Stock market psychology and behavioural finance: What investors should know

By Rahul Sharma, ET CONTRIBUTORS Last Updated: Mar 17, 2024, 06:12:00 PM IST

Synopsis
Financial success is not a hard science. It's a soft skill, where how you behave is more important than what you know. While everybody is looking at the same stock prices, same charts and has access to the same balance sheets and management commentary, not everybody has the same outcome in their trading and investing journey.

Financial success is not a hard science. It's a soft skill, where how you behave is more important than what you know. While everybody is looking at the same stock prices, same charts and has access to the same balance sheets and management commentary, not everybody has the same outcome in their trading and investing journey. This boils down to the single most important factor responsible for all the outcomes – our psychology and the subsequent behaviour that is driven by this.Most often than not this happens due to our existing beliefs and blind spots which most of us don't even know that they exist. Below are a couple few psychological/sentiment indicators that can help you decode various phases of the market:

VIX: this index generates a projection of volatility, which can show the speed and range of changing prices over a period. Investors may use the VIX to gauge market sentiment, specifically how fearful market participants feel.

Put-call Ratio: This ratio analyses the volume/oi of puts, or rights to sell an asset, and calls, the rights to buy an asset, over a period. Investors use this ratio to gauge the overall sentiment of the market because it can imply a possible reversal in market trend.

Fear & Greed Index: The fear and greed index is a market sentiment indicator that measures the emotions and psychology of investors in the **stock market**. It provides an overview of the market of whether market participants are primarily driven by fear or greed at a given time.

Markets may be a voting machine in the short run but they do provide a prism to make us believe what the "group" thinks and this can lead to a variety of biases like "an illusion of being indestructible", "collective rationalisation" or simply "being blinded to pitfalls".

According to **behavioural finance** theory, there are several types of cognitive biases that can affect an investor's judgment. Being aware of the most common ones can help you avoid them in order to make more rational decisions after all, It's not what you do in the markets that matters, but it is what you "don't do" that counts!

Overconfidence

Most people tend to overestimate their abilities in many areas. When you overestimate how much you know about the market or a specific stock, you'll be tempted to make risky decisions like trying to time the market, which is trying to predict the best time to buy or sell stocks, or overinvesting in high-risk stocks, which are more likely to lose money.

Herd Mentality

Humans are social animals, so going along with the crowd is in our nature. From the hot new fashion trend everyone is wearing to the crowded restaurant that requires you to make reservations months in advance, people tend to make choices based on what others are doing. In financial markets, however, herd mentality can lead to asset bubbles, which is when the price of an asset like a stock rises rapidly but will eventually fall, and market crashes, which occur when a lot of investors sell off their stock.

Loss Aversion

People feel the pain of a loss more acutely than the euphoria of a win, even if they win more than they lose. In financial terms, investors will often hold onto stocks they should sell to avoid realizing a loss. Conversely, they may sell too early to avoid further losses, when waiting for a market rebound would be the better option. Often investors with a strong loss aversion bias have portfolios that are too conservative, underperforming market norms.

Confirmation

Confirmation bias explains how two people with opposing viewpoints can hear the same information, and each comes away believing it supports their opinion. When you have a firmly-held belief, you give heavier weight to evidence supporting your belief while minimizing evidence contradicting it. In finance, confirmation bias can lead you to overlook investment strategies or assets that fall outside of your bubble, causing you to miss significant growth opportunities. You may also invest too heavily in one area because you haven't fully analysed the risks.

Behavioural Investing

While biases are a critical component in behavioural finance, there are other key elements in the theory, as well.

Behavioural Investing

While biases are a critical component in behavioural finance, there are other key elements in the theory, as well.

Heuristics

Heuristics is the process of simplifying a problem when you don't have enough information to make a "perfect" decision. In these instances, you're likely to use a shortcut or rule-of-thumb to make a decision that feels right. Heuristics simplify the decision-making process, which means they simplify the financial decision making process, as well. Without them, you'd have to spend much more time making decisions. However, relying on heuristics without carefully analysing investment options can lead to irrational or incorrect decisions.

Mental Accounting

In mental accounting, you place different values on money based on how you obtained it. If you buy a winning lottery ticket, for instance, you might blow it all on a spontaneous shopping spree even though you carefully budget your paycheck. This can lead to irrational financial decisions.

Anchoring

Anchoring is a type of heuristics that involves subconsciously using irrelevant information as a reference point. Historical values are common anchors. For example, if you bought a stock for Rs. 100 but it starts losing its value, you may be tempted to hold onto it because you don't want to sell it for less. Salespeople take advantage of anchoring by starting negotiations at far above market value. The inflated price serves as an anchor, so when they come down, it'll seem like a good deal.

Successful Trading and Investing requires a lot more than having the right process and discipline. In the long run, the hardest financial skill is getting the goalpost to stop moving.

*(**Rahul Sharma** is Director & Head – Technical & Derivatives Research, JM Financial Services. Views are own)*