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A Psychological Investigation of the Determinants of Investment Risk Management of the Investors: Special Reference to Bangladesh

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ABSTRACT

The paper examines the risk management practices of investors of Bangladesh, special attempts are made to understand and dissect the psychological predispositions of the investors of Bangladesh. In this paper, an attempt has been made to investigate the nature and types of investment risk management and analyze determinants of investment risk management from a psychological perspective that influences investors' investmentdecision-making process. The objective of the study was to critically examine risk management practices of investors in Bangladesh i.e., types of risk, procedure, and techniques used to minimize the risk, etc. The paper also put forth some recommendations to overcome those psychological biases. Using secondary sources of data, this research employs qualitative research techniques to investigate the research questions. The study reveals that a significant number of investment risk management strategies are adopted and practiced by the investors in the investment decision-making process. The psychological perspective of investment risk management plays a key role in making those decisions. The study found significant support for the psychological impetus of the investment decision-making process. This paper also uses the context of Bangladesh where data fit into.

KEYWORDS: *Investment Risk Management, Psychological Determinants, Decision Making*

INTRODUCTION

Investment risk management (IRM) is considered as the foundation of business as it lets the financial institutions offer services quintessentially and help investors invest meticulously in a regular fashion. There are many sources of risks forbusiness, such as liquidity risk, default risk, interest rate risk, etc.Risk management is the process of identification, planning, and acceptance or alleviation of uncertainty in investment decisions. Largely, risk management takes place when an investor or a fund manager explores and tries to quantify the potentialities of losses in an investment like a moral hazard, and then takes the appropriate action accordingly.

However, the risk is inextricable from investment return, and without risk, no business will function. Risk can be quantifiable both in absolute and relative terms. A better understanding of risk and IRM procedures can help investors to make a profit safely, better recognize the opportunities, trade-offs, and save costs with different investment approaches.The thumb rule of investment is to maximizeprofit andminimize the risk of loss. Investors' psychological structure, in this regard, plays a key role in making investment decisions. Human minds tend to be partial whichleads them to follow a particular quasi-logical conduit or shape a certain perspective based on certain psychological conditions, mental structure, predetermined perceptual notions, and beliefs (Baker & Nofsinger, 2002). Therefore, understanding psychology in IRM is pivotal to minimize loss and maximize return because if investors act on a bias, they fail to consider the full spectrumof investment and can unknowingly take decisions that may contradict their initial opinions. Some common psychological issues in investmentinclude representative bias, familiarity bias, cognitive dissonance, disposition effect,mood, optimism and overconfidence, endowment effect, status quo bias, mental accounting, gambler's fallacy, and so on. This paper attempts to understand the nature of risk management, discusses some of the psychological and emotional biases, investigates the psychological impact on the investors of Bangladesh, and suggests some recommendations to prevent the ill-effect of investment risk.

RESEARCH QUESTIONS

The main research question of this study is to examine the factors affecting the psychological perspective of the investors of Bangladesh. The specific research questions are as follows:

RQ1. Whydo psychological factors matter for investment?

RQ2. What are some psychological characteristics of the investors?

RQ3. Howdo these psychological factors determine the decision-making process of investors of Bangladesh?

RQ4. Which strategies can help investorsavoidinvestment risk?

METHODS

This article uses a qualitative research method to investigate the objectives of the paper. Secondary sources were used to gather the relevant data of this study. Data were collected from different books, journals, magazines and newspapers, blogs, websites of different financial institutions, and other relevant internet resources. The collected data were analyzed and cross-checked for ensuring consistency among various sources.

STATEMENT OF THE PROBLEM

All investors are concerned aboutthe risk involved with all investments. Risk management henceforth works as a shield to address the risks on investment and help find the most appropriate ways to avoid or overcome the risks. Investors, along with portfolios managers, should understand and have expertise in risk management because it will decrease or increase investment risks for them.

The necessity of advanced risk management practices has been devised from the studies of several world financial crises in the last couple of years. In particular, the financial crunch of 2008 warned investors around the world to understand and gauge the issue intensively. In that crisis, not only the developed countries but also the developing countries have been suffering enormously. Until now, international financial institutions and their managers have been seeking a sustainable solution that may help investors andbusinesses to be risk adjustable or minimize the loss. Therefore, this study will attempt to shed light on that end—examining the psychological causes involved in investment risk and prescribing some recommendations to prevent them. This study presumably also would help the scholarly community as well, to bolster existing knowledge on IRM.

LITERATURE REVIEW

The psychology of the investorsimpacts their decision-makingprocess which traditional finance used to disregard. At the time of investment decision-making, psychological considerations play a significant role in the choice of where, when, and how to invest. A significant number of studies have been conducted so far on various aspects of IRM. However, studies,regarding the psychological perspective of IRM of investors of Bangladesh have not been highlighted distinctly in the earlierresearch. Among the few, Health, Huddart & Lang (1999) studied "Psychological factors and stock option exercise" and found that the reference point of IRM played a key role inthe stock price of the previous year. Similarly, Goetzmann and Peles (1997) studied "Cognitive dissonance and mutual fund investors" and found support for Cognitive dissonance as the catalyst for investment decisions. The study also found that the average recollection of performance was greater than the actual performance among the respondents (investors) of the study surveyed. Huberman, G. (2001) found that investors tend to buy the stocks of companies that have local or regional business affiliations. Nofsinger (2002) in his study "Do optimists make the best investors?" found and claimed that investors can suffer from optimism or overconfidence. Likewise, Ryota et. al. (2010) found in their study "Effect of Overconfident Investor Behavior to Stock Market" that overconfidence causes people to be correct in their judgments and take faulty investment decisions; thus, the more often investors' predictions come true, the more overconfident they become. Shefrin (2000) studied "Beyond greed and fear: understanding behavioral finance and the psychology of investing" and assessed that due to the psychological biases, investors did specific miscalculations of which some are minor, and others are serious, and these mistakes did serious harm to their wealth.

THEORETICAL FRAMEWORK

Among various theories of IRM, prospect theory, developed by Kahneman and Tversky (1979)provides a psychological analysis of investment decisions and delivers a descriptive framework for the way people make investment choices in the face of risk and uncertainty. According to this theory, investors, due to psychological spur often act in an irrational manner and make mistakes and face losses. This theory, sharing many attributes of the traditional SEU models gives weight to the cognitive limitations of human decision-making capabilities.People usually think they are better decision-makers than they actually are. In addition, they tend to obtain information that confirms their belief. This constantself-deception leads to more investment risk. Observing these situations in Bangladesh, the author feels to work on this emerging issue.

FINDINGS AND ANALYSIS

At the time of investment decision, investors tend to be influenced by various types of psychological determinants which were studied in this paper and the findings are as follows:

Representativeness Bias

Representativeness Bias is a psychological conditionthat leads to a bias toward the belief thatgood companies are demonstrative of a good investment, past worthy return as evocative of future investment, and past stock price trend as the symbol of future better price trend. This type of bias instigates investors to invest in seemingly good sectors which may turn risky in the long run (Shefrin, 2000). Largely, people becomeperplexed about a momentary profitable company with a good investment portfolio. For example, some people purchase a stock since this stock performs well at the market and price has been showing an upward trend for the last couple of weeks but in rigorous analysis, it may be found the opposite, with no earning, no profit, eventually,that causes negative return for the investors. Accordingly, a good company refers to a company that makes strong earnings with high sales growth, superiormanagement, and strong position in the industry, and so on (Solt & Statman, 1989). Investors fall into this trap of superficial profit of a company only by examining its past profit records. This particular situation, for example, occurs oftentimes in the stock market of Bangladesh, where investors invest in seemingly profitable companies seeing a temporary increasing trend of their share value of those seemingly profitable companies.

Cognitive Dissonance

Cognitive dissonance is defined as the inconstant mental state where people tend to ignore, discard or disparage any information that conflicts with a particular belief (Festinger, 1957). Cognitive dissonance makes investors attempt to avoid or overlook conflicting beliefsthat they have and pursue support for their preferred belief. Consequently, investors tend to put too much confidence in the investment sectorsthat they consider potentially profitable onesand gather data and information in favor of those companies/ sectors. In addition, when investors decide to invest in a certain business, they sometimes underestimate the amount of risk associated with the sector.

Optimism and Overconfidence

The term optimism in business investment means having hopefulness and confidence about the future or successful outcome of the investment. Nofsinger (2002) asserts that investors can suffer from optimism predisposition, which is one of the precursors to overconfidence that results in investing in risky projects. imprudentoptimism affects investors in their decision-makingprocess in two ways. Firstly, optimistic investors tend to study the project nominally in making their investment decisions. Secondly, optimists oftenoverlook negative information about the project/sector that they have decided to invest in.

Similarly, overconfidence makes investors optimistic about future success and usually drives them to be overconfident about their capacities, without considering the ins and outs of the investment. Belsky and Gilovich (1999) consider overconfidence as “the ego trap” and maintain that overconfidence is pervasive in nature and it may spur any investors anytime. They also suggested that over-optimistic investors tend not to learn from their failures. We can see almost similar scenarios in the context of the small investors of Bangladesh, especially those who trade in share markets.

Risk Perceptions and Preferences

Risk perceptions and preferences outline the initial investment choice, the evaluation, and subsequent decisions. Investors may have an extremely positive perception about investments, can fall into psychological traps, and take unnecessary risks through an impulsive decision. Emotions gain momentum after big gains or losses (Thaler & Johnson, 1990). After getting some large gains, many investors are stirred by the greed and take severerisks for additional investment. Conversely, large losses do the opposite, investors may withdraw from the investment completely or keep their money idly—either way, they react in extreme ways. Kahneman and Tversky (1979) name this phenomenon as *loss aversion*. Having said that, the other extreme reaction to a large loss can be to take on more risk in an attempt to recover the loss. Shefrin (2000) calls this situation *‘get-evenitis’*. Many people in Bangladesh lost everything after such an immense loss.

RECOMMENDATION TO MANAGE PSYCHOLOGICAL PREFERENCES

Understanding the psychological predispositions and taking appropriate measures to resolve such miscalculations may reduce the effects of negative investment decisions and possibly lead to better investment returns. Van Eaton (1999) and Nofsinger (2001) provide several recommendations on how an investor can protecthim/herself from various emotion-driven decisions. The following guidelines may be of use for the investors to invest wisely and with less loss.

1. Setting realistic objectives.

2. Learning about the investment, understanding the nature and impact of psychological biases, and knowing their own emotional weaknesses can reduce the risk of investment.

3. Investors also need to know, identify and allow for various constraints of investment such as liquidity and time horizon to accomplish their objectives.

5. Portfolio investment can also help increase the stability of returns and reduce risk.

6. Investors should occasionallyassess their investment choices to cope with the market.

8. Investors can also manage investment risk by diffusing their investment beyond the capital market. Other choices

of an investment may help investors not to respond to the baseless information and other psychological stress.

10. The investors should evaluate each company's situation from different perspectives in order to develop the most realistic picture of the investment landscape.

CONCLUSION

This paper aims at examining the nature of IRM, its psychological basis and recommend some suggestions to manage the investment risks. It is apsychological narrativeofthe financial behavior of investors. To manage investment risks, investors need to understand the business properly, recognize the greater picture of investment, be cognizant of their emotional limitations and strength to overcome the investment challenges, and apply that knowledge to their own investment decision-making process.

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