



Emerging Markets Queries in Finance and Business

# Effects of Behavioural Finance on Emerging Capital Markets

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## Abstract

A recent common view of finance experts is that it is becoming increasingly difficult to understand how the economy as a whole works. Although the efficient market theory might be considered an ideal model enabling the interpretation of market behavior, it has begun to lose ground, and the rationality hypothesis failed to explain the excessive volatility of the returns and trading volume recorded on both developed capital markets and emerging ones. Adding the behavioral finance perspective to the equation can help us to understand better how market agents will react. In this article, we investigate the factors that may explain the trading volume evolution on two emerging capital markets, Romania and Brazil. We analyze the impact of both investors who ground their trading behavior on rational expectations and investors who show *behavioral errors* as independent variables on the trading volume as dependent variable. The period under analysis covers four years, from June 2009 to June 2013, and includes the daily values of the most important indices traded on both markets, i.e. BET for Romania and IBOVESPA for Brazil, and the daily trading volume for each of the two indices. The results indicate that trading is influenced by the investors' irrational behavior. Thus, the rationality hypothesis can be rejected for both capital markets.

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Selection and peer-review under responsibility of the Emerging Markets Queries in Finance and Business local organization

*Keywords:* rational expectations; behavioural finance; capital markets

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## 1. Introduction

It is necessary to introduce new factors in addition to rational expectations to explain the evolution of returns and trading volume in the capital markets. Some of the new research trends approach financial markets from a biological perspective, more precisely an evolutionary one, based on the assumption that markets, instruments, institutions and investors evince a dynamic interaction and evolution, according to the “laws” of economic selection. Starting from this assumption, financial actors compete and adapt, however not relying on optimum behavior.

The behavioral finance investigates the subtle facets and interactions in the human brain, faced with the uncertainty of making economic decisions. The most common human traits (fear, anger, greed, selflessness) place considerable emphasis on our decisions about money. Intellect (grasping a situation), reason (long-term consequences of the action taken) and emotion (considering a course of action) are all interrelated; they are the springs behind human decision. Human behavior is generally reactive, not proactive; therefore, it is difficult to make predictions on the basis of narrow rules. Behavioral finances can relatively easily explain why an individual has made a decision, but have difficulty in quantifying what effects that decision will have on the individual.

Information is a public set of data, made available to everyone in an objective manner. Information can have a material impact on the asset price when it is combined with knowledge, hands-on experience and assessment of investors. Investors interpret important data and events on two cognitive levels:

- the intellectual level of ordering, processing and analyzing the actual factors (economic data);
- the level of the logical and rational understanding of how this objective identifies factors that will influence the perception of other market players.

The concept of information can be defined only by relevant data at some point on the market, but must be correlated with the amount of professional knowledge (human intellect) and interpersonal dynamics of market players (emotions and feelings). Moreover, due to uncertainty and constant change, there is a strong interdependence between experiences (autobiographical memory) and rational expectations about the future. Our experiences influence the way we view the available data based on relevance. If we add to these the decision equation (where the accuracy of the decision is recorded only *ex post*), time pressure, decision-related stress, we obtain the sum of the insecurities of the interactions between the rational and irrational.

Assessing market participants’ psychological reasoning is very important – since other market players’ decisions and actions have a decisive effect upon one’s success or failure (*Game Theory*, J. Nash, 1950: *Equilibrium points in n-person games*, Proceedings of the National Academy of the USA, 36(1):48-49). In this case, building expectations is subject to time and constant insecurity pressure.

Akerlof and Shiller (2009) substitute the rationality hypothesis to the investors’ behavior to explain the volatility of market profits. They attribute economic dysfunction especially to what they call “animal spirits” and extend the *General Theory (The General Theory of Employment Interest and Money*, McMillan London) developed by Keynes J. M. in 1936. The latter defined animal spirit as “a spontaneous urge to action, rather than inaction”. Although the author considered that most economic activities have rational economic motivations, people also have non-economic reasons, much of the economic activity being governed by these animal spirits. With this respect, the authors state that it is “necessary to incorporate animal spirits into macroeconomic theory in order to know how the economy really works.” They extend Keynes’s definition, the term “animal spirits” referring to the investors’ irrational behavior, as this comprises, among others, optimism, pessimism and spontaneous reaction. In modern economics, “animal spirits” have been coined into an economic term that refers to the restlessness and inconsistency existing in today’s economy.

Another author (Dhaoui, 2011) has shown in his study that the economy is behavior driven particularly by these animal spirits. He considered that excessive volatility results from the presence of optimistic, pessimistic

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