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Do Confidence Indexes Consider The Available Macroeconomic Information on Short Term?

Alexandra Gabriela Ţiţan [a]*

[a] PhD Student at Faculty of Finance, Insurance, Banking and Stock Exchange, Bucharest University of Economic Studies, Mihail Moxa 5-7, 010961 Bucharest, Romania

Abstract

The question whether investors are rational or irrational has already been extensively discussed in specialized literature. But no final answers were received during the few decades of research. This paper represents a research of what factors influence investors' opinions regarding expectations of future evolution of an economy. This subject is important because investors' overconfidence can cause economic bubbles that may severely affect a capital market (Brown and Cliff, 2004). A lack of confidence may also have a series of negative impacts on a market. The study focuses on Romania, by using the CFA Romania Macroeconomic Confidence Index in an empirical research to find whether past events influence financial analysts regarding future expectations and which of these factors influence them most. The sample of research consists of three years of monthly data regarding the CFA Romania Macroeconomic Confidence in correlation with a few distinct macroeconomic figures (monthly information about unemployment rate, average personal income, inflation rate, short term interest rates, index performance for Bucharest Stock Exchange, foreign direct investments in Romania as well as Romanian business condition). After performing the Jarque–Bera test of normality and after testing the data for autocorrelation, cross correlation, multicollinearity, the analysis of correlation and regression was performed. The conclusion is that financial analysts are influenced by past economic data in the moment they form their expectations about future economic conditions. As a result, they may be considered as being rational. There is a high correlation between the CFA Romania Macroeconomic Confidence Index and the considered macroeconomic indicators.

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* Alexandra Gabriela Ţiţan. Tel.: +40-7235.11.38;
E-mail address: alexandra.titan@gmail.com

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1. Introduction

Investors' behavior is a very controversial and of particular interest subject for financial economists, professors and researchers as confirmed by the large body of specialized literature. Even if many tried to find the truth about the factors influencing investors' behavior, no ultimate conclusion exists. Behavioral finance is a component of finance that studies the behavior of investors by using more relaxed models as compared to traditional finance – behaviour finance does not consider that the assumptions of maximized utility and rational character of investors must hold. Instead, behavioral finance considers investors are influenced by their sentiments (they are "normal") and important limits to arbitrage exist (markets are not entirely efficient).

In forming their opinions, investors usually take into consideration many factors surrounding them, like macroeconomic news, company specific information as well as their expectations about future. Most of the time they are over-confident meaning they put more weight on the most recent events, ignoring most of the historical evolution of the market (Ritter, 2003).

Investors' sentiments have an important impact on a country's economy as well as on the global economy as the sentiments are propagated abroad. Still, as shown by Verma and Soydemir (2006), the effects are different across countries, depending on their economic relationships.

In my paper, I present some of the many research studies on behavior finance and investors' confidence and afterwards the analysis of investors' reaction on the Romanian market, using the CFA Romania Macroeconomic Confidence Index as a proxy for financial analysts' confidence on the evolution of Romanian market for the following six months. The questions answered are whether financial analysts develop future expectations influenced by short term past events and also which are the factors that influence them.

The conclusion is that past economic data influences the future expectations of financial analysts regarding economic conditions. As a result, they may be considered as being rational. There is a high correlation between the CFA Romania Macroeconomic Confidence Index and the considered macroeconomic indicators.

2. Behavioral finance at a glance

Behavioral finance is considered to trace its roots back in 1972, when Slovic published his article entitled "Psychological study of human judgment: Implications for investment decision making". The "normal" investors are not necessary rational, they may react irrationally, without following strict theoretical principals, may be influenced by sentiments and by the well-being surrounding them. Other assumptions of behavior finance are: markets may be inefficient and expected returns may be described using behavioral models, not standard asset pricing theory (Statman, 2014).

There are many patterns discovered over time about investors' behaviour. There are rules of thumb that make investment decisions easier to be adopted. For example, Benartzi and Thaler (2001) concluded that investors tend to allocate their budget in equal proportion between all alternatives they have. Another important observation is that investors tend to be overconfident in their skills as they do not diversify their investments enough. They tend to maintain their habits and invest in what is familiar to them (Ritter, 2003). Regarding the transactional behavior, Barber and Odean (2001) found that investors tend to perform poorer as they trade more frequently and men usually loose more as they trade more, as compared to women.

Rabin (2002) made another observation regarding the patterns of investors' behavior, namely that investors tend to put more weight on recent events than on historical ones (known also as the law of small numbers – it is a judgmental bias because of the lessons learned from small sample analysis considered to resemble the entire population).

Many papers analyzed the disposition effect, like Niehaus and Shrider (2014), Frydman and Rangel (2014) and Li and Yang (2013). This phenomenon is an anomaly observed during the years referring to investors' tendency to keep investments in financial assets that dropped in value, while selling financial assets that recorded price increases. This may be explained by the fact that investors are not willing to recognize their losses (so that they maintain the loosing shares in their portfolios), while they are more willing to recognize the gains (so that they sell the profitable investments).

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