Investors Behaviour between Theory and Practice

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ABSTRACT  From the outside, financial markets appear dry and technical. However, their inner mechanism is psychological. Thus, this paper is dedicated to personality psychology, whose mastery is crucial to the investment game. Theory is different from practice, and that is why modern economic theories focus more on the psychological knowledge of the participants to the investment environment. Traditional economic model of the market have assumed that individuals/investors are “fully rational” and make decision optimally. In contrast, psychology has observed how they fail to be rational from an economic viewpoint when making decisions in the markets.

KEY WORDS  Trading skills, personality psychology, risk, decision

JEL CODES  F3

1. Introduction

The brain is a complex computer system, a system that takes information as input sensors, makes them different ways, it saves, it analyzes, integrates them, and then apply the decision rule it "translates" the output. The idea that a group of people process and respond to information received in the same way describes what is called feedback loops (circuit side).

The combination of words, in translation, means the way information is processed. Transformation process information means that there is a difference between information in the form of input and output information as the same stage (Plummer 2010: 36). The result, is that change’s output is then input the information for the next stage. The trading activity is at the intersection of several fields - economics, mathematics, sociology, statistics and psychology.

Investment is considered to be effective, a logical mechanism, as it claims to be: all investors know they have to buy cheap and sell expensive - yet too often investors shall do the reverse, as they all know that market is almost impossible to be defeated - but all think they can do it; everyone knows that to sell in times of panic is a bad idea - but a company which announces a gain of 23 cents per share, instead of 24 cents, may lose millions of the market value in a single minute; everyone knows that the Wall Street experts can predict what might happen on the market - but investors always consider financial experts that provide forecasts in the media.

2. The general pattern of trading skills

The main pillar of success in investment is psychology. Psychology is a science that rapidly progresses in order to discover, understand and explain human nature - the behavior and mental processes that make us who we are and distinguish us from other beings. Personality psychology, a part of social psychology, observes the way people are influenced by other individuals, by
information, or by actions that happen and try to understand the personality characteristics that tend to change little from one situation to another. Moreover, many investors are convinced that success is based on features such as personal skills of the investor (the way of thinking, feeling and acting). The general pattern of trading skills highlights the tactical (awareness, tactics development, mental rehearsal, constant attention, action, monitoring, daily evaluation, periodically statement) and strategic action (management of own shares, data management, financial management, market analysis, lifelong learning, stress management) that should be undertaken by investors in order to obtain returns on foreign exchange markets (Sether 2007: 24-30).

3. Reasons to understand personality psychology

Academic research usually does not consider trading activity as a profession, requiring the addition of certain personality characteristics, skills and abilities. However, based on research conducted in my PhD thesis, I believe that a better understanding of investor psychology is the key to a fruitful trading activity. In other words, personality psychology aims to investigate the ideas, feelings and behavior of individuals.

In traditional economic models, investors’ personality within the foreign exchange market does not play a primary role as financial markets are considered efficient in that prices always reflect the available information and trading decision is taken by rational agents in an absolutely correct manner. In this case, such a hypothesis cannot force those who claim this to investigate the personality of decision makers in the financial market in general, and in the foreign exchange market in particular.

Modern economy, researched by open-minded economists with multiple personality psychology knowledge has demonstrated that personality should not be neglected. In other words, personality has a significant effect on the speed with which the individual acquires skills and professional knowledge. This statement is supported by an investor in the foreign exchange market who has made the following observation: “I am a natural investor ... I became a successful investor because of my skills to make money for the organization I was working for” (Oberlechner 2004: 415). The speed with which the activities are developed on the global financial market and the diversity of participants in these activities led me to outline the reasons why we must understand personality psychology: knowing (the investor can understand his own personality, including his own ideas and attitudes. The scenario created among investors on trading decision is that, when the decision is taken, it is structured as follows: 75% 25% psychology and methodology); understanding (the investor will be able to understand the psychological process of the human mind); reducing stress (the investor will learn how to cope with stress and factors that may influence his decision. Two of the most obvious human emotions that the investor tends to experience are fear and greed); recognizing (the investor will acquire ability to recognize symptoms of panic disorder determined by the moments that appear in the market); YES/NO (the investor will understand the need to refer to the actions of market participants and to ignore the actions of others); mutuality (the investor will understand how he can be affected by the investment environment, and how he may influence other investors); feelings (the investor will be able to make the difference between beneficial emotions and destructive emotions); information (the investor will be able to understand the stages of development concerning the information released in the market); “treatment” (the investor will be familiar with the “treatment” one needs
to take when the market is in panic) and vision (the investor will be able to achieve the most important thing – he will be able to analyze the behavior of other investors) (Mionel 2011: 224).

4. Investors typology

Depending on their behavior caused by psychological factors and risk tolerance, investors may have created the following typology: protector, leader, follower, power player. Protector investor shows a low risk tolerance and is very insecure about money. This type of investor wants to keep every penny, even if it is worth nothing in a few years. The second type, leader investor is confident and willing to take risks to achieve high yields. He is considered more analytical and an "independent" thinker. The third type, follower investor shows a slightly higher risk tolerance, but is scared of money. He doesn’t want to make a wrong decision and always regrets past decisions; as a result he wants someone else to make decisions in his place. The last type, power player investor shows increased confidence and high risk tolerance. This type of investor is willing to take any risk only to invest (Biafore, Buttell and Fabbri 2010: 45-54).

The protector hates change and is always restless. He is unsure of what he knows about money; he has very low risk tolerance and has trouble listening to logical arguments. Usually, the protector exhibits the following reactions: aversion to losing money. In this situation, any investment idea disappears when there is fear of loss. In fact, the instinct tells people to consider loss more "painful" than they consider earning pleasant; fear of the unknown occurs when the investor is not aware of what investment is all about. Each investor shows aversion to risk due to human nature and the desire to obtain high returns without taking any risk. In many cases, the investment risk is only fear for fear of the unknown. The best way to overcome fear of investment risk is for the investor to clearly understand what it is, how it affects him and to examine his personal comfort level in relation to the level of risk posed by each investment; fear of error, the protector investor chooses not to make any investment rather than to make a mistake. Fear is the strongest emotional trend that can "paralyze" and may prevent investors from taking the best decision.

The follower is led by the herd instinct when making an investment, because it provides investment security. Risk tolerance is low, although apparently risk tolerance appears to be high, and information on investment is low. However, this type of investor buys when everyone buys and sells when everyone sells. The follower displays following reactions: ignores loss (many investors ignore the losses, thinking that the market will recover; they are easily influenced by information released in the media and put great emphasis on short-term investments) and never learns from his own mistakes (they always rely on advice and knowledge of other investors to make their own decisions; they never analyze the information they need, and they neither develop their own investment plan nor do they evaluate investment in order to see if it is worth it).

The power player investor is "aggressive", show an entrepreneurial spirit, is safe in his investment, and emotions lead him to take extreme decisions. The power player has the following reactions: ego-centric personality and forgets losses. In the first case, he is considered to be an expert in investment and believes he can achieve high returns from any investment he would achieve. When successful, the investor is not nervous anymore and can exaggerate, relying on intuition rather than analysis. Because long-term investment success comes from analysis and not from instinct, this authoritarian type of investor can buy and sell frequently and especially amid the frenzy of the market, which may lead to repeated losses. Social psychology describes the
individual that has an ego-focused personality as being more preoccupied with his own self than others. Scientific research distinguished on the one hand, individuals who reflect a tendency to private self-reflexivity, the dominant being concern of their inner states, and on the other individuals who reflect a public self-reflexivity, the dominant being the tendency of self-monitoring their behavior in public. Individuals in the first category are guided by the "inner voice" of their conscience, which imposes a rising level of their requirements, while individuals in the second category are subject to social standards, as they cannot accept to be seen by others in a negative context. In the second case, *forgets losses* investor believes that he can always control random events. When the investment return is the expected one, the investor believes he knows everything about how the situation will evolve in the future. In 1973, Daniel Kahneman and Amos Tversky found that individuals often do assignments and other social judgments based on
cognitive heuristics: rules of thumb for information processing that make individuals able to think fast and easy, but very often they are wrong.

5. Conclusions

Currently, the financial market represents a domain that requires continuous study and a better understanding, being subject to on-going changes and adaptations to the “new order of the global economy”. The mutations that occurred during 80s and 90s in finance and technology have led to deep transformations in the structure of the market, as well as in the transactions carried-out on such markets.

References