreaction, and over representation are common to many investor prevents the company's share price from reflecting their intrinsic value. As a result the high-performing stocks of the past few years typically become low-performing stocks of the next few years.

This same behavior can be attributed to low returns on Initial Public Offering (IPO), a new listing, New fund offer and so on. And they got list presumably because such companies had a history of strong performance which was why they went Public. This leads to long term reversals in share price. On the other hand, due to systematic under reaction, over conservativeness the positive returns for stocks over the past few months are followed by several months of positive returns leading to good momentum in stock prices, the investor underestimates the true impact of earnings and share repurchase, so stock prices don't instantaneously react to good or bad news. The above two events of High-frequency events which occur often and low-frequency events which occur infrequently and may take long time to recover from. The high-frequency supports market efficiency, but it is hard to find a reliable trading strategy to make profits. The low-frequency evidence, however does not support market efficiency.

Few examples of mis-evaluations include

1. The undervaluation of stock market worldwide from 1974-1982.
2. The Japanese stock price and land price bubble of the 1980's
3. The October 1987 stock market crash
4. Dotcom bubble of 2000,
5. US Sub-prime mortgage crash in 2008
6. Standard & Poor's downgrading Greece's Sovereign credit rating to Junk & Bailout issue 2010.

Like any economic cycle or business cycle, the individual investor or collective investors undergo different phases of emotional instances which are reflected in the share price behavior. As the stock market goes through its cycle, investors ride a rollercoaster of emotions from Optimism, Euphoria and down to Depression. By feeling the emotional pulse of the market one can identify where he is in the market cycle. The point of maximum investment opportunity is when the market is feeling 'Panic' and 'Despondent'. This is when stock prices bottom out for an early recovery. The worst time to invest (maximum risk) is when the investor is feeling 'Thrill' and filled with 'Euphoria'. This is when stock prices are high and ready for the big fall in align with Market cycle.

The fourteen stages of Psychological Cycle of an Investor formulated Chris Firth a Neuroscientist who in 2007 authored a book "Making up the Mind" and presented the evidence of how brain creates our mental world, in 2010 wrote about investor's 14 emotional stages that is briefed below. Like any other Boom-Slump cycle that is common to all markets, investor behavior or their emotions display a similar rise to a peak before declining to a low level, later followed by a recovery can be witnessed. According to Firth, markets reflect these emotional cycles along with the economic and business cycles.

Optimism: An investor's positive outlook or a Hunch about future prospects leads to buy stocks.

Excitement: When initial ideas work, excitement builds and anticipation about profits starts.

Thrill: Investor cannot believe his success and tags himself "Smart" with complete confidence.

Euphoria: This marks the point of maximum gain and maximum risk. When decisions go right quickly and easy profits are made, investor begins to ignore the basic concept of risk.

Anxiety: Market turns against investor for the first time, gains shrinking, and the investor mask themselves as Long-Term investor and that all ideas will eventually work in his favor.

Denial: When market doesn't turn as quickly as expected, investor denies of making wrong choice and long term view is shortened to near-term hope for an improvement.

Fear: When market reality sets in, the investor becomes confused. He believes the stock he own's will never move in his favor as anticipated. At this point one should exit with small profit and move on, but in reality we don't for some reason.

Desperation: Gains are lost at this point and realization of missed opportunity sets in the mind. Not knowing how to react the investor grasps the idea that market will allow him to exit at break-even.

Panic: Feeling of Helplessness sets in and investor feel like they are at the mercy of the market without having any control over it.

Capitulation: Losing all hopes in stock market and deciding that the portfolio will never increase again, the investor sell his holding to avoid future losses and exits.

Despondency: After exiting the markets the investor is shy to enter and buy stocks again and hence avoid the market. This is the rare opportunity the investor should mark as this point offers maximum financial opportunity.

Depression: Investor realizes their foolishness and tries to understand their decision and learn lessons from this episode. Real investors go further by starting at this point by learning from their past mistakes.

Hope: After learning from past mistakes and understanding the market cycle, the investor's start looking at new opportunities.

Relief: The investor renews his faith on seeing their prior investment doing well and believes there is future by investing again. The cycle starts all over again.

As explained above stock market is a world with special terms, concepts and practices. A beginner or a novice investor can actually master the art and science of trading on stock exchanges around the world just by being in sync with market cycles, business cycles and the required psychological makeup. An investor should understand the purpose of stock market and the stocks. Investors can buy and sell stock between each other at from the fluctuating market prices on established stock exchanges. Understanding the historical methods of trading stocks, earlier it was out-cry method of buying and selling shares, now buying and selling of shares is done by clicking the button on the net. Investor can contact the stock broker, get advice and place their orders through telephone and also through online trading platforms. The internet has changed the ways stock market is operated and traded. The investor should thoroughly understand how price shift takes place when a range of factors like financial data, changes in the industries, economic and political issues and news releases. It is also important to study and adhere to different stock trading strategies. Investor's commonly employ trading strategies suiting their risk tolerance and time frame, and trade strictly with stop loss to limit the loss and regularly book on profitable positions. One can develop short term and long term investing strategies to ride both the bull and bear markets. Investor should take both side of being a long term investor concentrating on growth, dividend etc and of short term relying on volume rather than high profit in anticipation of large gains. Towards these above objectives the investor or a speculator should have a blue print to navigate through the stock market

Step1: Understanding Basics: Investor should create his own potential investment opportunities by identifying the companies and sectors by understanding the market well. Even investment legends Warren Buffet and Rakesh Jhunjunwala invest only in companies they completely understand. This will help to understand the impact of changes in the economy, management changes or any corporate news related to it. This requires lot of effort to get right and needs a rigorous process to be adhered to. Constantly keeping updated through newspapers & televisions is a must to know the first hand information which helps to make immediate decision to enter or exit from investments.

Step 2: Proper Investment Planning: The investor should be clear whether he would be investing on his own or seek advisory services. If he has time and energy to research, purchase and track his portfolio by handpicking of stocks. Conversely, if one has an equity portfolio but does not have time to track performance then he could go for investing in mutual fund where portfolio management is professionally done by MF houses.

Step 3: Research investments: The investor has to carefully research his investments. For stocks, stock screening tools are available like yahoo finance or any other good financial sites and updating constantly. Sorting the stocks and comparing with market performance is very important. Mutual Fund can be selected from financial websites and investments can be made based on data such as fund type, manager experience, expenses and fund type.

Step 4: Goal & Performance Monitoring : Earning money in stock market appears to be easy and the investor can lose all the hard-earned gains during market crash that can ruin everything. Earnings should be tracked in tandem with investment objectives. Investor/Trader should religiously place stop loss order to minimize loss & protect invested capital.

Step 5: Sound Investment Strategy: Integrating fundamental and technical analysis for optimum decision making. An investor should thoroughly understand the dynamics of market and optimize their decision making. The advantage of applying technical analysis is that the past data will give the market trend . As history repeats itself, so does the market cycle and booms and busts. Technical analysis makes it possible to find the market patterns, identify the areas of demand and supply which helps the seller to identify supply zone or sell at a high rate and buy it back at low prices or at demand zone.

Step 6: Managing Risk: To have a clear goal before investing. It is recommended to have a diversified portfolio of investments based on target and risk tolerance. As the old saying goes, Don't put all your eggs in one basket. A well balanced portfolio comprising of different sectors can bear any bad impact on the market. Should understand his financial risk reward ratio while investing. Never take the advantage of over leverage and to buy or trade or upto to the margin at hand. If an investor is vary about the financial world and plethora of financial products then an investor should seek advice from Financial Advisor who can do the financial planning and thus one can be saved from falling in to psychological traps through timely advice. Investor can become aware of their weaknesses and manage with support of a Financial Planner.

It is well known that investment markets are prone to rounds of irrationality which take them away from levels that may be justified in the long term basis, this is rooted in investor psychology that arises due to investment biases. If investors move away from speculative and take a long term investor stand then they can reap the benefits of the power of compounding, the dividends and bonus accrue for the long term and creating huge wealth. Sometimes even the most analysis on fundamentals fails to pinpoint the best time to buy or sell a stock and make profits. Technical analysis helps the investors to predict price behavior of a stock, commodity or any financial instrument, giving clues about the market direction for coming weeks and months. Technical analysis has become an important tool for timing the market and in essence to make a logical and well informed decision about a trades or investment's future. One can accumulate wealth through patience and trust in the functioning of free enterprise system. Fortunes are invariably made out of tough times.

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