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Assignment 3 – Individual research project

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What are the prevailing behavioural biases seen in the stock market within the Covid-19 pandemic?

Abstract

The dominance of traditional finance in the financial and economic domain for an extended period has sparked controversy owing to its reliance on false assumptions. Behavioural finance has emerged as a means to address several abnormalities and disruptions in the stock market that conventional finance has been unable to explain. This field has garnered significant interest as it seeks to bridge the gap between traditional finance and these unexplained phenomena. In addition to conducting a comprehensive literature review on the evolution of behavioural finance, this study will also identify certain behavioural biases seen in the stock market during the Covid-19 pandemic. The purpose of this analysis is to provide readers with valuable insights that may help them mitigate possible traps in their decision-making processes.

I. Introduction

Classical finance and efficient market theory have dominated economics and finance for decades (Rosa 2023). Classical finance theory emphasises rational investors and market efficiency (Richardson 2023). The famous efficient market theory states that market players always act rationally to maximise profits. This idea states that stock prices reflect all market information. Since all traders have symmetric knowledge, speculation would disappear in an efficient market (Fama et al.2017).

However, various academics and empirical data have proven that the real market is not as efficient as traditional finance and investors are not always rational (Rosa 2023). Examples include the Great Depression and Global Financial Crisis. The inability of traditional finance to explain financial market breakdowns highlights the need for a more complete framework. Behavioural finance originated as a new and better way for studying financial markets about 1979, according to Kahneman and Tversky. This was important because irrational individuals threatened traditional finance (Cafruny and Ryner 2012).

In conjunction to the financial crisis, the COVID-19 pandemic has caused market volatility and investor conduct that deviates from traditional financial views. Thus, researchers have returned to behavioural finance (Heukelom 2014).

This paper reviews the literature on behavioural finance and examines key psychological biases. To answer the question "Which behavioural biases manifest in the stock market amidst the Covid-19 pandemic?" this essay will examine behavioural finance in the context of the Crisis.
Section II will cover the history of behavioural finance in connection to various famous concepts. Section III will explore four stock market behavioural biases, while Section IV will include numerous Covid-19-era behavioural biases.

II. A development in traditional finance and behavioural finance

Traditional financial theories began in the mid-18th century when numerous concepts evolved to explain investor decision-making and financial markets (Kamoune and Ibenrissoul 2022). The anticipated utility theory underpins conventional finance (Chung et al. 2019). It seeks to explain decision-making. This theory states that market participants compare anticipated outcomes to maximise utility when confronted with risk or uncertainty (Dhami and Al-Nowaihi 2023). The concept of rational economic man (homo economicus) is discussed. This concept refers to a well-informed human who optimises utility within limits (Çalışkan 2022).Rational economic man is based on "perfect rationality, perfect self-interest, and perfect information," the foundations of conventional finance (Baber 2023).Using anticipated utility theory, "Markowitz portfolio theory," which describes how to build an optimum portfolio, was presented.o. Terraza and Mestre (2023) established the "Capital Asset Pricing Model" and Fama (1970) expanded the efficient market theory.t. The theory states that the market is efficient because asset prices represent all available information.e. Salvador et al. (2004) state that Fama's efficient market hypothesis is based on expected utility theory.In 1950, Herbert Simon established the "Theory of Bounded Rationality" to contrast with the idea of homo economicus.The information accessible to investors and their cognitive constraint impact their varied rationality, according to this idea.It also recognises that people predict future outcomes differently.s. Other theories in traditional finance may provide insights into investor behaviour and influence decision-making, but they cannot account for investor irrationality, which has caused many stock market disruptions and abnormalities (Sträter 2023).Sujata and Jaya (2017) include stock market bubbles, overreactions, underreactions, momentum, and reversals as irregularities.s. Since the 1970s, behavioural finance has developed into a strong framework that uses a behavioural and psychological approach to explain numerous anomalies.Investment decisions in uncertain situations are impacted by heuristics and cognitive biases, challenging the idea of full rationality in classical theory.s. Tversky and Kahneman

developed "prospect theory" in the 1970s to evaluate decision-making in the context of risk.k. When earnings are involved, investors tend to be risk-averse.In contrast, investors tend to be risk-seeking when faced with losses.r. This shows losses impact investor decision-making more.g. The theory is well recognised for influencing future research (Kai and Feng 2012).Prospect theory proposes the disposition effect, which states that investors sell assets that have gained value too rapidly while hanging onto assets that have lost value longer.e. In the 1990s, Statman et al. (2023) established the "behavioural asset pricing model" (BAPM).The BAPM divides investors into informational traders, who act rationally, and noise traders, who make cognitive errors and diverge from common wisdom.The BAPM then evaluates how these two groups interact.The "Behavioural Portfolio Theory" was established in the 2000s to examine investors' behavioural biases to manage their portfolios.s. This idea builds a pyramid with several stages, each with different goals and risks.

III. A number of prevalent behavioural biases.

Adriaense et al. (2023) categorises behavioural biases into two distinct classifications, namely emotional prejudices and cognitive biases. Cognitive biases are attributed to the inherent variations in human reasoning, while emotional biases are influenced by certain emotional states. This section will provide an in-depth analysis of many prevalent biases, including overconfidence, anchoring, loss aversion, and herding.

1. Overconfidence

Overconfidence has been characterised by (Singh 2023) as a cognitive bias characterised by an inclination to overestimate one's abilities while engaging in decision-making processes. Individuals that exhibit overconfidence tend to rely heavily on their own knowledge and talents, disregarding input from other reasonable traders. This tendency leads them to develop an excessive level of optimism over the information they possess (Mundi and Nagpal 2023). It has been shown that overconfident investors tend to underestimate the associated risks and exhibit a higher level of optimism towards the expected rewards. This, in turn, leads to an excessive increase in both the quantity and volume of transactions (Shefrin 2018). In conclusion, the substantial increase in trading volumes would ultimately lead to a diminished overall return, so exposing investors to the challenge of maintaining portfolios that are either hazardous or suboptimal. Consequently, this phenomenon contributes to an elevated level of risk and volatility within the market (Chung et al. 2019).

2. Anchoring

In addition to overconfidence, anchoring is identified as another prevalent behavioral bias (Nagtegaal et al. 2023). According to (Godlonton et al. 2023), anchoring is a cognitive bias seen in investors, whereby they exhibit a tendency to excessively depend on a single piece of information while making judgements. The first source of information is often the primary reference point for investors (Frech et al. 2023), and they often exhibit a resistance to accepting corrections, even when subsequent evidence demonstrates the inexactness of their prior beliefs (Givi and Galak 2023). The anchoring effect often results in loss-averse behaviour and the underweighting of stocks in portfolio management.

3. Loss aversion

According to Schleich et al. (2023), loss aversion is a cognitive bias seen in investors, whereby they exhibit a tendency to evaluate wins and losses asymmetrically, attributing more significance to possible losses. The emotional effect of loss is twice as significant as that of gain. The extent of loss aversion may be determined by examining the historical outcomes experienced by investors, specifically in relation to gains and losses (Lejarraga et al. 2023). In the context of an economic downturn, it was observed that investors exhibit a higher degree of loss aversion as compared to periods of economic expansion.

4. Herding

Herding behaviour manifests when investors opt for consensus or collective sentiment instead of making autonomous investment decisions grounded in personal judgement or information, despite the potential for more precise outcomes with the latter approach (Bouri et al. 2023). One of the fundamental aspects that contributes to this phenomena is the investors' notion that participating in herding behaviour can potentially offer them knowledge that is more valuable and reliable (Yamashita et al. 2023). Furthermore, it has emphasised that the phenomenon of herding behaviour can be ascribed to the perception of safety that individuals experience when they are part of a bigger collective. This perception prompts individuals to manage financial risks and prevent the potential oversight of a potentially profitable stock. Novice investors frequently exhibit these behaviours in the context of market instability and asymmetric information. The adoption of a uniform strategy by all participants in the market has been observed to have a substantial impact, leading to the formation of speculative bubbles that ultimately collapse and can trigger financial crises (Sias 2023).

IV. Which bias in behaviour occurs during Covid-19?

In recent years, there has been a notable increase in the interest and recognition of behavioural finance among scholars, with its significance being widely acknowledged (Berlinger et al. 2023). It is posited that the explanatory power of conventional finance is limited in its ability to comprehend financial phenomena, whereas behavioural finance assumes a pivotal role in elucidating market volatility (Vasileiou 2023). The Covid-19 pandemic has resulted in significant volatility in the stock market, prompting a need for thorough analysis of behavioural finance. This analysis aims to enable traders to recognise and address their psychological and behavioural constraints, hence mitigating the occurrence of anomalies (Jariyapan et al. 2023).

In line with Aggarwal et al. (2021) findings, it can be seen that the stock market's behaviour during the Covid-19 epidemic, much like its regular functioning, lacks efficiency and defies accurate prediction via the use of a rational asset pricing model. It has argued that the efficiency of the market has been compromised as a result of the pervasive influence of pandemic-induced anxiety. Vasileiou's study used a Coronavirus Fear Index to examine the impact of fear related to Covid-19, a psychological variable, on the performance of the stock market. Amidst the prevailing danger and apprehension surrounding the Covid-19 pandemic, herding behaviour has emerged as a prominent factor exerting significant effect throughout this era (Alam et al. 2021). A study conducted in Pakistan revealed that a significant number of investors tend to rely on the recommendations of brokers, friends, or the prevailing consensus when making investment decisions (Shah et al. 2022). It was shown that herding behaviour is very probable to manifest in several nations, including Australia, France, Germany, Italy, the United Kingdom, and Spain. However, in contrast to occurrences such as terrorist attacks or natural disasters that often lead to significant stock sell-offs, the current situation has seen a substantial influx of retail investors who are actively engaging in long stock positions. This surge in participation might be attributed to their conviction in a swift economic recovery, which may have possibly fostered a sense of overconfidence. It has provided evidence of overconfidence prevailing in Pakistan, where investors seek to exploit the potential for higher returns. Similarly, Sinha et al. (2020) have observed a pronounced overconfidence bias in certain emerging and frontier stock markets, such as China, Taiwan, Turkey, Jordan, and Vietnam, amidst the Covid-19 pandemic. Conversely, no such bias was identified in the examined developed markets. In addition to overconfidence and

herding, many additional biases have been identified in the literature, including loss aversion, anchoring effect, risk aversion, and representation bias.

V. Conclusion

Recent developments and interest in behavioural finance have grown. Behavioural finance has answered several questions that traditional models cannot, largely due to their investor rationality assumptions. Note that behavioural finance does not replace traditional finance. These two disciplines complement each other to provide a comprehensive view of decision-making. Additionally, this investigation reviewed important literature on several cognitive and emotional biases. These biases include overconfidence, anchoring, herding, and loss aversion. After examining the stock market's volatility, various studies have shown biases such overconfidence, herding, risk aversion, loss aversion, and others across countries. This research will help investors and readers understand behavioural finance and avoid mistakes in a volatile market, according to the author.

It is important to note that this article has limitations. Given the vastness of behavioural finance and the restrictions of time and place, this research cannot fully describe it. This paper does not fully explain the four biases. In addition, the author's analysis did not include a broad range of countries, which hampered its grasp of the global market. Due to the Covid-19 epidemic's proximity and the time-consuming nature of research paper release, the author has trouble accessing a large body of qualified literature on behavioural finance in the pandemic.

VI. Reflection

Part B: Industrial engagement

With the Industry Talk, Mr. Thang with a strong financial background and currently working as a Senior Risk Consultant, has provided valuable knowledge about the topic “Equity and Derivatives in Vietnam Market”. He introduced the ongoing developments of derivatives market in Vietnam, he also explained different types of derivative products which are currently available in Vietnam. Moreover, he also gave an interesting information that more than 90% of derivatives traders have recognized loss in this market, proving the harsh of this financial product.

At the beginning, he explained that there are three type of Equity investment: Direct investment, indirect investment, and Derivative - which is the main topic. This related to topic 9: Equity market

and topic 10: Derivative market. The derivatives product began in Vietnam in 2000, starting with commodities futures. For easier understanding, derivatives product is a financial instrument which does not have intrinsic value, but rather the value is derived from underlying assets or set of assets, such as stocks, bonds, commodities, currencies, or even interest rates. They are used to manage or speculate on price movements, hedge risks, and gain exposure to various financial markets. The purpose of derivatives is to provide market participants with tools to mitigate risks associated with price fluctuations, facilitate efficient price discovery, and enable investors to take positions based on their market outlook or investment strategies.

Moving on, Mr. Thang explain the future contract - which involve two parties agreeing to acquire or sell an item at a fixed price on a specific date. It requires the buyer to buy and the seller to deliver the asset at the agreed-upon price and date. Producers and speculators utilize futures contracts to hedge price risks in commodities including oil, gold, and agriculture. They let market players lock in future pricing and hedge against price changes.

He concluded by explaining a covered warrant, a financial instrument that allows the holder the right but not the duty to buy or sell an asset at a particular price and time. Securities issued by financial institutions or exchanges are traded on stock exchanges. The issuer has the underlying asset or has arrangements to cover the warrant's prospective obligations, making them "covered" warrants. It gives investors leveraged exposure to the underlying asset's price swings, allowing them to enhance their returns or losses.

Overall, the industry session has widened my knowledge in the financial field. I have known some additional types of investment, thus enabling me to dig deeper into the finance world.

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