

# ROLE OF INFORMATION IN ADOPTION OF INVESTMENT DECISIONS ON CAPITAL MARKET

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*Keeping information is a hard thing to do nowadays, mostly because of the development of communication and informational technology. An individual can hardly administer the huge amount of information he's being bombarded with and that exceed his capacity of rational analysis. The limited attention, memory and the abilities to process information force people to focus their attention on certain information. The linear thinking risk in investment is due to the exaggerated attention given to the short term performances, regardless whether we're talking about a good or bad evolution. The causes of psychological nature may influence the behavior of rational investor when taking the decision, being necessary for the investor to make a difference between facts and opinion, between information and gossip, between reality and appearance.*

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*JEL Classification: G11, G12, G14*

## **1. Introduction**

The capital market's evolutions are influenced by the information' existence. Information is definitely a rare good, which has an essential role in performing financial operations. Having information before everyone else can generate important gains. This thesis is proved by many examples when people got rich because they were the first to have certain information.

Keeping information is a hard thing to do nowadays, mostly because of the development of communication and informational technology. Relevant market information is incorporated in the price almost instantly, so that only the first one who triggers the operation based upon it is the fully beneficiary of its effects. Accessing information generates interesting psychological effects. In this paper, we'll analyze the importance of information for the investors' attitude on the capital market and it's impact over the investing decision on the capital market.

## **2. Empirical evidence**

An individual can hardly administer the huge amount of information he's being bombarded with and that exceed his capacity of rational analysis. The supplement of information does not always generate a surplus of psychological comfort and a higher efficiency of the investment. Nevertheless, the huge amount of information available in real time creates the impression of understanding and controlling the micro variations of the capital market. But only the capital market's specialists can understand and use the capital market's micro variations, succeeding this way to anticipate the other investors' actions.

On one hand, the investor is constantly seeking for information and on the other hand he is incapable of processing infinite number of information he's being bombarded with. This investor's difficulty triggers a mental saving process and also an information selecting and

simplifying process, conditioned by his own expectations. The financial instruments that have brought satisfaction in the past are most often positively valued.

The limited attention, memory and the abilities to process information force people to focus their attention on certain information. The links created at the subconsciously level also creates a selective focus. Many studies proved that additional verbal information influence the decision process.

The selective associations lead to availability effects (Kahneman și Tversky). An informational signal is significant when it can captivate attention or it can generate associations which make recalling easier. According to the availability theory (Kahneman și Tversky), the most common things are the easiest to recall. This is normal, since the common situations are the most often observed and reported ones, and so their remembering is the easiest.

People are influenced by the way of formulating the problems because they can't select perfectly the relevant information from their memory. They underestimate the situations that aren't available in an explicit way. This suggests a form of overconfidence and also an overreaction of the market during the manifestation of these unpredictable situations.

The halo effect (Nisbett și Wilson) leads to the extension of a favorable evaluation which is made by an individual over a certain person or situation, having just one significant piece of information. When you compare, you can see that a subtle prejudice belonging to thi category can lead to the wrong price establishment on the capital market. On an efficient market, the fact that a stock is valuable (this is because in the future it is thought that the stock's price will rise) doesn't give you any information regarding the yield's adjustments to future potential risks, which are considered nul. If people extend their favorable evaluation (based on present results) over the future evolutions, the rising stocks will be overestimated (Shefrin și Statman).

The linear thinking risk in investment is due to the exaggerated attention given to the short term performances, regardless whether we're talking about a good or bad evolution.

An example of linear thinking is the rise and fall of the technology and telecommunication field in U.S.A, during the past ten years. A relevant index for the technology and telecommunication field is the NASDAQ Index. During three consecutive years (March 1997 – March 2000), the NASDAQ Index recorded an incredible value of 79,4%. Thinking that this trend will also continue in the future, many investors were deceived and they didn't manage to obtain the expected return; this happened because they addressed the investment in a linear way.

How does information influence the investing decision during a financial crisis? Empirical evidence proved that every economical crisis is preceded by several Stock exchange decreases and every stock exchange decrease cycle is accompanied by short term increase periods. In order to prove this, we selected the Dow Jones Indus. Avg. Index graphic during the U.S.A.'s recession, recession that is often compared to the present financial crisis. During almost three years of decrease, there were six increase intermediate trends. These trends lasted between a month and a half and five months, and the increases were from 12% to 45% for each such period (se the 1st Graphic). What is the explanation for this investing behaviour? The investors have a different attitude towards the risk and perceive in a different way the available information on the capital market.



Graphic no. 1. DJIA Index evolution during 1928 -1933  
Source: www.kmarket.ro

The behavior and opinions of capital market's investors have an essential influence on the individual's behavior and opinions, especially during an uncertainty period. In the small size investor's case, the fear of a loss can substitute their rationality.

Andreassen and Kraus (1990) noticed that, when exogenous prices fluctuate modestly on an experimental market, the subjects buy when prices are decreasing and sell when prices are increasing. When a trend appears, the subjects are no longer following the previous pattern, but the trend. This reflects itself also on the real markets. Different empirical studies conclude that the assets' prices are more or less sensitive to novelties. Cutler, Poterba and Simmons (1991) studied different markets between the years of 1960-1988.

Jegadeesh and Titman's researches suggest a late reaction model: during a given period, the winning stocks' income surpasses the loser stocks' income. De Bondt and Thaler show that the situation is reversing itself on long term.

Kaminsky and Schmukler (1999) studied the investors' reaction to news during the Asian crisis (1997-1998). They observed the first twenty daily fluctuations and concluded that their causes aren't political or economical news. Kaminsky and Schmukler also deduced that the course's fluctuation is stronger as the crisis gets bigger and during times like these, the stocks' price is more influenced by the negative than the positive news.

Resembling with the primitive behavior, when seeing everyone around running, the first impulse is to follow them, the investors' behavior can cause a real mass hysteria and the individual's

personality completely vanishes (you can talk about primary emotionality). These extreme forms may lead to destructive results and to the stock exchange's collapse. (Ghosh and Ray, 2002).

Emotions play an important role in rational considerations regarding risk or time preference. Ellsberg's paradox (1961) shows that people have dislike towards ambiguity and this leads to irrational decisions. Dislike towards ambiguity has been confirmed by experimental market's tests. According to Camerer (1995), the dislike towards ambiguity can increase unduly the risk bonus when new financial markets appear, mostly due to the fact that there are uncertainties about the economic environment and potential results. A possible explanation of the dislike towards ambiguity is the obvious lack of an identifiable parameter of the decision problem, which can be taken as a higher risk.

The dislike towards risk, regret and loss shows a premeditated avoidance of unpleasant future feelings. But still, people's present feelings affect the perception and choices made regarding the taken risk. For example, the Lotto sales in the state of Ohio were higher during the days that followed the victory of Ohio State University (Arkes, Herren and Isen, 1988).

In general, people who have a positive state of mind are more optimistic about the election and judgments that they make instead of those who have a bad state of mind. Negative states of mind are associated with detailed and critical analysis strategies of information. Emotional states contain information that individuals can use in building its image about the environment. However, people often attribute feelings to the wrong source, leading to erroneous judgments.

While economists studied individual's psychology, social psychology didn't receive such attention. The conversation is essential in broadcasting the popular ideas about financial markets (Shiller, 2000). In an individual investors study, Shiller noticed that almost every investor who had recently purchased stocks, have drawn attention through direct interactive communication. Humans have a limited attention and tend to focus on the ideas and the facts that are brought by conversation, rituals and symbols. As a result, the cultural element becomes determinant for behavior.

On the capital markets, information is transmitted in cascade, causing a large dimensions group behavior. Shiller believes that a certain level of the market's quotations isn't the result of single made valuations, but rather the result of collective behavior.

The collective behavior is caused by the fact that individuals decide not to waste time and energy in order to identify the real market value of an instrument; they give up this way on the possibility to produce an independent impact on that instrument and adapt to the trend. This type of behavior contradicts the expected utility theory: one investor's behavior is independent from the others' choices, because it has its own utility function. This way, the collective investing behavior is more likely to be influenced by the information trade between the individuals.

When uncertain, the individual's opinions tend to be strongly influenced by the group's behavior and opinions. The market is therefore influenced by a group behavior that is different from the sum of individual behaviors.

The collective compliance of the investors is counterproductive, because the uncertainty makes the investors look for market information in the media (profile newspapers, TV shows), without checking the exacted and quality of received information. It matters more **who** says it and not **what** it is being said. This happens because there is a need of identifying a leader, a market „guru”, whose behavior can be imitated.

These leaders are so worshiped that they tend to become „gods” in the collective imaginary. The mortals, incapable of making their own choices, expect the „gods” to always make the right decisions. An example this way is Warren Buffet, who through his opinions moves the beverage's world. His declarations are seen as an anticipation of the future because, being in front, he's thought to hold information that mortal don't.

Often, the investors' losses are caused by their subjective decisions. The reason why problems occur on the stock exchange is that they are addicted to the other investors. Thus, the investors

often give up their own strategies and prefer following the path that the others have chosen. According to behavioral finance, the less an investor knows, the easier is for him to be affected by the „group mentality”. The less experience investors have, the sooner they panic.

### 3. Conclusions

Investors may be rational or not taking a decision on the capital market, which is reflected in the prices of financial instruments which may fluctuate, depending on either financial circumstances or in light of the interests of investors, oscillating between collective hysteria and indifference. Attempts by individual investors to be rational can sometimes seem downright absurd.

Macroeconomic forecasts are usually incomplete to have any value for small investors, particularly when economic development is influenced by small details, but fundamental, that nobody could forecast.

The causes of psychological nature may influence the behavior of rational investor when taking the decision, being necessary for the investor to make a difference between facts and opinion, between information and gossip, between reality and appearance.

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