Irrational Decision Making During Times of High Market Volatility

Nana Khimkova

Master's Thesis is submitted to Ilia State University, faculty of Business Administration in compliance with the requirements of obtaining Master's academic degree in Business Administration

Master of Business Administration

Scientific Advisor: Nikoloz Kavelashvili, PhD Professor

Ilia State University

Tbilisi, 2018

1 Part I

1.1 Declaration of Authorship

I do hereby declare that the following thesis paper is a true original document created by me and submitted to Ilia State University in the pursuit of a Master of Business Administration Degree. Ilia State University may reproduce and distribute copies of this thesis document in whole or in part.

Tbilisi, Georgia, on February 15, 2018

Nana Khimkova

1.2 Abstract

Throughout the history of financial markets there have been periods of great volatility and there is no reason for an investor to think that this time things will be different. However, even knowing that volatility has been a constant, many investors still behave irrationally and follow investment strategies that more often than not act against their own best interests. This thesis looks at how investors allow psychological factors to steer them away from rational behavior. Such factors include: Herding, Overconfidence, Noise, Cognitive Dissonance, Gamblers' Fallacy, Regret Aversion, Hindsight Bias, Anchoring, and Mental Accounting. These can affect the editing phase of and thus skew the utility computation of the Prospect Theory model, leading to irrational results even when following what might seem a rational thought process. Primarily, this thesis will look at Herding, Noise, and Overconfidence as a cause of irrational decision making.

During tumultuous times in financial markets, large groups of investors often behave in an irrational manor. There is a tendency to make assumptions about market trends that are more wishful thinking than well thought out financial strategies. This can occur in the stock market, bond market, real estate market, commodities and so forth.

There are many reasons that people make irrational decisions with their finances. This is often simply a matter of poor understanding of the financial instruments in which they are investing. Taken individually, markets are not much affected by such poor decision making; however, when markets are highly volatile, large numbers of ill-informed investors can begin to move at the same time, making irrational decisions, which only increase the volatility. These waves of irrational actors can undermine otherwise sound investment strategies and spread even to better informed investors. This paper will demonstrate that irrational actions in times of high volatility exacerbate times of high market turmoil and have a knock-on effect that is detrimental to the entire economy.

1.3 Acknowledgements

I would like to express my gratitude to my professor.

I thank Ilia State University.

I would also like to thank my family members, fellow students, and colleagues who have helped me in the pursuit of this goal.

Nana Khimkova