How Emotion Regulation Influences Decision Making while Trading (high-risk) Stocks

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Abstract:

It is well established that emotions play a key role in human social and economic decision making. People evaluate objective features of alternatives such as expected return subjectively. Emotions are understood to influence these subjective evaluations. In this paper, I will explore how emotions and emotion regulation strategies affect an individual while trading in (high-risk) stocks.

Keywords: emotion regulation, financial decision-making, emotions, trading, high-risk stocks

How Emotion Regulation Influences Decision Making while Trading (high-risk) Stocks

It is well known that emotion plays a key role in human social and economic decision making (see, e.g., Elster, 1998; Loewenstein, 2000; Peters, Va¨stfja¨ll, Ga¨rling, & Slovic, 2006). People evaluate objective features of alternatives such as expected return subjectively (Edwards, 1962; Kahneman & Tversky, 1979). Emotions are understood to influence these subjective evaluations (Loewenstein & O'Donoghue, et al. 2004; Naqvi, Shiv, & Bechara, 2006; Slovic, Finucane, Peters, & MacGregor, 2007). Trading is a fast-paced decision-making environment with significant cognitive and emotional demands. Traders make judgements about risk and potential returns under time pressure with potentially major financial consequences (Fenton-O'Creevy, Mark; Lins, Jeffrey; Vohra, Shalini; Richards, Daniel; Davies, Gareth and Schaaff, Kristina, 2012). Contrary to the financial-economic models of traders which treat traders as rational utility maximisers (with cognitive limits), evidence suggests that emotions have important effects on a traders decisions and behaviour.

Furthermore, active monitoring of a portfolio is important for navigating the changing tides of financial markets. It is also essential for individual investors to manage the behavioural impulses of emotional buying and selling that can come from following the market's ups and downs. Indeed, investors seem to have a knack for piling into investments at market tops and selling at the bottoms as it is not uncommon to get entangled in media hype or fear i.e buying investments at peaks and selling during the valleys of the cycle.

Certainly, traders have to think fast and make quick decisions, darting in and out of stocks on short notice and to accomplish this, they need a certain presence of mind. Not only this but they also need a certain level of financial discipline to stick with their trading plans and know when to book profits and losses. (Lerner & Keltner, 2001)

So, what emotions are experienced by traders?

The most common emotions experienced during trading (Hariharan & Adam, 2015) are hope, optimism, euphoria, nervousness, fear, greed and hopelessness. Moreover, there is also evidence from field research that highlights the pervasive role of these emotions in traders' working lives (Fenton-O'Creevy; Nicholson; Soane & Willman, 2005, p. 199).

Market Volatility and VIX:

A particular source of emotional pressure for traders is associated with market volatility. In volatile markets, outcomes become more uncertain and consequently, risks are higher. A commonly used measure of market volatility (the VIX) is colloquially known as the ‘fear index’. High levels of the VIX are coincident with high degrees of market turmoil and spikes in this measure can be seen at times of stock market decline eg. during the threat of war or other major events which create great economic uncertainty. (Whaley, 2000).

Apart from this, recent behavioural finance approaches draw upon insights from cognitive psychology to incorporate cognitive biases into models of financial decision-making (De Bondt, Palm, & Wolff, 2004; Thaler, 1993). As we move on, we shall explore research findings on the role of emotions in judgment and decision-making, highlighting both emotional effects which are detrimental to human performance and the role of emotions in enhancing performance.

The advantageous role of emotions in decision-making:

There is also evidence that the use of emotional cues offers an important advantage in everyday decision-making. For example, Seo and Barrett (2007) carried out a study of investment club members, using an internet-based investment simulation accompanied by emotional-state surveys, they found that individuals who reported the experience of more intense emotions achieved higher decision-making performance due to the “flight or fight response”.

The flip side to emotions in trading:

In contrast, most researchers believe that the flip side to emotional trading overshadows the positive sides; as an investor, you may expose yourself to unnecessary risk- you tend to adopt a myopic approach. If you trade under emotions, it elevates the quantum of risk manifold. Goal-based investments ensure that money is available when you need it. However, when you trade emotionally, you tend to make judgements that hardly do justice to this principle. Traders often lose sight of why they invested in the first place and make decisions that contradict logic and facts.

Stock markets, particularly equities, have the potential to generate inflation-beating returns. A sour experience, especially during formative trading days, can act as a dampener and turn you off markets once and forever.

The danger doesn’t end there. Revenge trading may also result in overtrading which would significantly increase your costs. Moreover, your stress levels would also escalate, and the probability of making bad calls would also soar. As a ripple effect, you may also feel a profound need to overcome the loss in a short period of time, and in a bid to do so, traders may go about making trades they would have otherwise never made.

Thus, when you trade unemotionally, your judgments are based on logic, facts, and figures. You trade according to the goal you wish to achieve and get your calls right. Doing so will not only enhance your wealth but give you a better experience.

Summary of the body of the paper

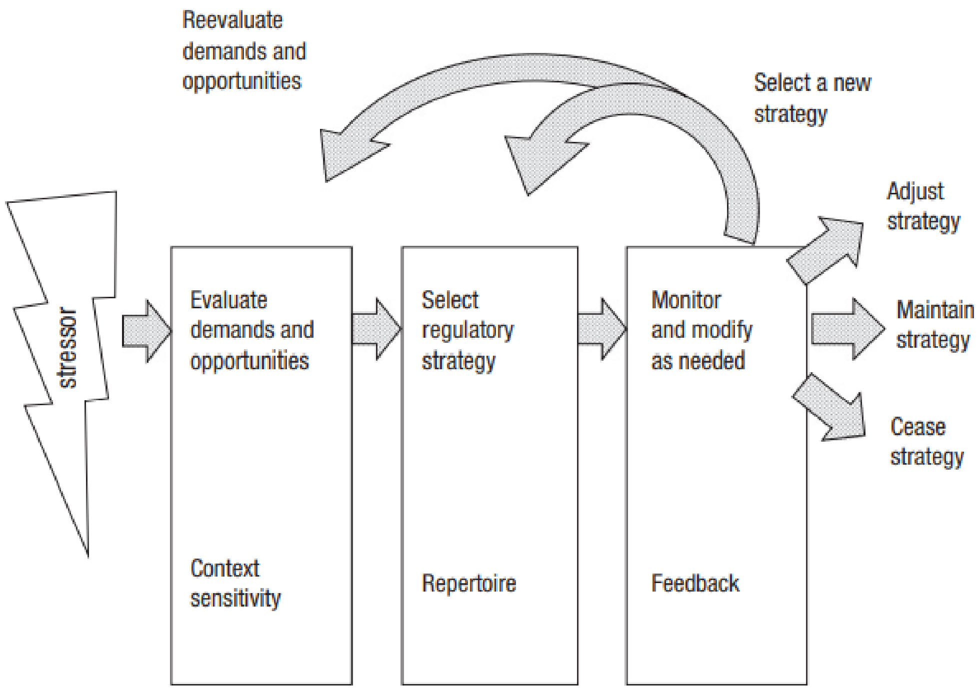
Firstly, I will summarise the Regulatory Flexibility Model by Bonanno and Burton (Bonanno and Burton, 2013) to provide a framework for the research paper. Complimentary to this framework, I will talk about the interpersonal and intrapersonal emotion affect and regulation. Then, I will discuss the strategies that could be used to effectively regulate emotion during trading in the real-world context consequently, stating how exercising these strategies will impact an investor’s success. Finally, I will end by concluding or rather summarising my paper and talking about where this research can go next.

The Regulatory Flexibility Model:

The Regulatory Flexibility Model (Bonanno, 2013) [fig.1] is one I will be referring to intermittently. This model has three sequential components - (1) context-sensitivity, (2) repertoire, and (3) responsiveness to feedback.

Figure 1

Three sequential components of regulatory flexibility and their corresponding abilities.



Context sensitivity, [see fig.1] in broad terms, means evaluating demands and opportunities. In more precise terms, it's about evaluating and differentiating between various contexts. This would also have to account for contextual demands and across time, as different situations would require the use of different emotion regulation strategies.

For even the most context-sensitive person, the perception and understanding of situational demands and opportunities are only as accurate as the context allows. Many stressor situations provide relatively clear contextual cues about the impinging demands and opportunities, and in such situations, it is possible to estimate with considerable confidence what the most effective regulatory strategy might be.

However, in stressor situations where the contextual demands and opportunities are less readily decoded, the determination of the most appropriate or effective regulatory strategy becomes more of the best guess among plausible alternatives. This “best guess” is owing to the fact that contextual evaluations are not perfect, it is often necessary to revise and adjust regulatory strategies in the regulation process. (Bonanno, 2013)

While this is a crucial part of the process, this alone will fail to suffice, the second step is choosing an appropriate regulatory strategy i.e ***repertoire***. A major point to note while discussing this topic- the number of strategies known (available) to the investor plays a crucial role; temporal variability i.e regulatory strategies across time, stressor situations and categorical variability of strategies also account for the repertoire. [see fig.1] (Bonanno, 2013)

The final sequential component of the regulatory flexibility model is ***responsiveness to feedback;*** it consists of monitoring feedback by judging the impact of regulatory strategy and modifying it as needed. [see fig.1] (Bonanno, 2013)

Interpersonal and Intrapersonal regulation strategies

Now onto interpersonal and intrapersonal regulation strategies- in layman terms, interpersonal regulation is emotional regulation taking place in a social context (eg.

your friend provides you comfort after a bad test) whereas intrapersonal is regulating your own emotions (eg. you convince yourself this test doesn’t have a substantial effect on your future) (see, eg, Zaki & Williams, 2013). Therefore, it is important to note that although interpersonal regulation as defined here can only occur in social contexts, individuals can deploy intrapersonal regulatory processes both when they are alone and with others. (Zaki, 2013). That being said, interpersonal regulations strategies are beyond the scope of this text and I will be mostly focusing on intrapersonal regulation (self-regulation) to keep the article relevant.

Emotion Regulation Strategies:

As you would have guessed by now, emotions play an important role while trading and failure to regulate emotions can have a large-scale impact on your success in the stock market and on your health. (Heilman & Cris¸an, Houser , 2010). So the question is - how do we keep our emotions in check and become better traders by exercising emotion regulation? (Creevy, 2005) i.e how do we modify not only your repertoire but also your feedback to become better traders. (Bonanno, 2013).

Short-term strategies:

Firstly, create ***personal rules***- Setting your own rules to follow when you trade can help you control your emotions. (repertoire modification in terms of categorial variability and number of strategies) (Bonanno, 2013) Your rules might include setting an equilibrium for risk/reward, entering and exiting trades and even profit trade and losses.

Secondly, trade in the ***right market conditions*** (i.e modifying your contextual situations in terms of emotion awakening cues) (Bonanno, 2013), try to avoid investing during highly volatile times like during a plague.

While I disclaimed this by saying the right “market” conditions, this also applies to your overall mental state. Try to avoid investing when your personal life may be affecting your decisions or when you’re not at your optimal health.

Equally important is ***decreasing your trade size*** the next time you feel anxious about investing in a stock. By decreasing your trade size in terms of money and stock size you will feel less pressured to make a successful investment and more at peace. (context modification) (Bonanno, 2013). Consequently, by taking a rational and realistic approach to investing—during what seems like a short time frame for capitalizing on euphoria or fearful market developments you may make better investments that wouldn’t stem from fear and/or pressure. (repertoire and feedback in terms of internal feedback) (Bonanno, 2013).

The most important and easiest way to take the emotion out of investing in the **d*ollar-cost averaging and diversification*** strategy. This would take some of the guesswork out of investment decisions and reduce the risk of poor timing due to emotional investing as a result relieving you of pressure.

Specifically, ***Dollar-cost averaging*** is a strategy where equal amounts of dollars are invested at a regular, predetermined interval. This strategy can be implemented in any market condition. In a downward trending market, investors are purchasing shares at lower and lower prices. During an upward trend, the shares previously held in the portfolio are producing capital gains and, since the dollar investment is a fixed amount, fewer shares are purchased when the share price is higher.

The key to the dollar-cost averaging strategy is to stay the course. Set the strategy and don't tamper with it unless a major change warrants revisiting and rebalancing the established course. The goal of dollar-cost averaging is to reduce the overall impact of volatility on the price of the target asset; as the price will likely vary each time one of the periodic investments is made, the investment is not as highly subject to volatility as compared to the alternative. This proves successful because, in a way, you detach yourself from your judgement and therefore feel less anxious.

Lastly, we will explore the strategy of ***diversification***, which is the process of buying an array of investments rather than just one or two securities. In a normal market cycle, using the diversification strategy provides an element of protection because losses in some investments are offset by gains in others. Diversifying a portfolio can take many forms- such as investing in different industries, different geographies, different types of investments, and even hedging with alternative investments like real estate and private equity. There are distinctive market conditions that favour each of these investment groups, so a portfolio made up of all these various types of investments should provide protection in a range of market conditions.

This can also help diminish the emotional response to market volatility. After all, there are only a handful of times in history when all markets have collapsed at the same time and diversification will prove to provide a little protection to your anxiety.

Long-term regulation strategies:

Most articles focus on short term band-aids to a bigger problem, however, I'd like to state a few more strategies for the long-term investor.

Understanding fear:

When traders get bad news about a certain stock or the economy in general, they tend to panic. They may overreact and feel compelled to liquidate their holdings and refrain from taking any more risks. Upon this instance, they may avoid certain losses but may also miss out on future gains.

Traders need to understand what fear is: a natural reaction to a perceived threat. Fear is a threat to their profit potential. Quantifying the fear might help traders consider just what they are afraid of, and why they are afraid of it. But that thinking should occur before the bad news, not in the middle of it.

Namely, by thinking it through ahead of time, traders will know how they perceive events instinctively and react to the macroeconomics and will be able to move past the emotional response. Of course, this is not easy, but it's necessary to the health of an investor's portfolio and not to mention the investor.

Conducting Research and Review:

Traders need to become experts in the stocks and industries that interest them. Keep on top of the news, educate themselves and if possible, go to trading seminars and attend conferences.

To begin with, devote as much time as possible to the research process. That would mean studying charts, speaking with management, reading trade journals, and doing other background work such as macroeconomic analysis or industry analysis. In addition, knowledge can also help overcome fear.

Overcoming Greed:

There's an old saying on Wall Street that "pigs get slaughtered." This refers to the habit greedy investors have of hanging on to a winning position too long to get every last tick upward in price. Sooner or later, the trend reverses and the greedy get tangled.

As guessed, greed is not easy to overcome. It's often based on the instinct to do better, to get just a little more. A trader should learn to recognize this instinct of greed and develop a trading plan based on rational thinking and not just whims or instincts.

Setting Rules:

A trader needs to create rules and follow them when the psychological crunch comes. Set out guidelines based on your risk-reward tolerance for when to enter a trade and when to exit it. Set a profit target and put a stop-loss in place to take emotion out of the process. In addition, you might decide which specific events, such as a positive or negative earnings release, should trigger a decision to buy or sell a stock.

It's wise to set limits on the maximum amount you are willing to win or lose in a day. If you hit the profit target, take the money and run. If your losses hit a predetermined number, fold up your tent and go home. Either way, you'll live to trade another day.

Stay Flexible:

Not only do traders need to set rules for themselves but they also need to remain flexible and consider experimenting from time to time. For example, as a trader, you might consider using options to mitigate risk. One of the best ways a trader can learn is by experimenting (within reason). The experience may also help diminish initial feelings of shock

Periodic assessment of performances:

Last but not the least, traders should periodically assess their performances. In addition to reviewing their returns and individual positions, traders should reflect on how they prepared for a trading session, how up-to-date they are on the stock exchange and how they're progressing in terms of ongoing education. This periodic assessment can help a trader correct mistakes, change bad habits, and enhance overall returns.

Conclusion:

To conclude, emotion regulation influences decision-making while trading (high-risk) stocks. Emotional dysregulation affects your clarity of logic, causes you to make hateful investments and impacts your success while navigating the volatile market. Hence, emotion regulation is essential while trading (high-risk) stocks.

To manage your emotions while trading you can choose to adopt short-term solutions like setting strict rules, trading in the appropriate market conditions or the ever famous dollar-cost averaging strategy. Nonetheless, if you plan to stay in the market for a long-time but are struggling to manage your emotions, you can always look deeper into your emotions to find the root cause of it. These strategies will not only up your investment game but also improve your overall health and make your experience with the stock market much more pleasant.

Moving Forward:

That being said, more research needs to go into how investors can manage their emotions. This would help investors manage their emotions better and promote healthy trade practices. A lot of changes need to go into the way research is conducted. My suggestion is maybe less investment into how high-risk trading impacts an individual and more into how an investor can manage emotions while trading. The strengths of research in this area include transparency and the impact of emotions on health and efficiency in the market. However, a major flaw remains that little research has been done on how to navigate emotions associated with trading.

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