

The Impact of an Investor's Emotional State on Risk Aversion and Aggregate Stock Returns: A Case Study on Australian Investors

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Abstract. This research investigates the influence of an investor's emotional state on risk aversion in financial decision-making and its subsequent impact on aggregate stock returns. Grounded in Behavioral Finance Theory, this study challenges the rational investor paradigm of Traditional Finance by examining the psychological underpinnings of market behavior. The research employs a qualitative, interpretivist methodology, utilizing semi-structured interviews with a stratified sample of 30 professionals from Australia's finance and human psychology sectors. Data will be analyzed through thematic analysis to identify key patterns and themes. The study seeks to identify specific emotional states that impact risk aversion, evaluate the scope of emotional influence on investment decisions, explore mechanisms for balancing rationality and emotion, and deduce evidence-based strategies for Australian investors to optimize decision-making. The findings are expected to provide significant insights into the role of psychology in financial markets and offer practical guidance for achieving more consistent and optimal investment returns.

Keywords: Emotional State, Risk Aversion, Financial Decision-Making, Stock Returns, Investor Behavior

1. Introduction

The stock market is a dynamic financial sector whereby the cross-section of returns to economic factors volatility and investors' risk aversion strategies bears substantial uncertainties to investments [1]. An investor's emotional state bears a significant influence on their respective risk aversion approaches they typically take into account in the financial decision-making process. According to Moueed and Hunjra [2], an investor's behavioral psychology is a complex construct that is influenced by news, stock market variations, and an individual's emotional state. Hence, financial decision-making is a complex process for investors due to the potential repercussions of undertaking risks and the perpetual uncertainty of whether opting for an alternative investment opportunity can lead to more favorable returns. Therefore, the scope of risk aversion embodied by investors when deciding to invest in stock market assets and aggregate returns potential is influenced substantially by an individual's emotional state.

2. Literature review

2.1. Previous research

Although economic stability and political factors are the key determinants for the performance of assets traded on the stock market, investors' perceptions regarding risk aversion and judgment bias bear a substantial influence on financial decision-making and aggregate stock returns. Risk aversion within the context of the stock market refers to the tendency of investors to prefer lesser risk volatility stock alternatives while investing in financial decisions [3]. According to Diaz and Esparcia [4], risk-averse investors in the stock market are concerned with the preservation of capital rather than maximizing potential gain earnings. For instance, risk aversiveness justifies an individual to make investments in relatively low-risk assets such as government bonds and divided-based stocks, whose returns are typically less volatile compared to growth-based stocks [5]. Hence, during volatility periods in the stock market, risk-averse investments typically sell their riskier assets and buy stocks in lower-risk securities.

Due to the risk associated with investing in stocks, an investor's emotional state bears a significant influence on their respective decision-making regarding the asserts they deem potentially profitable and doesn't predispose a substantial risk. Although the active monitoring of financial and stock markets is crucial in facilitating the making of rational decisions, the findings captured in Goodell et al. [6] imply that investors must acknowledge the influence that an individual's emotional state can have in triggering impulsive decisions regarding the buying or the selling of stock market assets. The emotional states that can influence financial decisions among investors on the stock market include reluctance, optimism, excitement, exuberance, denial, fear, desperation, panic, capitalization, despondency, depression, apathy, and indifference [7,8]. Investors experience these emotional states in cycles whereby the emotions they experience during each stage influence financial decisions to either make risk-averse decisions or act rationally, focusing on the long-term trends of the stock market.

During the first stage of the cycle, investors experience the reluctance emotional state whereby an individual lacks the confidence to invest their funds into a particular stock market assets or securities [9]. However, sustained performance consistency convinces investors to invest due to the fear of missing out. The emotional states experienced by investors during the second stage of the cycle include; optimism, excitement, and exuberance. The stability of a stock's value, positive sentiments echoed by the press, and testimonials from other investors nurtures optimism, which can cloud an individual's capability to make rational decisions. Excitement and exuberance emotions can influence an investor's judgment by underestimating risks and overshooting the funds they had initially planned to invest in [10]. Hence, the emotional states experienced by individuals during the second stage in the cycle of investor emotions skew financial decision-making from rationality and logic.

The emotional states during the third phase of the investor emotions cycle include denial, fear, and panic [11]. When the stock market becomes volatile, investors enter into a denial emotional state and shield themselves psychologically either by refusing to consume news reporting on the stock market volatility [12]. Denial compromises an individual's capacity to make rational investment decisions, such as selling their stock assets and securities, hoping that the negative trends will recover. Additionally, investors can experience fear and desperation which increase the probability of making emotionally-based decisions in attempts to reclaim salvageable investments [13]. Moreover, an investor can panic due to the strong emotional attachment people have to their monetary resources and decide to sell their stocks on impulse.

The fourth stage in the cycle of investor emotions includes capitulation, despondency, depression, apathy, and indifference [14]. When a significant number of investors decide to sell stocks, the excessive supply triggers further decline in price value. Consequently, investors can experience capitulation and despondency emotions, which biases the financial decision-making process against the return potential of investments in the stock market. Additionally, investors can enter into a depressive emotional state, becoming apathetic towards future investments in the stock market [15]. In contrast, an indifference emotional state makes investors emotionally immune to stock market volatility, thus optimizing consistency when making rational, logic-based financial decisions.

2.2. Theoretical framework

The Traditional Financial Theory posits that investors approach the stock market rationally and make logic-based financial decisions [16]. According to Moueed and Hunjra, an individual's psychological and emotional state bear a significant influence on the judgments they proposition to stock market assets and can induce them to make irrational or inconsistent financial decisions. These findings are backed up by the human psychology theoretical framework that posits that an individual's; perceptions, confidence in expertise, emotional state, and heuristics predispositions biases, which ultimately influence financial decisions [17]. Hence, The Traditional Finance Theory overlooks the impact of the interactions of these multifaceted factors that can influence an individual's judgments regarding investments in stock market assets by assuming that investors approach financial decisions rationally.

Emotional state varies based on an individual's personality, stress resilience level, and previous experiences which can impact of an investor's emotional state on risk aversion. The Behavioral Finance Theory posits that psychological and social factors influence investors' risk aversion frameworks and impact on their investment decisions on stock assets, which ultimately determines aggregate returns [18,19]. Thus, The Behavioral Finance theory, whose principles address the rational investment assumptions of The Traditional Financial Theory, will be crucial for deducing implications and interpreting findings yielded from undertaking the proposed research. Therefore, the principles of the Behavioral Finance Theory will be leveraged to interpret the results generated from analyzing the data collected from the selected respondents, as detailed in the Methodology chapter below.

3. Methodology

3.1. Research design

The proposed research seeks to shed insights into the influence of an investor's emotional state on risk aversion and aggregate stock returns. Hence, the research will link concepts from the fields of human psychology to investors' financial decision-making for investments in the stock market. Thus, the underlying research philosophy for the proposed study will be interpretivism because the paradigm will facilitate the interpretation of subjective qualitative data collected from the selected respondents. The inductive approach will be utilized for the proposed study whereby the findings yielded from analyzing the qualitative data will be referenced to evaluate the four research questions specified in section 1. The action research strategy will be adopted for the proposed study whereby primary qualitative data will be collected from the respondents who will be selected among Australian professionals working in the Finance industry and the Human Psychology sector. The

time horizon for the proposed research will be cross-sectional since qualitative data will be collected from each of the selected respondents once.

3.2. Sampling

The stratified sampling technique will be adopted to select a total of thirty respondents who will be interviewed to collect qualitative data. The stratified sampling technique is a two-step process in which the population of interest is categorized into defined subgroups or strata based on a defined characteristic [20]. Since the proposed study seeks to shed insights into the influence of an investor's emotional state on risk aversion and aggregate stock returns; the research links concepts from the fields of human psychology and finance. The first phase of the stratified sampling will entail the grouping of the target population demographic of interest for the proposed research into two strata: Finance industry professionals and Human Psychology practitioners. The second step of the stratified sampling process will entail the selection of fifteen respondents from each stratum. For the Finance Industry stratum, three respondents will be selected from the following professions: Financial Analysts, Portfolio Managers, Hedge Fund Managers, Risk Managers, and Stock Exchange Professionals. For the Human Psychology sector, three respondents will be selected from the following professions: Behavior Analysts, Behavioral Economists, Psychological Counselors, Emotional Intelligence Consultants, and Human Behavior Researchers. Selecting an equal number of respondents from the Finance industry and the Human Psychology sector will facilitate the collection of high-quality qualitative data from the sample. Therefore, a sample size comprising thirty respondents selected among professionals working in Australia's Finance Industry and Human Psychology sector will facilitate the collection of relevant and accurate qualitative data.

3.3. Data collection

The qualitative data for the proposed research will be collected from the selected thirty respondents via interviews. According to Eppich et al. [21], interviews are effective in collecting in-depth information from research participants. For the proposed study, the selected thirty respondents will be interviewed whereby ten open-ended questions will be posed by the scholar to the interviewee. The open-ended questions to be featured in the interview will be formulated and organized logically to facilitate seamless coherence regarding the flow of information from the respondents. A pilot test on the interview tool will be conducted before initiating the qualitative data collection to justify the capability of the ten open-ended questions to collect relevant and coherent in-depth information from the research participants. The pilot test will facilitate the identification of any ambiguities in the phrasing of each of the open-ended questions, whereby appropriate modifications will be made to optimize the effectiveness of the interview tool in collecting coherent qualitative data. After justifying the appropriateness of the data collection tool, 30-minute interview sessions with each of the selected research participants will be scheduled based on a respondent's availability. Each of the respondents will be requested to propose the most appropriate date, time, and location to undertake the interview. Upon the allocation of these specifics for each respondent, the researcher will commute to the designated location for the interview session. The interview sessions will be recorded on audio tapes.

3.4. Data analysis

After the completion of the data collection process, the audio tapes for each of the interview sessions will be transcribed to transform the audio recordings into a textual format. The transcribed qualitative data will be analyzed via thematic analysis. According to Wipulanusat et al., thematic analysis is a multi-step method utilized by scholars to analyze qualitative data. The first step will involve the initial coding of the qualitative data to capture the essence of the research participant's responses to each of the ten open-ended questions. The second phase will entail the defining of underlying themes and the development of a thematic map framework. The third step will involve the categorization of relevant qualitative data to each of the defined themes using quotes and excerpts from the transcribed interview sessions. The fourth phase will entail the interpretation of the qualitative data within each theme to derive meaningful interpretations from the respondent's responses during the interview sessions. The fifth step will involve the verification of consistency across the dataset to identify redundancy and to justify that the qualitative data has been analyzed appropriately per the initially defined themes. Upon the completion of the five sequentially fulfilled phases of the thematic analysis process, the findings will be interpreted and discussed.

3.5. Ethical considerations

Informed Consent:The selected respondents will be fully informed on the purpose of the proposed research and the significance of the qualitative data from the sample to the study.

Confidentiality:The names of the selected respondents and any other confidential information will be anonymized by assigning pseudonyms and numerical identifiers.

Voluntary Participation:A consent form will be emailed to the selected respondents to inform them why they were selected to participate in the proposed research. The respondents will be requested to affirm their willingness to participate in the data collection process by signing the consent form.

Beneficence:Pilot tests will be conducted on the interview tool to justify that the ten open-ended questions to be featured in the interview sessions won't trigger negative emotions from the respondents.

3.6. Significance and implications

Undertaking the proposed research is crucial because the findings, discussions, and recommendations will contribute to advancing knowledge on the influence of emotions on financial decision-making. The implications deduced by the scholar in the dissertation reporting on the proposed research will be key reference source for future researchers seeking to advance knowledge in the field of Finance. Therefore, the proposed research is significant and bears substantial implications in advancing knowledge regarding the influence of an investor's emotional state on financial decision-making, risk aversion, and aggregate stock returns.

4. Conclusion

This research investigates how an investor's emotions influence their risk aversion and subsequent stock market returns. Challenging traditional finance theory, it adopts a behavioral finance perspective. Using a qualitative approach, the study will conduct interviews with 30 Australian finance and psychology professionals. The goal is to identify key emotional drivers, understand their

impact on decisions, and develop evidence-based strategies to help investors balance emotion with rationality for improved returns.

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