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INVESTOR'S PSYCHOLOGY CYCLE ON THE ROMANIAN CAPITAL MARKET

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Abstract

Modern financial economics assumes that we behave with extreme rationality but we do not. Furthermore, our deviations from rationality are often systematic.This paper tries to offer a starting point in the investor's psychology analyses in the framework of the latest events in the Romanian capital market. The main conclusion is that the two main phenomenon noticed on this market – the "auto-sustainable" downward trend and the tendency for increase in the market intrinsic volatility lead to a mouvement in the investors' psychology cicle from the enthusiastic position (in the final of 2007) to the fear/panic position in the October 2008

Key words: investor psychology, stocks, risk, return, behavior
JEL classification: G12,G14

1. Introduction

Even if there are recent studies to prove that the belief high income is associated with good mood is mostly illusory [Kahneman, Krueger, Schkade,Schwarz and Stone ,2006,1908-1910] argue that when people consider the impact of any single factor on their well-being –not only income-they are prone to exaggerate its importance; they refer to this tendency as the focusing illusion) from the ancient times people were concern about their financial status and investors about the return and the risk of their investments.

Each investor sees and values risk in his own way. That is why theories as: the theory of expected utility [Bernoulli ,1954, 23-27] assumed that the states of wealth have a specific utility, and proposed that the decision rule for choice under risk is to maximize the expected utility of wealth-the moral expectation) or rational optimizing economic theory (assumes that people calculate their rational advantages and than act consistently with that) are usually not applicable in real life.

Kahneman [2003,1457] argues that "…utility cannot be divorced from emotion, and emotions are triggered by changes. A theory of choice that completely ignores feelings such as pain of losses and the regret of mistake is not only descriptively unrealistic; it also leads to prescriptions that do not maximize the utility of outcomes as they are actually experienced"

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The hyperbolic discounting theory developed by David Laibson [1997,443-450] bring in attention an important human tendency: a tendency to postpone consideration of important problems indefinitely. People violate the precepts of rational optimizing theory by displaying time inconsistency, repeatedly violating their own plans for the future.

The theory of mental compartments developed by Richard Thaler[1980,45-48] helps us to understand why people may be very cautious to protect themselves against some small, even inconsequential risks, and to ignore some of the biggest risks of all .

A new risk approach "risk as feelings" hypothesis asserts that emotional reactions to situations involving uncertainty of futurity often radically differ from cognitive assessments of those situations (Shiller [2005,14]).

This paper tries to create a link between those theories and the recent evolutions from the capital markets, especially from Romanian capital market starting with answering to the question:" why investors' psychology leads to bad decisions?" (part 2) and continuing with analyzing the position the Romanian investors have in the investor psychology cycle, (part 3). The fourth part is designated to the conclusions.

2. Why investor's psychology leads to bad decisions?

In the last decades researchers continue to uncover more evidence that our brains are hard-wired to react to risk in specific ways that might have worked well in our evolutionary past, but that are not necessarily adapted to modern financial decision-making. If we consider the subprime mortgage crisis and its reflection on the stock markets at least two behavioral biases come in mind: ***overconfidence*** and ***loss aversion***.

Maybe the best definition of ***overconfidence*** is offered by Daniel Kahneman, the Nobel Prize winner for economics who has described as a tendency to construct forecast that are "too rosy". It is easy to see how overconfidence pervades the stock market. In the first place money managers and advisors are paid for their expertise and "their superior skills". Unfortunately in real terms only half of them consistently perform above average peer benchmarks .In the investor case, overconfidence plays out in other ways, such as chasing short-term performance and hot asset classes. The sentence "It's different this time" is the foundation rock of an overconfident investor. The late 1990s "TMT" buble-the surge in technology, media and telecommunications stocks could offer us an classical example of market psychology driven by overconfident forecast. The subprime crisis from USA was I part due to problems of outright fraud and market manipulation but the greater driving forces was an al-too-human skill at creating overly optimistic forecast.

If market actors overreact on optimistic side in bull markets it seems that the overreaction is more profound in periods of bear markets. Researchers have noted a psychological tendency toward ***loss aversion*** – a tendency to overweight losses relative to gains. In psychological terms is twice painful to lose a dollar than the pleasure to gain one. Loss aversion appears to be at the root of many of the worst types of investment behavior: selling out of the market entirely; abandoning asset classes based on short term returns, focusing on specific losing investment rather than on overall portfolio performance.

In the end the capital market reflect important features of investor psychology. Is a continuous war between emotion and discipline, between our present –day selves, looking for a winning strategy today and our future-oriented selves, striving to be patient about long-term thinking and investing. When people are too much "in the present" they become impatient and swept up in market swings. When people think at long term, they tend to make more prudent choices for their futures.

A large part of these two behavioral biases come from the investor's personality. At the capital market is common to say that the investor personality is the cause of loosing money not the market. That was a key finding of a study done by the research firm of Mathew Greenwald &Associates Inc for Merrill Lynch Investment managers. Merrill divided investors into four distinct personality types:

- measured investors
- reluctant investors
- competitive investors
- unprepared investors

Measured investors are secure in their financial situation and confident they will have a comfortable retirement. Least likely to say that they waited too long to start investing or that they haven't invested enough, this investors are the last one plagued by emotions such as fear and anxiety that commonly cause investment mistakes. The most common mistake is not letting go of losing investments.

Reluctant investors do not particularly enjoy investing and prefer to have an financial adviser in order to spend as little time possible managing their holdings. This kind of investors is least likely to become overly attached to an investment or to put much money into a single holding.

Competitive investors enjoy investing, are inform and try to beat the market. They start investing early, invest regularly but can have hard time letting go of losing investments, often dedicate too much of their portfolio to one stock or investment and tend to be greedy and chase hot stocks.

Unprepared investors are characterized as unhappy with their financial situation and lacking in confidence. They tend to invest late and are at least likely to rebalance their portfolios.

3. The investor psychology cycle: the investors' positions in market evolution

Because we are human all our decisions including the financial ones are governed by emotion, by feelings. Too many times on the capital market the investor reaction does not come from a coherent analysis but from how they perceive the opportunities and the financial threats. The investors' position in market from a psychological point of view could be seen as a perpetual cycle. Each time when a bull market is started a new cycle is initiated as one could see in the next figure:

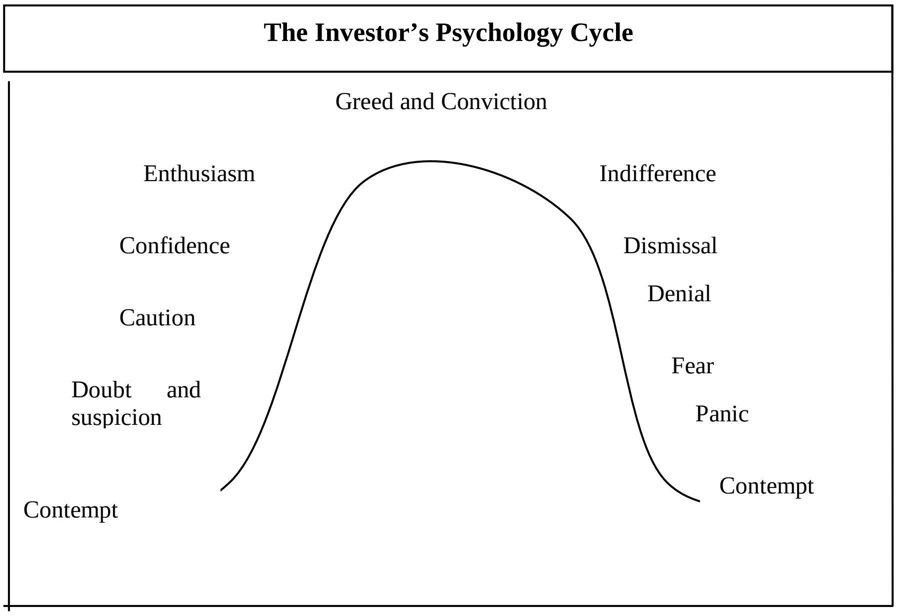


Figure No. 1 The investor's psychology cycle

Contempt: a bull market starts when market is at a low and investors scorn stocks

Doubt and suspicion: the investors are trying to decide if to invest what whey have left in low risk instruments as money market fund or not, because they lost a lot with stocks and they do not want to loose again

Caution: now, the first sighs of market recovery are seen. Most investors stand in the same position but prudent investors are already drooling at the possibility of profit

Confidence: usually in this stage, due to the stock price raise, the investors' feeling of mistrust changes to confidence and ultimately to enthusiasm. As a result most investors start buying their stocks at this stage

Enthusiasm: in this stage smart investors are already starting to take profits and get out of the stock market, because they realize that the bull market is coming to end

Greed and conviction: now investors' enthusiasm is followed by greed

Indiference: investors look beyond unsustainably high price-earnings ratio

Dismisal: at the market declines, investors' lack of interest turns into dismissal

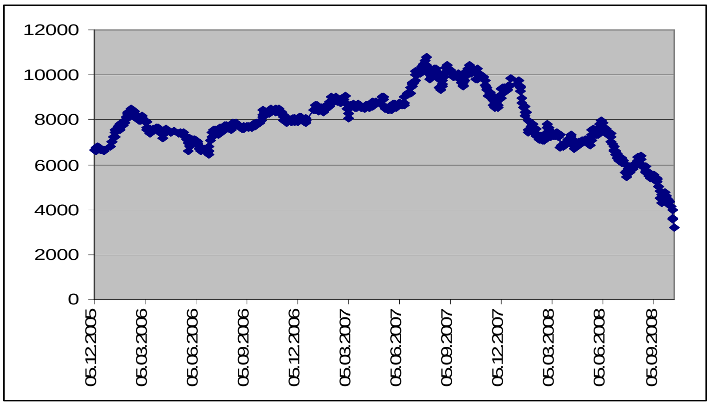
Denial: usually at this point investors regularly affirm their belief that the market definitely cannot fall any further

Fear, panic and contempt: concern starts to take a hold and fear, panic and despair soon follow Investors again start scorning the market and once again they vow never invest in stocks again.

In order to determine where we find ourselves, the challenge is to identify the prevalent stage of the psychological cycle. I would, for starters argue that we are on the right – hand side of the curve, but how far down the slippery slope sentiment has declined is less clear.

In order to bring some light we will analyze the evolution of three Romanian indexes (BET- the index calculated using the evolutions of the most liquid stock from the market, BET-C –the composite index of the market and BET-FI- the index for the Investment Societies sector) in the last five years starting with the December 2005 until October 2008[1].

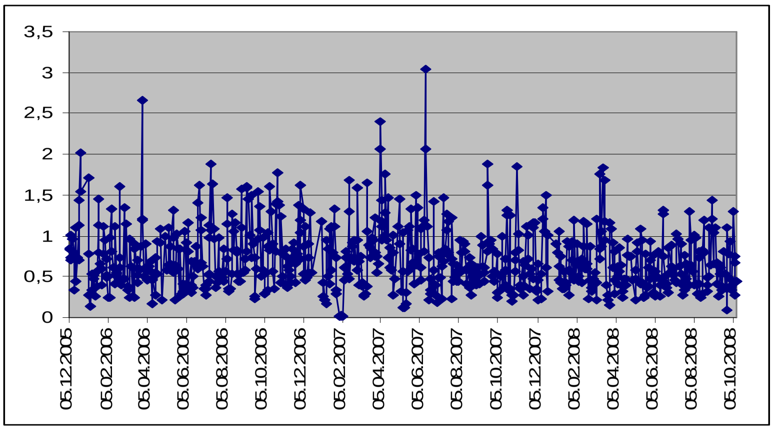
As one can see from the following figure, in the analyzed period one could identify a moment of enthusiasm on the capital market in the last part of 2007 due to the very good increases of the Bucharest Stock Exchange (BSE) (we are using the fact that a good market evolution will determine a optimistic reaction from the investors who will eventually determine a new increase in the prices)



Graphic no.1 BET evolution

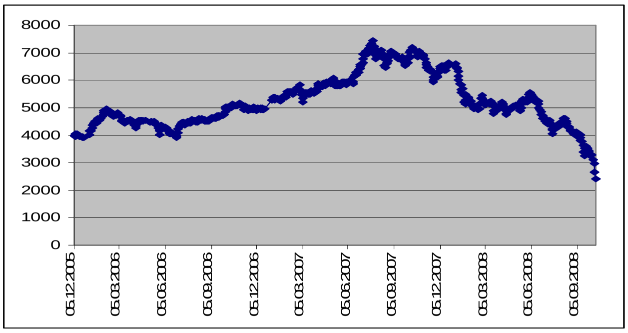
Last year the evolutions from the BSE were not spectacular at all and this fact influenced the investors' attitude. Starting from an enthusiastic attitude in the end of 2007 the large mass of investors reached the fear and panic stage in the past weeks due to the events from the international capital markets, on the existing downward trend. The contradictory news from the American economy has lead to high volatilities in all capital markets including Romanian's one (see next figure). If one looks at the main causes of the volatility in the last decade (a strong emotional status which overwhelms the main stream of the investors due to the existence of some positive factors – sentiments of euphoria, joy, greed – or some negative factors – sentiments of apathy, risk aversion, fear or even panic; the globalization of the capital markets) and analyses the last crises evolution is easy to notice the presence of both main factor of volatility and of course of their results.

[1] The source of data is National Bank of Romania: www.bnro.ro

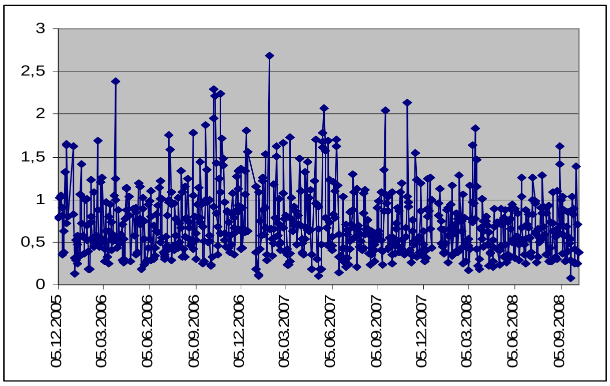


Graphic no.2. BET's standard deviation

Same tendency is easy to spot at the market regarded as a whole as one can see in the next figure, but if we look at the risk (figure no.4) we can see a higher levels and more volatility than in BET's case.:

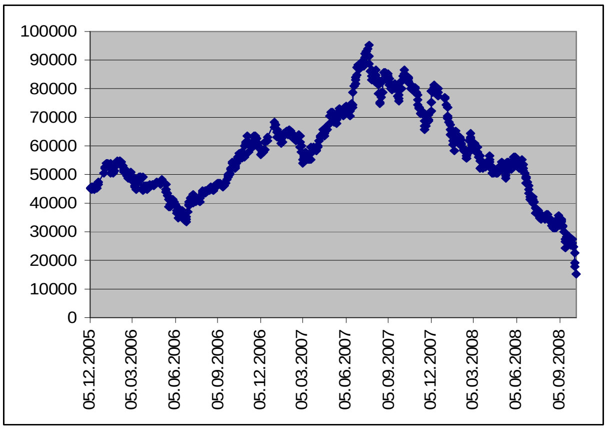


Graphic no.3 BET-C evolution



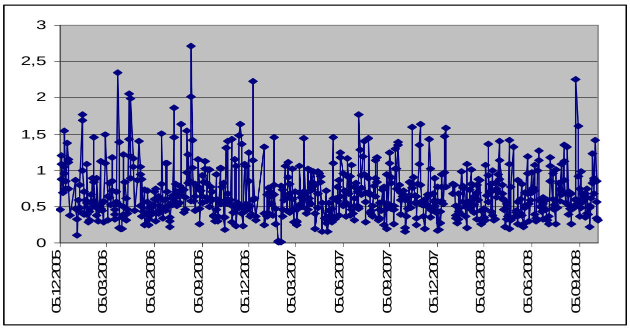
Graphic no.4. BET-C's standard deviation

Because of the distinct features of the companies included in the last index (here are included investments companies which have in their portfolio a lot of stocks from different companies) one can see that the evolutions where a little bit more accentuated than in the other two cases in terms of initial increases and olso in terms of final drop of their markets.



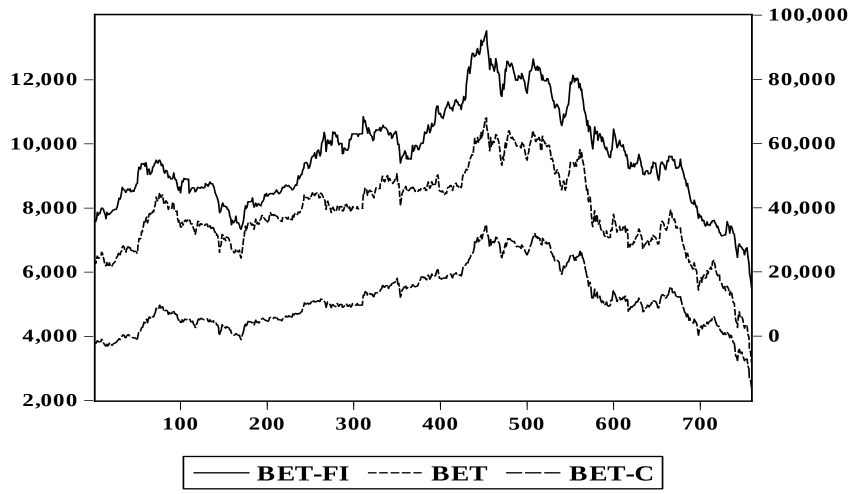
Graphic no.5 BET-Fi's evolution

If we look at volatility probably the BET-Fi's evolutions are more comparable with BET's as we can see in the next figure:



Graphic no.6 BET-FI's standard deviation

The cumulative evolutions for the three analyzed index could be surprised in the next figure, in order to be able to draw some final conclusions.



Graphic no.7 The Romanian indexes evolution

4. Conclusions

Individuals by definition are usualy governed by feelings and no matter how rational they are, make a lot of decision based on what they feel. In the investment field is no different. A bad evolution in the capital markets brings an increased risk aversion which finaly leads to new decreses. In this field we can see the snow ball efect because of the cause-efect relation. Thet is the reason we can say that the two main conclusion which we have drawn from the latest evolutions:

- an "auto-sustainable" downward trend for the market prices starting with August 2007;
- a tendency for increase in the market *intrinsic volatility* as an expression of the unbalanced **bid/ask** ratio due to the increase of uncertainty in the transactional environment.

Could be seen as a cause but also as an effect of the investor attitude on the market. The last decreases on the market for example are not necessarily a result of a rational decision based on the financial indicators' degradation for the quoted companies but more a result of the panic due to the newest capital markets international evolutions.

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