



Contents lists available at ScienceDirect

## International Review of Economics and Finance

journal homepage: [www.elsevier.com/locate/iref](http://www.elsevier.com/locate/iref)

# The effects of national culture and behavioral pitfalls on investors' decision-making: Herding behavior in international stock markets<sup>☆</sup>

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## ARTICLE INFO

## Article history:

Received 19 December 2013

Received in revised form 26 October 2014

Accepted 30 December 2014

Available online 13 January 2015

## JEL classification:

G02

G11

G15

## Keywords:

Herding behavior

National culture

Behavioral pitfalls

International stock markets

Behavioral finance

## ABSTRACT

The purpose of this study is to explore the determinants of investor decision-making in international stock markets. Unlike previous literature, this study provides insight into the effects of national culture and behavioral pitfalls on investors' decision-making processes in international stock markets. Its empirical results provide evidence that herding behaviors occur in Confucian and less sophisticated equity markets. Additionally, it finds that some national culture indexes are closely correlated with the exhibition of herding. Finally, it shows that investors' behavioral pitfalls dominate their herding tendency, as shown in cross-sectional absolute deviations of returns.

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## 1. Introduction

With the goal of examining herding behavior in international stock markets in depth, this study looks at the effects of national culture and behavioral pitfalls on irrational decision-making by investors. Since the 1980s, various studies have identified irrational investment behaviors in markets. Of these, herding behavior has been a subject of particular concern. Herding behavior is when the same investment strategy is adopted by a majority of investors during the same period of time, in that they sell or buy the same or similar stocks during that time. Previous literature has provided evidence of herding behavior among investors. For example, [Choi and Sias \(2009\)](#) discover that institutional investors sell and buy stocks in the same industries during the same periods of time, leading to herding behavior. [Venezia, Nashikkar, and Shapira \(2011\)](#) find strong herding tendencies among investors in small-cap companies and those facing low systematic risk, and have determined that professional investors demonstrate weaker herding tendencies than amateur (retail) investors. [Demirer, Kutan, and Zhang \(2014\)](#) and [Yao, Ma, and He \(2014\)](#) indicate that herding

<sup>☆</sup> Chang thanks the Ministry of Science and Technology of R.O.C. (Taiwan) for the financial support (project number: MOST 101-2410-H-390-016-). Helpful comments from editor and anonymous referee are gratefully acknowledged.

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behavior is more widespread at the industry (sector) level than at the market (country) level. Lin and Lin (2014) show significant herding tendencies of institutional investors and margin traders on sharp price movements.

In addition to demonstrating the existence of herding behavior, previous studies have attempted to examine the causes of this behavior. Scharfstein and Stein (1990) argue that fund managers ignore private information in order to maintain their reputations, and instead imitate others' investment strategies. Banerjee (1992) suggests that investors observe others' behaviors to gain implied information content, and then follow their leads. This imitative herding behavior is like a waterfall, and results in an informational cascade. Hirshleifer, Subrahmanyam, and Titman (1994) suggest that the employment of the same investment strategies among investors occurs due to the acquisition of similar or identical information, based on which investors develop herding behaviors. Dass, Massa, and Patgiri (2008) suggest that reputation and relative performance among mutual funds result in herding behavior among fund managers, and contributed to the dot com bubble at the end of the 1990s. Yang (2011) argues that information externality of the second decision-maker plays a major role in the efficiency of herding behavior among subsequent decision-makers.

Although investors' herding behavior has been identified by earlier studies, which have explored its causes, most have been based on the theoretical approaches of standard (traditional) finance. Herding is irrational behavior and so can be better examined through the lens of behavioral finance, which primarily examines investors' decision-making based on irrational or long-term market inefficiency. Hirshleifer et al. (1994) indicate that when investors believe that they are acquiring information quicker than others, they demonstrate overconfidence and herding behavior. Nofsinger and Sias (1999) find close ties between herding and positive feedback trading, as well as a positive correlation between the herding tendency of institutional investors and previous returns. Demarzo, Kaniel, and Kremer (2004) point out how the major influence of the community affects investment decision-making, and explain that the need to "keep up with the Joneses" (compare oneself with one's neighbors) results in herding behavior among communities, as members follow others' investment strategies. Brown, Ivkovic, Smith, and Weisbenner (2008) and Shemesh and Zapatero (2014) also provide, respectively, evidence of significant community effect for stock market participation decisions and the decision to buy a car. Moreover, Hong, Kubik, and Stein (2005) suggest the use of a contagion model to describe the information acquisition of investors through word of mouth, as well as the influence on fund managers of counterparts in the same city who buy or sell the same stocks. Venezia et al. (2011) reveal herding behavior for both amateur and professional investors and the tendency to herd among amateurs is higher as a result of their financial illiteracy and inexperience.

Factors that influence the levels of irrationality of investors and the degree of inefficiency of stock markets in different countries mainly involve external environments and inner psychology. As such, it is beneficial to discuss the causes of herding and the determinants of investors' irrational decision-making based on an examination of external national cultures and internal behavioral pitfalls. Hofstede (2001) addresses national culture in terms of the five dimensions of power distance, individualism, masculinity, uncertainty avoidance, and long-term orientation, which he has also quantified. Schmeling (2009) uses individualism and uncertainty avoidance as proxies for herding behavior and overreaction, and has pointed out the strong influence of investor sentiment on stock returns in countries that are more likely to demonstrate herding behavior or overreaction. Chui, Titman, and Wei (2010) adopt Hofstede's (2001) individualism index to conduct an empirical study, and find that a positive correlation exists between individualism and the profits of momentum strategy.

Differences in national culture are worthy of notice when investigating why investor herding tendency differs across countries. National culture refers to the behavioral norm and conventional beliefs of the majority of people in a certain country. It dominates the investors' behavioral reaction to an information shock and the decision-making for an investment. Further, it may cause the exhibition of same or similar investment strategies for the majority of investors in the stock market indicating herding behavior. In other words, differences in national culture may shed insight into the reasons for herding and cross country culture comparisons are crucial for the examination of herding behavior in international stock markets. Specifically, Confucian culture emphasizes ethics, obedience, humanism, and collectivism, indicating that a Confucian society may have a high power distance, low individualism, high masculinity, low uncertainty avoidance, and low long-term orientation. On the other hand, western culture is based on science, reality, individualism, and happiness. Its core ideals are the requirements of human's fundamental rights. This may imply a prevention of the emergence of herding behavior in western countries. Previous literature has also found that cross country culture comparisons justify the differences in the human's behavior and investor right protection across countries. For example, Stulz and Williamson (2003) show that Protestant countries protect the creditors' rights better than Catholic countries. Nabar and Boonlert-U-Thai (2007) present that differences in national culture are one of the determinants of manager's accounting choice across countries.

In addition to national culture, another indicator used to measure the irrationality of investors and inefficiency of markets is investors' inevitable tendency toward errors (i.e., behavioral pitfalls). Among the behavior pitfalls discussed in existing behavioral finance literature, excessive optimism, overconfidence, and the disposition effect have been shown to exist. Excessive optimism refers to the inclination of people to prefer the probability of occurrence of favorable outcomes to that of unfavorable outcomes. Brown and Cliff (2005) conclude that lower returns result from investors' excessive optimism, while Kutsuna, Smith, and Smith (2009) report that investors' excessive optimism causes underwriters to adjust IPO offer prices upwards.

Overconfidence refers to the perception of people that they are more competent than average. Gervais and Odean (2001) point out that although overconfident investors are more likely to have a superior ability to collect information, they fail to make the best use of this information, and thus receive lower returns. Gervais, Heaton, and Odean (2011) find that overconfident managers try their best to collect information that will improve their success rates and the values of projects, and so tend to accept compensation contracts that involve excessive risk.

The disposition effect refers to the tendency of investors to sell gaining investments too soon and hold losing investments too long. Frazzini (2006) shows that the underreaction of investors to news is due to the disposition effect. Grinblatt, Keloharju, and

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