INVESTORS PSYCHOLOGY AND THE HERD EFFECT ON THE FINANCIAL MARKETS

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Abstract: Human psychology is the key to understanding the world and also to understanding investment. Go against the crowd, against the specialist advices in the papers and in the end, you will be one of the few winners. This is what the ”against the crowd” supporters tell us. The market will always give you the chance to play your card differently, the problem is: can you go against every one of our instincts? Are you strong enough as to take decisions against every impulse that you get from your body and your mind?

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1.The impact of human emotions on investments

Emotions become our enemies when we take decisions on the market and in business in general. On a bull market (growing) we tend to buy excessively, almost blindly and to hear only what we are interested in hearing, out of the information that the market comes with. We instinctively want the price to grow, which is why we act like the bull, exposing ourselves even more to losses. On a bear market (decreasing), by contrary, doubt, fear and lack of confidence grow proportional to the decrease of the prices. Thereby, the investors tend to ignore the signals that announce a new growing tendency of the market.

Another problem that the derivatives especially raise, referees to that exaggerated optimism specific to people, optimism that makes the idea of short transaction and betting on price dropping extremely difficult. Therefore, short transactions seem very risky, because in some way they go against human nature. To be able to gain from a dropping market, the investors need, first of all, to give up their unconscious need of seeing the market grow on a medium and short term, which is obviously against human nature. But the truth is that a short position on a dropping market brings much more money and faster than a long position on a growing market. This happens because the bear market is commonly on a short term being propelled by the investors’ fear, while the bull market has much slower moves until it gets to the top.

As a general rule, prices follow the markets trend that is why the most common method in investments is that of following the trend untill it finishes, taking into consideration that, according to the laws of movement, a market that has taken a certain direction, is more likely to continue on the same direction than to change it. So, the market will follow the trend untill it finds an equilibrium point or a reason to change its direction. Also the derivatives market is a market where ”history always repeats itself”:

it will always grow because of some rumors moving around and it will drop back again when the real information emerges; investors will either take a position too early or take the losses too far. The markets psychology has never really changed which determines history to repeat itself, the past representing an excellent map for the forecast of the future. This scenario is typical in the investors world: the so called"experts" come with statements like"nothing can stop this market" and the investors not only believe these statements but they also sustain them with their life-savings. As the prices increases the number of buyers also grows massively, untill the market gets to saturation. By then, the first ones to sell are the ones who will get the profit. The most important profits go to those who got into the market when prices were very low and sell now when they are approaching their maximum. But most of the investors bought sometimes on the way, most of them even when the prices were already high relying precisely on those expert advices in the media. The last ones will most definitely miss the maximum of the trend and will only start selling after the first category of investors, when the prices are already on a descending trend. Therefore, on the descending trend there are a lot of sellers but only a few buyers which determines abrupt decreases of prices, in a market that has become very illiquid and where most of the investors, in their panic, are willing to sell at any price. When prices drop to the point where it's worth it, the professionals come back into the market, buying from those who sell desperately to diminish their losses. This way, the market stabilizes itself again, prices start to grow and the same cycle starts again.

The first category of investors, which we talked about above, the ones who get profit out of their investments, fit into the category of those who go against the crowd, the investment theories being very much preoccupied these days of this investment method. But there still stands one question that needs an answer before it all:" If this theory of investing against the general trend really works so well, then why isn't it used by more investors?" The answer comes together with the second requirement of the efficient investments: you have not only to know the theory but also to apply it, without deviating from it, even when it's very tempting. The success of this strategy consists in always going against the normal reaction that the market induces you, against your own instinct which for 90% of the investors proves to be impossible.

Also it was proved that the most appropriate markets for this strategy of investing against the crowd are those with a very high liquidity and massive public participation. The hypothesis is based on the fact that, the bigger the number of unprofessional investors on a market, the more probable it is for the crowd to instinctively follows the general trend. Because of the reduced costs of transactions, the large number of computer owners and the wide internet access, the number of amateur investors on the market has grown a lot in recent years which makes the against the crowd strategy stronger than ever.

A very important segment of the latest books published on financial investments, consider the study of investor psychology much more important than on the spot market[3].The problem continues to be, the fact that investors can not properly apply the strategies and they are discouraged every time the market evolves a little bit, in a wrong direction. The central problem debated, refers to the overreaction of the

[3] „Also called cash market. A market in which traded assets are delivered and paid for immediately (or within two or three days depending on local regulations). The price quoted for a trade on the spot market is called the spot price." (Financial Times lexicon definition - http://lexicon.ft.com/term.asp?t=spot-market)

investors to certain events on the market but also to the fact that this reaction is part of a set of parameters that can be studied and used in our favor, being both predictable and systematic. Studies show that the way people divide their investments in "good" and "bad" changes in time, these classifications leading most of the times to the overvaluation of the first ones and the underestimation of the others. Thereby, the "good" investments were the precious metals in the '70s, real estate in the '80s and everything related to the emerging Asian markets in the last few years. In respect to "bad" investments, a good example is that of pharmaceuticals in the USA which in 1993 reached the minimum price because of the general belief on the market that the new health system supported by the Clinton administration at that time, was going to depreciate the whole pharmaceutical industry. In the following years, the pharmaceutical industry turned into the leader of the financial markets. Also, another undervalued case it that referring to the IT industry in 1991-1992, only in a few years the companies in this industry managing to multiply its profits. The conclusion of all those who studied investors psychology is the same: the tendency of following the trend and the so called herd effect, causes a rush to happen, both at the market entrance and at the exit, many being knocked off in the jam.

2. The domino effect on the market

In 1876, President Rutherford B.Hayes, after he participated to the first telephonic conversation between Washington and Philadelphia, declared:"It is a great invention, but who would want to use it?" In 1943, Thomas J. Watson, founder of IBM, declared" I think there is a world market for five computers". On June 3rd 1979 The American Institute of Architecture, was awarding the architect of the new arena built in town for excellence in architecture. The next day, the roof of the arena collapsed. Unfortunately the history of these kinds of predictions in economy and finance is not at all different.

The quantification of the investment risks and the ranking making, turned into a very good business in recent years. The companies that make these rankings, have become opinion leaders on the market, influencing the decisions of a large number of investors, either directly, through the investment fund that administrates their portfolios or through the advices of the consultants they work with. Even though the market is supposed to be "efficient" and the investors continue to believe in the strength of information and opinion leaders, the statistics show that the highest profits go to the individual investors, most of the investment companies situating themselves below the markets average. The "professional" opinions have proved themselves wrong every time the market passed through a crisis and the panic always got over the market when it made sudden moves against the general expectations.[4]

David Dreman, one of the supporters of the "against the current investments", offers a very conclusive example of the way the price for the shares of a company varies in time, based on the way that company or the entire industry is "labeled" on the market. Thereby the shares of Compaq Computers lost 65% of their value between 1991 and 1993, going down from 9 dollars to 3 dollars per share. Only in four years time, in 1997 they were up again, this time at 79 dollars per share. The huge change in price, unacceptable in a market that claimed to be stable, was a consequence of the fact

[4] Dreman, D., (1998), „Contrarian Investment Strategies:the next generation.Beat the market by going against the crowd", Simon & Schuster Publishing House, New York, p. 63

that in the beginning of the `90s, most of the specialists did not believe in the potential of the IT industry. So, the author tells us that, what is wrong in the investors behavior is their attitude towards experts and the tendency of underestimating their own opinions and analyses concerning the subject, in favor of the "expert opinion".

Herbert Simon, awarded with the Nobel Prize for psychology, has studied for many decades the human capacity of functioning like an information processor. The findings of his study show that humans only react at a certain part of the information they get, that is why receiving the same information they often reach different conclusions. Furthermore, he demonstrated through a comprehensive study that most of the time the experts in a field do not come with better forecasts than people with no contact with the field, by contrary some of them are below the average. Regardless of the chosen field, the analyst is bombed with a huge quantity of very hard to quantify information which takes him to misleading the public. In anxiety and uncertainty conditions, receiving too much information on the market, investors get to the point where they see any stereotype they want, ignoring much more important and obvious things.

Therefore, the investors tend to listen to the expert advices and to follow the investment decisions they recommend, reacting according to mass psychology, the way everybody does. This way we get to exaggerated reactions that produce the usual repeated and predictable errors.

3. The investors exaggerated reaction

The term „investors exaggerated reaction" is used in the strategy called „investing against the crowd", referring to the fact that investors repeatedly overestimate the potential of „good" shares and underestimate the potential of „bad" shares. Moreover they repeatedly extrapolate these positive or negative believes about the market, creating fix ideas about the future evolution of each type of shares.

The exaggerated reaction plays a role in every human activity, being also present on the financial markets. Exaggeration takes place in both directions, the consequences being equally devastating. As an example, the case of the abrupt fall of the emergent Asian markets in 1997 is very well known; the South Korean market got to the minimum of its last 10 years. The situation came as a consequence of the demand overcrowding on these markets, the losses most of the investors had then showing that no market is 100% safe and not even a „blue chip"[5] works always as expected. Exaggerating the positive trend of this market resulted in its congestion and a series of important losses when the trend reversed. In august 1982 investors and the media, were forecasting a market decline in the following period; this was just a few weeks before the highest market growth in history when the Dow Jones grew eight times. This time the negative feeling was not the one that prevented investors from taking advantage of this unique growth, most of them not being present on the market at that time nor having a position that speculated the drop of prices. The question that rises regarding these situations is: How should an investor react? Should he enter the market after the

[5] A blue chip stock is the stock of a well-established company having stable earnings and no extensive liabilities.Blue chip stocks pay regular dividents even when business is faring worse than usual.The term is derived from casinos, where blue chips represent the greatest value among the many colours of chips.
source: http://en.wikipedia.org/wiki/Blue_chip_(stock_market)

sudden reversal of the market occurred or should he wait for the market to calm down? As difficult as it is to sit and watch from a distance as the market grows, specialists recommend it, as entering straight in the middle of the panic can have adverse effects mainly because the new trend may not last. The true specialists are already in the market when the trend shifts and are out before it touches the maximum.

The hypothesis of investors exaggerated reaction is based on a series of statements it supports:[6]

- „Good" shares bring profit below the markets average but the „bad" shares go beyond the average
- The unexpected positive movements on the market lift the value of the „bad" shares more that the value of the „good" ones
- The unexpected negative movements knock the value of the „good" shares much more than the value of the „bad" ones
- There are two distinct categories of unexpected market movements: *„the event trigger"* (positive movement on the „bad" shares and negative on the „good" ones) and *„ the event strengthening"* (unexpected negative movements on the „bad" shares and positive on the „good" ones). The first category causes much more significant price movements than the second one.

Thereby, even the smallest disappointment regarding the „good" shares will lower their price while positive news will have insignificant effects. With „bad" shares, things will happen the other way around, which means they are more profitable when we expect a growth than when we bet on a decreasing trend. Two researchers in the field, Werner DeBondt and Richard Thaler, asserted that extreme price movements are mostly followed by similar movements but in the opposite direction. Thus, the more important the price changes in one direction, the more important the adjustment that follows. The two, demonstrated through an extensive research that few companies managed to sustain an uninterrupted growth rate for long time in history. In the same time though, even less companies get to total extinction, almost any descendent trend having its chance to recovery.

What takes „good" shares to a high profitability rate and „bad" shares to a low rate is the magnitude of reactions on the market. The moment when the smallest or the highest possible price is touched, the chain reactions of the investors acts like a ground for the success of those who choose to invest against the trend. The most frequent error of the investors is the fact that they tend to see the existent trend like a standard, however extreme the situation may seem sometimes.

4. Conclusion

Trading futures or shares require more than mastering a system, understanding the market, understanding the functioning of supply and demand, economic theories, fundamental or technical analyses. A market study is also a study of human psychology so, self-knowledge and the capacity of analyzing both your own behavior as well as that of the group, represent necessary elements of the investors success. Especially on the future markets this capacity of understanding and predicting people's reaction in different situations is essential, because the futures price is very sensitive to any kind of change in the transactional behavior of the investors.

Psychology represents in the same time the reason for the high performance of some methods and practices as well as the reason for the poor performance of others, as proof that trading is not a science.

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