International Journal of Economics, Commerce and Management
United Kingdom Vol. IV, Issue 9, September 2016
http://ijecm.co.uk/ ISSN 2348 0386

NEGATIVE EMOTIONS AFFECTING INVESTMENT RETURNS IN STOCK MARKET

Chang Yann Jie
IIC University Of Technology, Cambodia
yjie0509@gmail.com

Leow Chee Seng
IIC University Of Technology, Cambodia
drleowcs32@gmail.com

Abstract

Previous work on investment-decision making suggested that emotions prevent investors from investing in a rational way. This paper will study the common negative emotions of investors that contribute to the unsatisfactory investment return in stock market. The negative impact of emotion-driven investing upon long term wealth can be devastating. Thus, this paper is important to examine the negative emotions of investors and the ways to control those emotions in stock market investment in order to achieve financial freedom. Many studies showed that most of the investors achieve equal or below average performance not because of lack of knowledge or intelligence, but the contributing factor is due to their investment decision is always influenced by their emotions. Thus, in order to become a successful investor, the understanding of how emotions can influence investors' behavior and hence their investment result is crucial.

Keywords: Negative Emotions, Unsatisfactory, Investment Return, Stock Market, Financial Freedom

INTRODUCTION

Emotional investing can lead investors to make many irrational decisions that cause them to lose money in stock market. Emotions, and the behaviors they trigger, were part of the reason why investors underperformed the S&P 500 by nearly 4 percentage points, on average, over the past 20 years (Dalbar, 2013). Investors tend to buy high and sell low due to the desire to jump into a hot investment and to sell losers to avoid further losses. When the market rises, most of the investors get excited, so they will jump in to buy, but when the market drops, they will sell it due to panic. They tend to forget the principle of value investing, and their investment decision is mostly based on emotions, therefore they pay dearly for it due to the mistakes of overreaction. Psychologists have shown that affective reactions are often an unavoidable component of human decision-making (Schwarz & Clore, 1983, 2003; Finucane et al., 2000). Although emotions can be useful to inform the decision maker, there are several situations in which emotional reactions lead people to make costly mistakes (Finucane et al., 2000; Loewenstein, Weber, Hsee &Welch, 2001).

This paper will make an attempt to discover the major negative emotional influences which can have real impacts on the ability of investors to make the right investment decisions, and thus affecting their investment return. Besides, after knowing and understanding the emotions, the findings can guide the investors on keeping their emotions in check and limit the extent to which the emotions influence their investment decisions. By avoiding those negative emotional influences, investors can think and decide rationally based on their investment strategies and achieve investment success.

THE STUDY

The key research question to be answered in this paper is: what are the emotion-based behaviors that hurt the investing performance in stock market?

In order to achieve the objectives of the study and to answer the key research question, a critical analysis of related literature was conducted and the major emotions that contribute to investment failure as well as several ways to control the emotions for investment success are being determined.

EMOTION-DRIVEN INVESTMENT DECISION

The following behavioral finance concepts reflect how emotions can have real impact on the ability of investors to make a right investment decision.

Overconfidence

Research shows that internet trading leads to costly overconfidence (Odean and Barber, 1999), and the overconfident investors who trade too much tend to have lower net returns once costs are taken into account (Barber and Odean, 2000). Since every trade involves trading fees, the more you trade, the higher is the cost of investment. Moreover, most of the investors miss the chance to gain the optimum return because they sell too early for a small profit when the stock price rises a bit. Most of the time, the share price will surge up further after they sold it. One study found that investors over-estimated their performance by as much as 11.5% per year (Glaser and Weber, 2007). Investors who are confident tend to conduct more trades (Trinugroho and Sembel, 2011), and lots of trading are hazardous to the investment return. Over time, it's the difference between a good retirement and no retirement. The returns of heavy traders, on average, lag behind the returns of light traders, and the return of light traders, on average, lag behind the returns of those investors with long-term horizon who adopt buy, hold strategy and rarely trade.

Loss Aversion

People tend to avoid losses more than to acquire gains. Most studies suggest than losses are twice as powerful, psychologically, as gains (Kahneman, 1992). Investors are reluctant to realize their losses although they have been advised that the market is in a downtrend or the stock fundamental has deteriorated. This is because losses will make people feel more pain, so investors tell themselves it's not a loss until they sell. In the end, investors end up seeing their stocks continue to drop and they lose their courage and choose to sell at the bottom. This causes the investors to incur a permanent loss and hurt their portfolio return. Shefrin and Statman (1985) found that the tendency to hold losers too long and the tendency to sell winners too early can lead to poor investment decisions. A decision to sell the stock that has fallen 20% in its price, instead of waiting until it drops 80%, can protect the portfolio value.

Regret Aversion

Human nature always encourages investors to act to correct a regrettable decision, to exert some level of control (Presson and Benassi, 1996). For instance, an investor may understand that a specific stock is losing value and she should cut loss, but ends up keeping it in her portfolio anticipating the regret she would experience if the stock recovers the loss (Shefrin & Statman, 1985).

Herd Mentality

Investors tend to buy when the market is rising, more obviously when the market has risen sharply. On the other hand, many investors often move the money out of the market after the prices have fallen. Thus, most of the investors fall into the trap of buying high and selling low. The herd mentality is one of the common reasons why most of the investors perform badly in the stock market investment. Not only individual investors follow the crowd. The herd mentality of professional investors is clearly documented as well (Nofsinger and Sias, 1999). Investors must become a contrarian in order to achieve extraordinary gains in stock market. They should buy when everybody is afraid during market crisis and sell when other investors are buying aggressively in the bull market. This is because widespread market pessimism can drive the stock price below its intrinsic value, thus contrarian investors can take the opportunity to buy a valuable stock at discounted price and sell for a profit when the stock price reaches its fair value.

Short-term Thinking

Humans prefer immediate benefits than greater future rewards. As a result, it is often quite difficult to make long-term goals a priority in our everyday investment decisions. Most of the people are investing to pay for some events down the road, such as retirement or school fees for their kids. This is a long term goals which take years, even decades away. But while most investors plan for the long run, they react to the short run. While long term investment plans benefit from compound growth, short-term reactions are always affected by emotions and randomness. Trying to get rich quickly is not the right strategy to employ when investing in the stock market. This is because the get-rich-quick mentality will cause investors to do irrational decisions that would ultimately lead them to lose money in the stock market.

KEYS TO RULE THE EMOTIONS

It is tough to not let the emotions influence our investment decisions. However, there are some steps that investors can take to minimize their impact and keep them from losing money in the long run.

1. **Have a long-term investing plan that includes specific goals.** Investors should have concrete goals, preferably with intermediate targets along the way, so they will keep perspective on how close they are to achieving them and spend less time obsessing over daily fluctuations on the stock prices. The long-term goals can avoid them from overreacting when the stock market undergoes a correction. Stocks may fluctuate in the short term, and make us emotional about investing, sometimes they may even decline by 30-50% in a single

year, but historically, they yield an average annual investment return of 10%. When investors decide to get rich slowly and steadily, emotional investing loses much of its destructive power because they are looking at buying fundamental good stocks and keep for 10-20 years horizon. Warren Buffett stated that “If you aren’t thinking about owning a stock for 10 years, don’t even think about owning it for 10 minutes.” This is because no matter how good the business is, it will still need a long time to grow and prosper.

2. **Use the past experience as a guide to respond wisely to future market moves.** If someone panicked in the past when the market dropped, then he or she should adjust the strategy to reflect the lower tolerance for risk and volatility. Although market can fluctuate wildly in the short-term, but over the long-term the market has been definitely showing its stability. Investors should be greedy while others are panicked, and be panicked while others are greedy. A successful investor should be a contrarian who goes against prevailing market trends by buying stocks which are undervalued at deep discounted price, then hold tightly the stock and sell it when they perform well again.
3. **Make investing in stock market a regular habit rather than a knee-jerk response to changing market conditions.** Investors can set up automatic purchases to invest certain fixed amount of money on a regular basis, regardless of whether the stock market is going up or down, so they won’t need to pay much attention to daily fluctuations in the markets. This is because investors’ focus will be shifted to accumulating assets on a regular basis, instead of timing the market. In addition, based on dollar-cost averaging strategy, it will offer to buy more shares when the price is low and fewer shares when prices rise, giving them more benefit from any temporary bargain that comes along.

CONCLUSION

Buying low and selling high is much harder than it sounds. If investors can keep emotions out of their investing picture, they have taken a big step towards being a successful investor. Investors should be disciplined and focused on tested strategies in order to make money in stock market. Moreover, investors should put greater emphasis on other areas of their life, such as spending quality time with their families and maintaining a good health, in order to put things in perspective and to lessen anxiety. They need to practice inactivity, not hyperactivity in the stock market. Doing nothing is often the right thing to do and is one of the most powerful strategies in stock market investing which most of the investors don’t aware of. Investors should only make investment decisions when the opportunities arise. When investors do have an emotional response to market news, acknowledging the response and understanding that it is perfectly natural; however, they need to decide whether to let that emotion dictate their actions. Investors should always remind themselves that they have a long term financial goals to be achieved and don't be influenced by the daily market news. Investors need to avoid the impact of emotions on their decision-making process in order to earn money consistently from stock market investing.

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