

## Chapter 2

# Understanding the Investment Behavior of Individual Investors: An Empirical Study on FOREX Markets

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### ABSTRACT

*The FOREX market has become a popular ground amongst all kinds of market players. The leverage transactions of the market that may generate higher profit levels with low capital/investments make it very attractive for the individual risk takers. The research investigates the trading behavior of FOREX investors relying on the survey data collected from 167 Turkish investors in 2019. Within the scope of the research, the authors evaluate whether and to what extent behavioral factors, namely demographic characteristics; personal characteristics such as personality traits, love of money, and biases like disposition effect influence investment performance. The results reveal that among the personality traits, openness to experience and conscientiousness have a positive impact while disposition effect and love of money have a negative impact on the performance of investors. Additional analysis suggests that the effects of personality traits and biases on trading performance remarkably change among subgroups of investors regarding their income level.*

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## INTRODUCTION

The Foreign Exchange market, hereafter ‘FOREX’ market, is not only one of the most exciting, volatile, and engaging markets in the investment world, but also the largest market in terms of daily turnover. The BIS Triennial Central Bank Survey (2016) estimates that the total turnover in global foreign exchange markets is 5.1 trillion dollars a day and that is much larger than the turnover in U.S. treasury bonds and the trading volume at the New York Stock Exchange (Barker, 2007). The main players of the FOREX market are institutional investors namely dealers, banks (including central banks), and investment funds. Their shares in the trading volume are 42%, 22% and 16%, respectively (BIS, 2016). While the central banks use the FOREX markets to carry out monetary policies or to protect the value of money, corporations trade currency for global business operations and to hedge risk. The recent advances in electronic trading and its institutional trading adaptations have shifted the balance of the market participation from banks and other financial accounts to big and small ‘market participants’. This has resulted in domestic and global players becoming one of the primary drivers of the market in the recent years. Although the motives of FOREX trading are much more diverse than traders in the capital markets, FOREX market players are generally known to be speculative and return-motivated.

In general, the transaction volume of individual investors (retail investors) is very low compared with institutional parties, but interestingly, their participation in the FOREX markets has been substantially increasing in last decades (Rime & Schrimpf, 2013). The individual investors base currency trades on a various tools including fundamentals and technical factors such as inflation rate, interest parity, price pattern and technical indicator. Especially, low transaction cost, leverage trading, high liquidity, and resilient lot size have been making the market more attractive for retail investors. Brendan Callan, the president of FOREX Capital Markets in Europe, rationalize this picture by claiming that accessibility of currency news in the mainstream media has led the individual investors to become more comfortable with FOREX trading (Financial Times, 2011). On the other hand, a recent research on the French securities indicates that the FOREX market is much more complex and the risky for small investors than equity markets and 89% of all active retail clients lose their money (AMF, 2014). Nevertheless, many individual investors around the globe have been fallen down or lost millions of dollars in the last years due to widespread fraud (NBCnews, 2012). These experiences have led the regulatory authorities to take actions for individual investors. An example is the case of Turkey where after a series of failures of individual investors, the Turkish Market Regulatory Agency (SPK) has recently raised the minimum investment amount for the FOREX market to limit the entry of individual investors to the market (Republic of Turkey Official Gazette, 2017). Despite these facts and recent failures, the interest of individual investors to the FOREX market is still growing not only in Turkey but also worldwide.

Indeed, poor performance of individual investors is not limited to the FOREX market. Barber and Odean (2013) mention that individual investors in the real world behave differently than the investors in models of traditional finance such as Capital Asset Pricing Model. In this regard, they argue that the investment attitude of the individuals is well explained by the behavioral factors rather than the rational expectations. The research specifies that the individual investors have a tendency to trade frequently. As a result of this overtrading, they face high investment costs, make inefficient stock selections and lose money. Most of them hold undiversified portfolios, which generate high levels of diversifiable risk relying on their past experience and tend to ignore the prescriptive advice of experts. Daniel Kahneman and Amos Tversky, the founding fathers of behavioral finance, clearly state that “*human decision-making processes are distorted by inherent biases toward optimism and overconfidence*” and “*these subjective*

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