## Chapter 1

### Introduction

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1.1 Introduction

According to Robert Neal and Simon Wheatley, (1998) it is the common belief among the people about the stock market that the best time for buying stock is when individual investors are under the mood of selling and best time for selling is when individual investors are under the mood of buying the stock. This citation in their article for investor sentiment provides deep understanding and the base for the development of this chapter. In the stock market the view of individual investors is important. Individual investors are frequently wrong. Understanding of Individual investor sentiment may give an idea about the best timing of investment decision, but nothing has been scientifically tested.

The Efficient Market Hypothesis (EMH) has been a dominating theory among Economics and financial theories, which suggests that market prices fully reflect all relevant information (Fama, 1970). It has been used widely to theoretical models but experiential studies of equity shares prices show disagreement on fundamental of the price-discovery process (Lo, 2007) as per efficient market hypothesis. The EMH subsequently faced both theoretical and empirical challenges and gradually loses its importance just as other once-fully supported economic theories must encounter at some stage. The assumptions of EMH about the individual investor’s behaviour are often called into questions like rationality of individual investors, irrelevance of irrational investors and perfectly working arbitrage. The proponent of the EMH proposes that active money management is wastage of effort, and it does not justify the expense incurred. They suggest that investors would do best by pursuing a passive investment strategy of indexing their portfolios and does not try to outperform market by investing in undervalued stock.

The prevalent investor’s sentiment in the stock market plays an important role in the economy as it impacts the business cycle and financial situation of an economy. Investor’s sentiment works as proxy for investor’s group behaviour and affects the stock market. The contemporary research is focusing on the role of an investor’s sentiment and it’s consequence for financial markets and organization. There is growing body of both theoretical and empirical literature focuses now on testing the
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role of investor’s sentiment and its implication for financial market and organizations. This literature provides evidences of market anomaly like excessive trading volatility, predictability in returns of stock and investor’s over or under reaction to corporate announcements. Consequently, contemporary research shifted its focus on exploring drivers of their behaviours and its implication for market efficiency. But, most of evidences remain controversial so the debate relevant to the root cause of investor’s sentiment and its impact of asset prices is still continuing (Ronald Domingues, 2008; Sehgal et al. 2009).

The part of the excess volatility in stock prices that has not been explained is one of the most important anomalies in finance (Campbell and Shiller, 1988; Shiller, 2003). It also represents one of the biggest challenges to the efficient market hypothesis. Shiller (2003) advocates an irrational investor’s sentiment or investor’s behavior as the possible explanation for this anomaly. The high stock market valuation peaking in 2000 followed by the largest correction in history is an example of this anomaly and is referred to a stock market bubble. Over the past eras psychologist and behavioural scientist have acknowledged vigorous and logical violation of principles of Bayesian learning, expected utility theory and rational expectations. It creates the question mark on their validity as the descriptive theory of decision making (De Bondt, 1998). Additionally, Herbert Simon highlighted the significance of constrained rationality with regards to the restricted ability of human to adjust optimally to complex environments (Simon, 1991).

Individual investors are subject to biases in judgment, dependent on mental frame and use several heuristics (which might lead to an anomaly in the stock market) has been tested within the field of behavioural finance. Behavioural finance constructed on the two supports (i) “limits to arbitrage” and (ii) “psychology” (Barberis and Thaler, 2003). The psychology provides documentation of many abnormalities and the limit to arbitrage as one of main reasons of deviations form rationality of the human being. The limit to arbitrage proposes that rational investor can’t take the benefit of opportunity created by irrational investors. If irrational investors create deviation in asset prices from its fundamental value or intrinsic value by trading on noise the rational investor must be able to correct this mispricing through arbitrage but in the
real financial markets, the arbitrage strategy involves transaction cost, risk or many constraints so the inefficiency may exist for the long period of time.

Investor’s sentiment is one of the important parts of behavioral finance. It has been defined as the theory of how individual form his belief about the market and securities’ future prices. Individual Investor’s trading in the real world is significantly influenced by sentiment in comparison to institutional trading which usually depends on financial analysis. It is believed that individual investors are trading on noise, i.e. information which may not depend on fundamental facts, but on historical information or mainly attention grabbing news. In the real word, individual investors are subject to biases in judgment and usually make similar mistakes and due to that inefficiency in the market may persist. Now, there is no question for importance of individual investor’s sentiment but to know how individual investor’s sentiment is formed and which factors having significant impact on it is important for academicians as well as practitioners to assess market efficiency.

According to Singhvi (2001) individual investor’s sentiment means Investor’s Attitude and opinion towards investment. Investor’s sentiment means over and under reaction to current information announcements (Baur, Quintero and Stevens, 1996). An irrational behaviour about estimating the future valuation with an overly Bullish (Optimistic) or Bearish (Pessimistic) outlook in the market is considered as market sentiment. Previous research investigating the implicit psychological reason for investor’s behaviour advocate that investor over reacts to an equity shares price trend, gives more importance to the recent or personal information and does not show mean reverting behaviour of equity valuation derived by economic variables towards equilibrium situation (Kahneman and Riepe, 1998; Barberis, Shilfer and Vishney, 1998; Debondt and Thaler, 1985). Kumar and Lee (2006) used a large database of the trading transactions of individual investors and found that sentiment is significantly affecting stock returns. As per Kumar and Lee (2006) investors usually trade collectively in particular stocks which are characterized as small in value, low in price and with low institutional holding. Their trading pattern showcased unidirectional movement in share prices and volume, large enough to surpass the change in fundamental factors.
1.2 Rationale of the Study

Conventional research rests on asset pricing with special emphasis on company focused and economic drivers that hold significant impact on asset prices. Of date, the recent entrant in the area of finance literature has been non-economic factors like the investor’s sentiment as possible drivers of asset prices. Some of the researchers (Eichengreen and Mody, 1998) propose that variation in one group of equity shares prices may affect investor’s sentiment, therefore causing variation in an apparently unconnected group of equity shares prices in the short run and contagion effect is observed.

Human Behaviour has largely been ignored in understanding the financial market. The most of research on investor’s behavior has focused on testing the efficiency of the financial market, identifying the anomalies due to investor’s behaviour and testing the assumption that the economic agent are rational as prescribed by expected utility theory.

Several studies addressing the individual decision process suggest that individuals often update their objective evaluation with their subjective perception especially, under conditions when their involvement with the decision is high (Chaiken and Maheswaran 1994; Maheswaran and chaiken, 1991). Since most investment decisions are a result of high investors involvement, it is reasonable to assume that investor’s subjective perceptions will significantly impact investment decision.

The conventional models are not able to explain fully the movement in share prices. It is therefore suggested that understanding investor’s sentiment would provide a superior explanation of stock price performance. Against this backdrop, it becomes important to identify the factors affecting investor’s sentiment.

Fisher and Statman (2000) and Baker and Wurgler (2006) investigated and found that investor's sentiment may be a critical constituent of the market pricing activity. It is also advocated that the transition in investor’s sentiment may offer better justification of short term movements in equity share prices, than any other set of fundamental factors.
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To identify the factors which influence the Investors sentiment is highly important because it has significant impact on stock price movement (De Long, Shleifer, Summers and Waldmann 1990; Lee, Shleifer and Thaler 1991). Despite the recognition of importance and multi-dimensional nature of the investor’s sentiment neither the factors that constitute this sentiment nor their relative importance have been systematically examined. The goal of this research is to collect and analyze data on individual investors to measure the investor’s sentiment. The outcomes of the study might serve to provide recommendations to the policy makers as well as it will add some new knowledge in the field of behavioural finance.

In India research in behavioral finance is less in comparison to other developed countries so current research is useful to understand what factors considered most by Indian Individual Investors.

1.3 Research Objectives

- To understand investor’s sentiment concept.
- To identify the factors which influence most the investor’s sentiment in India.
- To find out which types of information the individual investors look at when making investment decisions in India.

1.4 Significance and Potential Value

The findings of this research are useful to the industry (Stock Broking firms), Investors, market intermediaries, government and market regulators. Based on factors found to be influencing most the investor’s sentiment (stock picking behavior), the study provides the recommendations to the market regulators to strengthen the financial market and maintain the interest of small investors in the capital market. It will add some new knowledge in the field of behavioral finance.

1.5 Outline of the Thesis

This thesis consists of six chapters and bibliography. Chapter 1 deals with the introduction of the topic under study, research rational, objectives of research, significance and the potential value of the study. This chapter also gives the outline of the whole thesis.
Chapter 2 describes the theory of traditional financial analysis techniques like fundamental analysis used by investors for the determination of intrinsic value of equity share and technical analysis techniques used by investors to predict the price of share based on understanding of the trend in price change through charting.

Chapter 3 contains the review of literature related to the research area. Literature review covers the studies undertaken on financial behaviour of individual investors and more specifically on investor’s sentiment towards equity market. It also provides the theoretical definition of key variables under discussion like investor’s sentiment. It contains different models for the measurement of investor’s sentiment and the model of individual investor’s sentiment selected for the present study. It deals with market specific factors and stock specific factors that influence individual investor’s sentiment. Market specific factors are Herd Behaviour, Macro-Economic Factors, Internet led access to Information, Best Game in Town, Performance Factors and Confidence of Institutional Investors and Risk and Cost Factor; whereas the stock specific factors are Expected Events Surrounding the Stock and Book Value, Financial Characteristics, Psychological Factors and Quality of Management, Past Price Performance and Sector Attractiveness, Who else is Buying and Recommendations of the Financial Community.

Chapter 4 describes research methodology which contains introduction to research, the statement of problem, research objective, hypotheses and research design. Research design includes the population under study followed by the sampling element, sampling frame, sampling technique, sample size, method of data collection, description of research instrument, type of research approach used for the present study, pilot testing of questionnaire, coding of questionnaire, time dimension of the study, research environment, sources of data, data analysis method, software used for data analysis and procedure of research.

Chapter 5 shows data analysis and interpretation, following the objectives under study. Different statistical tools are used based on requirement like descriptive statistics, factor analysis, multiple regression and Variance Inflation Factor (VIF) value. First of all factor analysis is conducted for market specific variables and stock specific variables to extract the factors which affect the investor’s optimism, investor’s participation and investor’s stock market outlook. Multiple regression is
conducted to test the factors significantly affecting the dependent variables under study and the VIF value was considered to assess the multi-collinearity issue. To assess the irrational behaviour of individual investor, frequency analysis is conducted to confirm existence of mental accounting and regret.

Chapter 6 contains findings, conclusion, implications and limitations of the study. Finally, chapter concludes with providing scope for further research.