# TABLE OF CONTENTS

| ACKNOWLEDGEMENTS                           | xii |
| LIST OF FIGURES                           | xiv |
| LIST OF TABLES                            | xvii |
| LIST OF SYMBOLS AND ABBREVIATIONS         | xviii |
| ABSTRACT                                  | xxii |

## 1 INTRODUCTION 1

1.1 Preamble 1

1.2 Research Objectives 5

1.3 Research Methodology 5

1.4 Outline of the Thesis 6

1.5 Highlights of this Thesis 8

1.5.1 ASM model of BSE 8

1.5.2 Investor Behavior in BSE 8

1.5.3 Market Maker Model for BSE 8

## 2 DYNAMICS OF STOCK MARKETS 9

2.1 Introduction 9

2.2 Securities Market 9

2.3 Market Segments 10

2.4 Market Microstructure 10

2.5 The Organization of Stock Markets 12

2.5.1 Traded Instruments 12

2.5.2 Market Regulation 13

2.5.3 Orders and Quotes 13

2.5.4 Market Participants 14

2.5.5 Trading Sessions 16

2.5.6 Execution systems 16

2.5.7 Market Rules 19
2.6 Price Formation and Behavioral Aspects
2.6.1 Order Initiation and the Behavior of Investors
   2.6.1.1 Policy Statement
   2.6.1.2 Investment Strategy
   2.6.1.3 Portfolio Maintenance
   2.6.1.4 Monitoring
   2.6.1.5 Time Horizon
2.7 Order Flow, Role and Behavior of Financial Traders
   2.7.1 Order Execution and the Role of Brokers
   2.7.2 Order Execution and the Role of Market Makers
   2.7.3 Execution of Orders on Call Markets
2.8 Execution of Orders on Continuous Markets
2.9 Challenges to Modeling Market Dynamics
2.10 Characteristics of a Good Market
2.11 Information in Markets
2.12 Market Efficiency
2.13 Theories of Modern Finance
2.14 Approaches for Studying Market Dynamics
2.15 Market Anomalies and Empirical Studies
2.16 Behavioral Finance and Experimental Economics
2.17 Market Microstructure Models
2.18 Recent Approaches for Study of Financial Markets
2.19 Behavioral Bias
   2.19.1 Behavioral Biases in Investor Decision Making
   2.19.2 Risk Attitude
   2.19.3 Portfolio Allocation
   2.19.4 Portfolio Management
   2.19.5 Information Processing and Learning
   2.19.6 Social Interaction
   2.19.7 The Role of Emotions
   2.19.8 Heuristics and Biases
2.20 A Cognitive Model of the Individual Investor
3 AGENT-BASED ARTIFICIAL STOCK MARKETS (ASM) 46
   3.1 Introduction 46
   3.2 Artificial Stock Markets (ASM) 46
      3.2.1 Characteristics of ASM 46
      3.2.2 Agents 47
      3.2.3 Agent-based Environments 48
      3.2.4 Nature of Stock Markets 49
      3.2.5 Features of a Stock Market 50
      3.2.6 Agent-based Computational Finance 50
      3.2.7 Agent-based Modeling of Stock Markets 50
      3.2.8 Weaknesses of Agent-based Modeling 51
      3.2.9 A Definition of ASM 51
      3.2.10 An Overview of ASM 52
   3.3 A Survey of Call Market (Discrete) ASM 52
      3.3.1 Santa Fe ASM 53
         3.3.1.1 The Agents 53
         3.3.1.2 Market Structure 53
         3.3.1.3 World Bits 54
         3.3.1.4 Structure of Agents 55
         3.3.1.5 Constant Absolute Risk Aversion (CARA) 55
         3.3.1.6 Classifier Systems 55
         3.3.1.7 Genetic Algorithm (GA) 55
         3.3.1.8 Reported Results 56
         3.3.1.9 Discussion 56
      3.3.2 Genoa Artificial Stock Market (GASM) 56
         3.3.2.1 Micro-structure of the GASM 56
         3.3.2.2 Discussion 58
      3.3.3 Agent Based Model for Investment (ABMI) 58
         3.3.3.1 Market-Making Model 58
         3.3.3.2 Behavioral Models 59
3.3.3.3 Discussion 60

3.3.4 Business School (BS) 60
3.3.4.1 Traders 60
3.3.4.2 Evolution 60
3.3.4.3 Discussion 61

3.3.5 LeBaron’s Model (BM) 61
3.3.5.1 Agents 61
3.3.5.2 The Information Set 62
3.3.5.3 Trading and Price-setting 62
3.3.5.4 Adaptation and Evolution 62
3.3.5.5 Discussion 63

3.3.6 Comparative Study of Discrete ASM 63
3.3.6.1 Structure 63
3.3.6.2 Trading 64

3.3.7 Findings of Call Based Trading Session ASM 66

3.3.8 A comparison of Important Parameters 67

3.4 A Survey of Agent Based Continuous Session ASM 68
3.4.1 Continuous Time Asynchronous Model (CTAM) 68
3.4.1.1 The Market 68
3.4.1.2 Market Price Discovery 69
3.4.1.3 Discussion 70

3.4.2 Electronic Market Maker (EMM) Model 71
3.4.2.1 The Model 71
3.4.2.2 Discussion 71

3.4.3 Continuous Extended Glosten Milgrom Model (CEGM) 72
3.4.3.1 The Framework 72
3.4.3.2 The Investors’ Behavior 73
3.4.3.3 The Behavior of the Market Maker 74
3.4.3.4 Discussion 75

3.4.4 KapSyn 75
3.4.4.1 The KapSyn Framework 76
3.4.4.2 Discussion 77
3.4.5 Comparative Study of Continuous ASM
3.4.5.1 Structure
3.4.5.2 Market Participants
3.4.5.3 Trading Sessions
3.4.5.4 Execution System
3.4.5.5 Formation of Price and Traders’ Behavior
3.4.6 Findings of Continuous ASM
3.4.6.1 Patterns in Price Series
3.4.6.2 Autonomy
3.4.6.3 Continuous and Asynchronous Behavior
3.4.7 A Comparison of Important Parameters
3.5 Modular CTAM Model of Katalin Boer Sorban
3.6 Evaluation of Modeling Aspects of ASM
3.7 Summary

4 AGENT BASED ARTIFICIAL STOCK MARKETS TO MODEL INVESTOR BEHAVIOR
4.1 Introduction
4.2 Kim and Markowitz - Portfolio Insurers Model
4.3 Brock and Hommes - Adaptive Belief Systems
4.4 Levy, Levy, and Solomon - Microscopic Simulation
4.5 Lux and Marchesi - Stochastic Interaction and Scaling Laws
4.6 Takahashi and Terano - Based on Behavioral Finance
4.7 Hoffmann et al. – SimStock Exchange Model
4.8 Discussion
4.9 Extensions of LLS Model by Lovric M.
4.9.1 Overconfident Investors
4.9.1.1 Behavior of RII
4.9.1.2 Overconfidence as a Judgmental Bias
4.9.1.3 Modeling Overconfidence in EMB
4.9.1.4 Price Mechanism
4.9.2 Modeling Sentiments in EMB
5 DYNAMICS OF INVESTOR INTERACTION: AN ANALYSIS OF BSE USING AN AGENT BASED ASM MODEL

5.1 Introduction 112
5.2 Agent Based Modeling of BSE 113
5.3 Review of Agent Based Model of LeBaron 113
  5.3.1 Agent Based Model 113
  5.3.2 Assets 114
  5.3.3 Agents 114
  5.3.4 Rules 116
  5.3.5 Input Values to the FFNN - The Information Set 117
  5.3.6 Trading and Price-setting 117
  5.3.7 Adaptation and Evolution 118
5.4 Implementation – Agent Based Model of BSE 119
  5.4.1 Validating the FFNN structure for Rule 119
  5.4.2 Agents Modeled 119
  5.4.3 Parameter Settings 119
5.5 Step by Step Process 121
5.6 Results 121
5.7 Prices 122
5.8 Returns 123
5.9 Statistical Observations 125
5.10 Other Miscellaneous Observations 125
5.11 Variation from LeBaron Model 126
5.12 Future Enhancements 127
5.13 Summary 127

6 AN ANALYSIS OF INVESTOR BEHAVIOR IN BSE USING AN AGENT BASED MODEL 128

6.1 Introduction 128
6.2 Levy, Levy, and Solomon (LLS) Model 129
6.3 ABM of Investor Behavior 130
  6.3.1 Categories of Investors 131
  6.3.2 Behavior of Fundamental Investors 131
  6.3.3 Behavior of Technical Investors (TI) or Chartists 133
  6.3.4 Uninformed Investors 133
  6.3.5 Price mechanism 134
6.4 Implementation and Performance Evaluation 134
  6.4.1 Replication of LLS Model 135
  6.4.2 General Characteristics of BSE Investor 136
  6.4.3 Overconfident Technical Investors 137
  6.4.4 Investor Composition in BSE 139
  6.4.5 Inclusion of Sentiments (Optimists & Pessimists) 141
  6.4.6 Inclusion of Recency/Primacy Effects 143
  6.4.7 Inclusion of Self Attribution Behavior Bias 144
6.5 ABM of NYSE 145
  6.5.1 Observations and Conclusions 146
6.6 ABM of NASDAQ 147
6.7 Limitations of LLS Model 148
6.8 Summary 148

7 AN AGENT BASED MODEL OF A MARKET MAKER FOR THE BSE 150

7.1 Introduction 150
7.2 Overview of the Chapter 150
7.3 Trading in Stock Exchanges 151
7.8 Implementation of EGM for BSE
7.8.1 Functions of the Market Maker
7.8.2 Demonstration of the EGM for BSE
7.8.3 Graham’s Intrinsic Value (GIV)
7.8.4 Implementation of EGM
7.8.5 Results

7.9 Future Extensions
7.10 Summary

8 CONCLUSION
8.1 Summary
8.2 Contributions of the Thesis
8.3 Scope for Further Work

APPENDIX
A AN OVERVIEW OF SECURITIES MARKET IN INDIA & FUNCTIONING OF THE BOMBAY STOCK EXCHANGE (BSE)
A.1 Market Turnover and Market Capitalization
A.2 Regulation of Stock Exchanges
A.3 Institutional Trades
A.4 Foreign Institutional Investors (FII)
A.5 Stock Indices
A.6 Returns in Indian Markets
A.7 Liquidity
A.8 Bombay Stock Exchange (BSE)
A.8.1 Trading Groups
A.8.2 Basket Trading System
A.8.3 Technology
A.8.4 BSEWebx.co.in
A.8.5 BSE Website
A.8.6 Safety of the Market
A.8.7 Membership of the Exchange
  A.8.7.1 Brokers and Sub-brokers
  A.8.7.2 Remisiers
  A.8.7.3 Market Makers
  A.8.7.4 Trading and Settlement
    A.8.7.4.1 BSE On-Line Trading (BOLT)
    A.8.7.4.2 Listed Securities
    A.8.7.4.3 Permitted Securities
    A.8.7.4.4 Tick Size
    A.8.7.4.5 Closing Price of Scrips
    A.8.7.4.6 Settlement: CRS
  A.8.7.5 BSE Indices
  A.8.7.6 Information Dissemination
  A.8.7.7 IT Support for Operations

A.9 Summary

B  FEED FORWARD NEURAL NETWORKS TO MODEL AGENT RULES

B.1 Introduction

B.2 Investment Decision: Risky Vs Risk Free Asset
  B.2.1 Artificial Neural Network (ANN)
  B.2.2 Modeling BSE SENSEX
  B.2.3 Model Architecture of FFNN-1
  B.2.4 Input Values to the FFNN-1: The Information Set
  B.2.5 Results: Training & Testing FFNN-1
  B.2.6 Radial Basis Function (RBF) Network
  B.2.7 Results: Training and Testing RBF Network

B.3 Investment Decision: Between Two Risky Assets
  B.3.1 The Concept
  B.3.2 Model Architecture of FFNN-2
  B.3.3 Training of FFNN-2
  B.3.4 Results
B.4. Future Extension 203
B.5 Summary 204

C ENTITIES MODELED AND PSEUDO-CODE FOR STUDYING
INVESTOR BEHAVIOR IN BSE (MODIFIED LLS MODEL) 205
C.1 Entities modeled 205
C.2 The Main Program 206
C.3 Aggregate Demand Function 207

D DATA PERTAINING TO MODELING OF INVESTOR
BEHAVIOR BIAS 209

REFERENCES 220

LIST OF PUBLICATIONS (BASED ON THE PH.D WORK) 231