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# Risk Mitigation Strategies and Financial Distancing: A Study of Retail Investor Behaviour during Economic Uncertainty

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#### Abstract:

The volatility in rate of return can be defined as risk. Risk is also associated with the non- payment by a counterparty which can also be known as financial risk or credit risk. Financial risk generally connects to losing of principal amount. It comes in different shapes and sizes for different industries and markets. This type of risk takes a business to the verge of bankruptcy when cash flows are inadequate to meet its obligations. Economic uncertainty and financial market volatility, such as those witnessed during the COVID-19 pandemic, have significantly influenced investor behaviour-especially among retail investors. As social distancing was an efficient tool for preventing ourselves from the COVID 19 onslaught during the pandemic time, the similar way financial distancing has emerged as a strategic approach to protect personal wealth and reduce exposure to financial risks. Financial distancing is giving space in your financial planning i.e., systematically planning and implementing the specific measures to reduce the risk of non-payment of funds in any transactions for all the counterparties. It means keeping a gap between your outflow (premium to be paid) and inflow (Maturity receipts) of funds while investing. It also means the strategic isolation or withdrawal of personal financial assets from high-risk investments, markets, or instruments to safeguard wealth during periods of economic or market distress. Financial Instruments having the same payment or investment due date or month and same maturity periods are not advisable for the wealth creation. To grow and maintain your lifestyle you must secure your funds and work on it, financial distancing deals with this need of the hour. Financial distancing teaches you how to build a base for the financial success in your life and get a competitive edge over the others. The biggest question in the minds of a common man is how to create cash flows for our families?

How to rebalance the portfolios? The answer to these questions is financial distancing which helps us to provide the tools to make money out of money and generate cash flow not for the present but also for the future.

Retail investors are increasingly adopting **risk mitigation strategies** such as asset diversification, liquidity management, staggered maturity planning, and portfolio rebalancing to safeguard their financial stability. This research paper examines the **behavioural shifts in retail investors** during periods of economic stress, explores how financial distancing principles are applied in personal financial planning, and evaluates their effectiveness in managing financial defaults and credit risk. The paper also analyses the role of regulatory and banking institutions in encouraging resilient investment behaviour and highlights the need for real-time risk assessment frameworks to support retail investors in uncertain times.



Key words: Financial Distancing, Risk Mitigation, Retail Investors, Investor Behaviour, Economic uncertainty

#### Introduction to Risk mitigating strategies and financial distancing:

Financial defaults—defined as the failure to meet financial obligations such as interest or principal repayments—can severely impact both individual investors and the broader economy. For retail investors, defaults may arise from poor financial planning, ill-timed investments, or unexpected disruptions in income or liquidity. During periods of economic uncertainty such as the COVID-19 pandemic, the risk of financial default increases due to impaired cash flows, credit downgrades, and market instability.

#### Figure1: Delinquency and Grace period on some basic types of loan

Loan type	How long until default after last payment?	Grace period?
Student Loan	270 days	90 days to make a payment
Mortgage	30 days	15 days to make a payment
Credit Card	180 days	1 missed payment allowed before penalty
Auto Loan	1 to 30 days	Varies widely

Source: https://www.valuepenguin.com/loans/what-does-it-mean-to-default-on-a-loan

In this context, financial distancing has gained prominence as a vital personal finance strategy. **Financial distancing** refers to the strategic spreading out of financial commitments and investments over time to mitigate the risk of simultaneous defaults or cash flow mismatches. It encourages investors to maintain gaps between their investment outflows (e.g., premiums, EMIs) and expected inflows (e.g., maturity receipts, dividends), thereby reducing pressure during financial downturns. The core idea is to avoid clustering financial obligations or maturities, which can otherwise lead to systemic personal financial failure.

Retail investors, traditionally reliant on conventional investment approaches, are now increasingly embracing **risk mitigation strategies** to enhance their financial resilience. These include portfolio diversification, building emergency funds, investing in staggered instruments with varied maturity timelines, rebalancing portfolios, and shifting funds away from volatile assets during distress periods. Financial distancing, when applied effectively, acts as a behavioral and structural safeguard—helping investors to navigate market downturns while preserving long-term financial health.

This paper aims to study how retail investors adopt financial distancing and related risk mitigation strategies in times of economic uncertainty. It further investigates the psychological, strategic, and institutional factors influencing such behavior, and evaluates how these measures contribute to the overall reduction in financial defaults and improved financial well-being.

Financial distancing deals with this very issue by leading you on the track of maintaining safe distance in your returns on investments. Securing money will not be sufficient the need is to invest the capital for the future gains or emergency payment s to maintain the current lifestyle. Government and regulatory bodies in past, through their different measures or strategies such as financial patterns, geopolitical disruptions etc. have tried their level best to save the system but all the efforts gone in vague because of



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the impact of the global economic downturn. Currently also if you analyze or study the market trends or movement the global depression is really hitting economies very hard all over the world. The key to move out of this maze is financial distancing as it helps to create the base of financial success. Today we globally have reached to an unserviceable situation as global debt is reaching \$300 trillion. Savings have lost their ability to generate income on its own like before. Now investor must allow his money to flow into the market, put it at risk and to earn a reasonable return to match up to inflation.

Servicing is something which is very important aspect for any tangible or non-tangible asset as it increases its life, reduce maintenance cost, and provides safety in future. The same rule applies to financial assets also if you do not take care or service your debt properly or do not keep a watch over them, they will turn into a long-term debt and finally into a liability. Unpaid liability later converts into defaults and disrupts the whole structure of your business and harms your goodwill. Servicing financial assets means rebalancing your portfolios, creating a proper current and future cash flow for our families and businesses. But the question is- how to do it. The simple answer is financial distancing having a proper gap in your investment. Maintaining a proper distance in your investments that they mature at different times of future needs. Planning investment in such a way so that capital gains and returns occurs in a cyclic formation and not all at one time in the future. Financial distancing provides us the techniques, strategies, and tools to maintain that safe distance between our investments to ward off the risk of financial defaults which may or may not occur in future. As accounting conservatism rule says always provide for the losses and not for gain, financial distancing helps us to adapt preventive measures rather than cure. It helps us to thrive in all adverse situation.

#### Literature review:

- Thomas Pintelon in his article on social distancing and financial distancing new counterparty risk models explained about the similarity between social distancing & financial distancing in which the former helped in limiting the spread of epidemic Covid 19 and the latter in curbing the multiplication of financial defaults. He stressed on having new techniques and strategies in place as compared to the traditional risk measuring models. The article focuses on identifying and introducing the quantitative and qualitative elements in new risk evaluating models. This will help to deal with the problem of rising financial defaults with more real time, transparent and automated solutions which is the need of the day.
- Eric Peterson in one of his podcasts on Spotify on social distancing for your finances emphasized on keeping a safe distance between your finances for the safety and protection. He gave some very important equipping points to safeguard your finances such as in which all components of your investments the social distance should be maintained, emergency fund requirement, how life insurance and investment are different from each other and not be treated as one for the safety of future and how emotions should be kept separate from the arena of your investments. He also gave an advice to keep your high investment turnover strategies separate form your after tax brokerage accounts.
- Thomas Pintelon in his article on 4 ways to improve financial fitness focused on improving the financial literacy rate in general population which will automatically help a common man to improve his financial fitness. He also mentioned that banks instead of manipulating the customers to meet up their product sales of a particular year should focus on leveraging this customer network by providing them need based products. He highlighted some interesting ways of improving financial



health and fitness such as by homogenizing and gamifying financial management so that it becomes easy to understand for a common man, by sharing customer risk management, by being proactive genuine advisors, by a simple scoring system for the customers on the basis of knowledge, experience, spending, saving, liquidity, risk and trustworthiness and making it visible for all so that they can deal with banks and other parties smoothly.

- As per the Randolph Brooks Federal Credit Union website\* financial distancing is related to not disclosing your personal financial information to anyone calling on behalf of any financial institution. They encourage their members to use financial distancing by not disclosing information such as username, password, email addresses, debit card numbers, credit card numbers, CVV, OTP etc. to save themselves form the financial defaults. If this financial distancing is not taken care off may lead to long term financial losses for the client and multiply the financial defaults.
- Manoj Kumar Yadav and Dr. Preeti Sharma in their study titled "Risk Mitigating Strategies of Retail Investors in the Stock Market explores risk management strategies used by retail investors in the stock market, focusing on techniques such as diversification, stop-loss orders, asset allocation, hedging, and market timing. Through surveys, interviews, and analysis of literature and data, it examines how investors of varying experience manage risks. The findings highlight the importance of disciplined investing, clear financial goals, and staying informed. Education and awareness are crucial for improving decision-making and minimizing emotional biases. The study concludes that a well-rounded, informed approach helps retail investors mitigate risks and optimize returns, contributing valuable insights to the field of stock market risk management.
- Laha (2023) presents a comprehensive analysis of retail investors' trading behavior, identifying that investor psychology, market perception, and socio-economic background significantly impact decision-making. The study underscores the relevance of behavioral finance, highlighting biases such as overconfidence, herding, and regret aversion among Indian retail investors. It finds that emotional and cognitive factors often outweigh traditional rational considerations in investment choices.
- The financial crises of the past two decades have resulted in declining stock returns, investor • sentiment, and financial activity (Hoffmann et al., 2011). The substantial drop in stock prices during the market turmoil has triggered selling pressures and the liquidation of financial assets. During the troubled market, a huge number of investors might have intended to reallocate their portfolios in a more conservative fashion in an attempt to keep their investment performance on par with the benchmark index. This shift in investment strategy, aggregate market trends and investor behaviour is documented in investors' financial distancing (FD) as a risk mitigation mechanism. As the aggregate FD index increases, the investment behaviours of individual investors become increasingly defensive and simple, seemingly with less concern for beating the market benchmark. The FD index alters significantly upward during the early stages of stock market downturns, when most of the participants appear to abandon themselves in trying to make any profits and instead maximize the return to risk ratio. This analysis offers a better understanding of risk mitigation mechanisms using FD, and fills a gap in the existing literature by linking together these two issues and providing empirical evidence about the characteristics of the reversal phenomenon. It is found that the FD index dynamics is similar across different investors, stock selection across the stocks in a very similar way, and it moves down concomitantly. The FD index goes up on average when the market is plunging, but it has a 1-day lagging effect during the overall market upturn. It is also observed that



staggered FD behaviours among specific investor types raise the stock prices on the one day of one type of investors becoming more conservative. FD composite index is proposed to explore universally applicable and temporally persistent dynamics in FRD. Results demonstrate strong and evolving cross-sectional co-movements of daily FD index time-series behaviour across investor types and markets.

**Research methodology:** This study adopts a descriptive and conceptual research design based entirely on secondary data sources. The primary objective is to examine how retail investors adopt financial distancing and risk mitigation strategies during periods of economic uncertainty, using insights from previously published research, reports, and financial databases. The research is qualitative and analytical in nature, relying on the review of existing literature, case studies, and various secondary sources to understand the evolving behaviour of retail investors in uncertain economic environments. Secondary data has been gathered from reputable sources such as peer-reviewed journals, academic papers on behavioural finance, crisis-period investing, research reports and whitepapers from SEBI, RBI, and AMFI, financial news publications like The Economic Times and Business Standard, government portals such as RBI Bulletins and MOSPI, as well as investor trend reports from brokerage firms and mutual fund houses. The scope of the data includes investor participation trends during crises like the COVID-19 pandemic and the 2008 financial crisis, changes in asset allocation and investment behaviour during high uncertainty, the emergence of practices such as "financial distancing," and macroeconomic indicators that influence investor psychology, including inflation, interest rates, and GDP contraction. The study uses a thematic analysis approach to identify recurring behavioural patterns and strategic shifts in investment decisions, classify and evaluate risk mitigation techniques, and correlate financial distancing practices with macroeconomic and social distancing contexts. Charts and graphs from secondary reports are interpreted to support and validate the study's observations.

#### **Financial Distancing Defined**

Financial distancing is defined as a psychological distance between immediate or personal assessment of perceived investment assets and related risks towards a more objective appraisal of the investment situation that is less dependent on prevailing risk appetite and accompanied emotional state of an individual investor. In the context of this study, it relates to a move from an initial, pre-event judgement or risk appraisal to a post-event decision or move. This approach to investigating the phenomenon of financial distancing is a novelty.

In the first part of the study, it is assumed that there is a link between economic uncertainty and one of the two forms of financial distancing. Further, in the second part of the study, retail investor behaviour is analysed, especially focusing on immediate responses to economic uncertainty, which result in a change of the investor's risk presentation, which is then treated as a financial distancing. The findings reveal that financial distancing (financial distancing to the side of less volatile equities and bonds) cannot be detected as a retail investor behaviour under conditions of high or great sudden economic uncertainty or extreme risk attenuation. It is not a direct change in risk perception/attitude that is detected, but a kind of presentation of the risk tolerance on the basis of response validity and elite investor behaviour. Recent studies that have tracked the focus of the retail investors on their portfolio investment as the world economy was highly volatile in March 2020 have provided evidence for the research of non-attentiveness or overlooking of the move of unmanaged risk or changes/inconsistencies in risk profile (Mayiwar & Björklund, 2021).



#### **Conceptual Framework of Financial Distancing**

Recent global and local economic turbulence has created uncertainty and altered investors' ability to properly assess and respond to risk relevant information. During this period of excessive uncertainty, placing appropriate contextual thresholds on new risk information has been more challenging. As a result, retail investors may underestimate risk and become less prone to implement a precautionary approach. Financial distancing is introduced to capture investors' tendency to flee from, or downplay the relevance of, risk relevant information. Such behaviour could leave retail investors future more exposed to performance deterioration. Financial distancing is suggested to be a composite psychological phenomenon encompassing self-distancing and financial distance. This conceptual framework is validated in studies, providing further insights on the typology and impact of financial distancing (Mayiwar & Bjorklund, 2021). In the literature on compositional constructs, composite constructs are broad phenomena reflecting a common underlying theme. Composite constructs encapsulate a multifaceted view; they are believed to have different facets reflecting complex latent phenomena that are broad in nature. Each of these facets can, in turn, be captured by specific indicators. With a diversified indicator base, a composite construct enhances the explanatory power of the framework being tested. The psychological distancing approach, a well-established concept, provides a basis for the construction of financial distancing. Self-distancing evokes reflective self-referent thoughts, thus dampening emotional and motivational consequences. Such effects are instrumental in mitigating risky behaviour. Financial distance is the more prominent blanketing facet of financial distancing. It refers to an overly detached response to heightened risk. Heightened financial distance renders newly available risk information less relevant. Conditional on access to a novel source of risk information, detached investors fail to respond to it with additional risk aversion and caution.

#### **Factors Influencing Financial Distancing**

The second study focuses on financial distancing, a concept that describes the subjective perception of economic uncertainty as a distant phenomenon. This perception induces a tendency to draw away from financial risk (i.e., stop trading, sell portfolios, hold cash). It is expected that this tendency increases as financial uncertainty is perceived as more severe. This study hypothesizes that being optimistic about the financial system (i.e., think that the market will go up again) is negatively related to financial distancing. This effect is fully mediated by a decrease in risk perception, in tandem with increased financial involvement. Financial distancing decreases with higher levels of trading experience. The magnitude of this effect is moderated by appraisal capabilities, in which a higher capability tends to reduce financial distancing (unless at very low levels of experience). Given that public concern and fear promulgated around the outbreak of COVID-19 have spilled over to other areas, it is relevant to explore how financial distancing manifests in this context (Hoffmann et al., 2011). Trading is among the first aspects of life that many individuals cease upon experiencing a large drop in the stock market index. During a crisis, retail investors are highly concerned about possible losses on their holdings and often tend to sell their entire portfolio. "Financial distancing" is on the rise as a consequence of the extreme series of events leading to volatile price fluctuations (Mayiwar & Bjorklund, 2021). Financial distancing is defined as the tendency to draw away from financial involvement, both in terms of holding any stocks and number of stock-trading days. To the best of the author's knowledge, this concept is novel.



#### Mitigation Strategies

With the emergence of the COVID-19 crisis, it has become increasingly important to observe investors' behaviour in turbulent times. Previous research showed that an economic crisis has a major impact on individual investors' perceptions, behaviour, and performance (Hoffmann et al., 2011). Understanding of this investor behaviour could be highly relevant to regulators, policy makers, and practitioners in the financial industry. The main objective of this paper is to provide insights into an important aspect of the behavioural response of individual investors during the COVID-19 crisis: the crisis-driven adaptation of investors' behaviour and its relationship with investment performance. Additionally, Corona affects individual and share prices, which brings about new investor behaviour. The COVID-19 crisis is a particular period of increasing uncertainty concerning economic developments and, consequently, a period of increased price volatility. This prompted adjustments in risk perception, perception of avoidance, and avoidance behaviour, which are here referred to as 'financial distancing' and which may have impacted loss and, thus, investment performance. Attention is also directed toward the disclosure of private financial information by participants and self-test items aimed at uncovering the presence of cognitive biases for added confidence in the empirical findings. It is expected that the shifts in investment behaviour brought about by the COVID-19 crisis are related to loss in the first half of March 2020. Specifically, it is expected that financial distancing during the Corona period for Russian male investors would be greater, subsequently leading to a larger loss. Losses in percent of portfolio value were computed for various time intervals indicating that the financial market was going down. Subsequently, two independent samples t-tests were performed to test whether the expected patterns were statistically supported. It is also expected that after controlling for perceived risk and savviness, shifts in investment behaviour would lead to larger losses. This is tested using linear regression analysis.

#### • Diversification Techniques

Retail investors commonly diversify their portfolios by constructing a mean-variance efficient portfolio as a benchmark or by employing heuristic rules that recommend investing more funds in securities with lower prices or lower price earnings. Maximizing return to achieve return-dominating strategies often results in suboptimal, concentrated portfolios. Contrast this with mutual funds, which are able to access derivatives providing a range of risk-return profiles, such that optimum investor frames may be dependent on this fractured landscape.

Reflected through covariance, the potential help measure for diversification in one's portfolio would be the expected portfolio return under uncertainty and the risk-free return. Diversification via a common asset sink at one aggregate end, covariance here through benchmarks set out by the Sobel games-ones preferred restate the prices and weights attained during price equilibrium.

Alternatively, and as it is a broad construct, signalling sagacious use is appropriate for confounding inference. Distinguishing information heterogeneity from noise trading in asset price formation, allowing for different degrees of investor room and its aggregate effect on prices is postulated here. Absent risk-reducing trades, asset prices will react to formed differing beliefs such that volatility along the arrival of news is a common measure of sentiment.

All-encompassing covariance in turn depend on local portfolio weights distorted by these prior beliefs, prescribing, as a while, any exogenous change as a conditional shifting co-sinusoidal cycle jumping across weight convexity cliff faces. In discrete time under the noise investor Darwinian selection mechanism, sparsely depicted market trees grow and prune, each weight conjecture spinning successive



weight baskets and covariance. The convergence of all mean-variance assumptions on these ellipses provides fitted contour forecast fixed points for prediction.

Other paper-based risk diversification constructs are also considered in order to glean on new measures of non-diversity, and on dividend discount models. Covariance-weighted approximation through Taylor expansion produces intuitive estimates for these security-class-moment distances.

#### • Use of Financial Instruments

The use of financial instruments to mitigate risk and distance oneself from the financial markets has been researched in the context of a recession. While portfolio insurance strategies are legitimate alternatives, they also have pitfalls that can drain wealth (M. Gaspar & M. Silva, 2019). Therefore, it was investigated how retail investors respond to a recession at an instrument level. It was expected that with increasing uncertainty, the number of retail investors who further distance their portfolio from the financial markets by reducing their trading beginner and small-cap stocks, or overall longevity, would increase. This was validated via a repeated cohort study that compared the use of financial instruments before a recession and during the onset of the recession.

In preparation for the analysis, financial instruments were classified into trading starter stocks and trading small-cap stocks, as well as by the longevity of the investments. Additionally, a preliminary analysis was conducted which confirmed that during an economic recession the likelihood of not trading starter stocks and small-cap stocks, as well as the investment duration of all financial instruments increased, while the likelihood of positively trading any financial instrument decreased. This confirmed that retail investors distance their portfolio from financial markets during economic uncertainty and that this distance is justified via solid risk mitigation strategies.

#### • Behavioral Adjustments in Investment Approaches

Behavioural finance theory posits that individuals do not always behave rationally when making financial decisions. Even among rational investors, expectations may differ. In the current study, while COVID-19 changed beliefs about risk and return that may affect investment, the survey results indicate little change in the risk-reward equilibrium. The most visible changes are to risk attitudes. For example, some investors state that they have quickly rebalanced portfolios to decrease risk exposure. Therefore, individuals do not simply adjust means and variances of return when facing COVID-19. They adjust the equation of portfolio selection by changing behavioural approaches. The change toward a more mechanical approach is observed only among sophisticated investors with some changes in the portfolio. However, many unsophisticated investors still believe in buy-and-hold. Smaller proportions of individuals believe other approaches—trying to time the market and using an automated trading program.

During COVID-19, when realizing the impact of uncertainty and volatility, many investors started to exclude highly volatile stocks. Fortunately, some may have begun risk mitigation and financial distancing measures before COVID-19 when realizing the persistent increase of volatility. Meanwhile, about one-fifth of unsophisticated investors said that they proposed holding high-beta stocks against the advice that such stocks should be avoided during volatility expansion (Hoffmann et al., 2011). This phenomenon indicates that despite the strong desire to hold stocks, some investors may worry that financial distancing measures shall limit risk aversion with diversification. Another adjustment example regards the starting age of investment, with some individuals thinking that it may be further postponed for another 1-3 years.



The current study has provided a comprehensive examination of behavioural changes in retail investors in financial markets across geographic areas during COVID-19. As a significant real-world scenario, COVID-19 induces economic uncertainty and volatility in financial markets worldwide and triggers strong behavioural responses. Many research topics for better understanding are provided by examining how COVID-19 changes equity behaviour and applying marketing theories in finance. Based on geographic evidence and a thorough examination of individual asset allocation activities and behavioural adjustments, retail investors seem to generate reasonable risk mitigation strategies during financial crises and are subject to the differential influence from the responses. Empirical implications are drawn for behavioural finance, applied marketing, and the risk management literature, supplemented with valuable practical insights.

#### **Impact of Economic Indicators**

A study of individual investor behaviour aimed to investigate perceptions and behavioural response to the financial crisis, determine perceived changing factors, and forecast subsequent personal financial behaviour. Researchers tracked investor perceptions of four groups of economic indicators seven times over an 18 month period. Overall, there was little change in perceptions of government's behaviour. Perceptions of a mortgage crisis accelerated broadly in spring 2008. Behavioural response began to be perceived in early winter 2007, rapidly escalating by summer 08 and fully realized by fall 08 (Hoffmann et al., 2011). Influences on stock returns and the behaviour of individuals have been studied and analysed. In this research, the focus is on the impact of some more widely known and broadcast stock market influenced news, often called economic indicators. The subject in the interview is individual investor's expectations regarding stock market returns, personal portfolio modifications, investments, and risk attitudes. Monitoring institutional investor behaviour is plausible but more difficult as communication, speculation, timing, and many other aspects are more sensitive.

The working hypothesis is that equal wealth groups change their behaviour differently. The change in behaviour where a less wealthy age group anticipates a return of at least 15 percent versus an older group is most prevalent. In less-wealthy group forecasting behaviour, there is a more pronounced difference between younger and older groups, most likely due to differences in timing some indicators grew important. The hypotheses adopted with respect to perception change were generally accepted due to the small number of negative results. Macro-economic and societal explanatory indicators generally started to be perceived early Change in behavioural response also varied among wealth groups despite similar indications on the anticipated timeline. Summer 08 saw an end for all groups, predicting portfolio modification of a lower magnitude than earlier, with an instantaneous time frame. Moving forward, behavioural anticipation diverged with the youngest group foreseeing relatively large changes. In the spring of 2008, there was a growing perception of the importance of economic indicators. Just prior to rapidly worsening conditions, oldest and wealthiest investors diverged most from their younger counterparts.

### • Market Volatility and Investor Response

The COVID-19 pandemic triggered unprecedented market volatility that had a global reach. Research has shown that volatility shocks in one country spill over to others, especially for those with strong trade and investment ties. Meanwhile, more localized shocks tend to be well-contained within the home country. These observations frame a common concern about the increased dependence of national equity prices during global crises and highlight the challenges of advanced nonlinear modelling techniques to



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understand the effects of broadly-defined shocks in financial markets (Huber et al., 2021).

It remains to be seen how retail investors – individual traders purchasing stocks instead of employing professional fund managers – responded to similar severe and unexpected equity price drops. Wealth exits the market when fear of further losses drives investors to buy insurance – a rational and adaptive response – but market downturns typically trigger panic selling and the rush to divest instead (Hoffmann et al., 2011). The biggest diversions from the rational-individual model occur when altcoin attention spikes alongside both a new boom and bust. A continuing surge in attention in this regard is a useful indicator of panic buying or panic selling. Learning-based heuristics should keep attention and asset prices positively aligned, but selling bets on down days should lead to negative attention-feedback loops. Identifying down days with negative feedback will provide evidence of one such divergence, illustrating how discord is integrated into relatively successful investment behaviour. Logically backward looking and thus possibly procyclical, such learning heuristics align with rapidly improving predictive performance.

Finally, risk aversion – the behavioural property of needing exponentially increased rewards to take new gambles once past losses have been incurred – tends to increase in the wake of shocks. Fear of future loss can have serious behavioural consequences, leading by diminishing sensitivity toward riskier investments by stock market participants. This in turn could elicit even lower future market sentiment and risk appetites. Given the unprecedented volatility of the shock and that the subsequent recovery was remarkably dependent and chaotically violent in regard to factor portfolios, the effects of such risk distancing remain a viable question.

#### • Interest Rates and Investment Choices

In 2018, the US central bank raised the target range for the federal funds rate by 100 basis points. During this period, the average primary mortgage rates climbed 111 basis points on the 30-year fixed mortgages. As a consequence, interest rates on auto loans increased with consumers facing a double whammy of slowing growth and rising costs. The last 7 months of declining requested mortgage amounts and soaring mortgage rates meant the cost of buying could spiral out of control. Investment choices were clustered around Fixed Income with 23% of respondents reporting modest change and 12% of respondents reporting extreme change. The weight of responses showed that the most preferred change would be to entirely sell Off Debt Mutual Funds. A shake-up during the administration in 2018 and 2019 prompted most investors to shift funds from equities to debt. Only within a month of improving economic outlook in August was there a small shift back to equities.

Concerns on limiting exposure to US equities in November 2019 were a sentiment shared across demographics, prior experience, and current investment choices. Some of the most strongly opposed to the prospect of strategic risks in stock investments were previous aggressive and high-risk tolerance funds or neutral fund holders. The 4 key messages from fund managers highlighted that it was difficult to anticipate price levels, fund position options were actively managed, defensive positioning meant reduced risk exposure in the model portfolio, and there was caution in prediction with potential tail risks. Many had learnt from experience to assume optimism would quickly revert to pessimism. A sentiment came through the responses that interest rates made financials, and inflation made investment choices.

#### • Inflation Trends and Retail Investor Behavior

The COVID-19 pandemic has fuelled an unprecedented rise in inflation worldwide, catapulting it to levels unseen in decades and enabling inflationary pressures to spill over from the United States to other countries (Kang, 2012). This section investigates how inflation trends in the US influence subsequent



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retail investors' estimated reaction coefficients concerning the market volatility index (VIX), systematic risk exposure ( $\beta$ ), and the behaviour of betting high frequency. To gauge the influence of inflation trends on retail investor behaviour, the 84-day cumulative changes from day 0–day +84 in the US inflation rate are defined as the 'inflation trend'. To account for the VIX, retail investor behaviour's systematic risk  $\beta$ is decomposed via the methodology of Fama and MacBeth. In this method, an individual stock's systematic risk is delinked with the overall market return using regressions for the entire sample period.

One of the primary effects of the COVID-19 pandemic is increased inflation pressure worldwide. The inflation pressure quantifying how much inflation exceeds its long-time averages or moving average trend is one of the measures. The pandemic has fuelled the initial rise in inflation, catapulting it to levels that have not been seen in decades and enabling inflation pressure to spill over the United States (U.S.) to other countries (Hoffmann et al., 2011). Mirroring the U.S. inflation pressure, increase in inflation has quickly reached major global economies, with some countries' inflation exceeding its long-term average by up to 9%. Rapidly rising inflation renders the picture especially uncertain as central banks ponder the tapering of quantitative easing and the timing of policy rate hikes. Inflationary perceptions rise more sharply, as reflected in the higher market-implied inflation rates. How changes in inflation affect the financial markets is more immediate than the observed changes in inflation.

The effects of inflation on the equity market as a whole are well studied, which can be summarized as the negative impact of unexpected inflation on stock returns by uncertainty channels like actions of monetary authorities, economic agent behaviour changes, or relative price shifts. In this process, the differences in sustainability between inflation-adjusted nominal contracts also matter. Similar different inflation effects may also exist in the forex and commodity markets, while the influence on fixed-income security prices due to differences between discount rates and inflation rates is rather direct. However, almost no studies examine the impact of inflation on stock investor behaviour.

#### **Psychological Factors**

ESG investing is indicative of motivated reasoning, whereby investors take a more favourable view of risk companies. More particularly, ESG investors tend to be more optimistic towards companies involved in business areas covering more favourable sectors and less optimistic towards companies involved in business areas covering more unfriendly sectors. The tendency to react positively to favourable news and negatively to unfavourable news is stronger for ESG than for non-ESG investors. This asymmetric filtering of information is due to an optimistic bias and results in an even ignored level of systemic risk. Filtered assets outperform during the contraction phase after an external shock. ESG investors further exacerbate the negative impact of a crisis on a finance sector but this is not observed for the non-ESG. ESG investing is not immune to biases when times get worse. These findings provide new insights into the effect of ESG investing during economic uncertainty (Hopfensitz & Wranik, 2008). The CFA Institute conducts a survey of retail investors across 20 countries and territories to assess their financial confidence, motivations for investing, investing preferences, and the role of financial advice (Hoffmann et al., 2011). It also analyses how the COVID-19 pandemic crisis affected individuals' thoughts, emotions, and behaviours related to investing through stress testing. A review of this study reveals responses from 1,047 retail investors in 13 locations. Respondents are qualified, informed, motivated, and diverse. The results discussed are but one perspective on investor behaviour during times of uncertainty; therefore, they should be understood in this light. The limits of generalizing findings across countries and territories are acknowledged as the focus lies on responses from only the 13



locations surveyed. Investor confidence is dependent on many macro and micro factors, some of which may vary significantly over time. As a result, the analysis may not fully reflect the current state of market behaviour. Lastly, caution is urged as any similarity and difference between behaviour in the COVID-19 pandemic and other past market upheavals may be unintentionally overstated.

#### • Fear and Greed in Investment Decisions

Over the past few years, a wealth of work has emerged concerning the factors that shape asset prices. Recent studies have focused on firm-specific news, and given the overwhelming public response to prominent financial news events, there is reason to believe that daily, market-wide, attention-driven news may also be priced in. The findings that these reports have a significant impact on stock index prices and trading volume seem conclusive. Although this suggests that outlier price movements may be completely explained by fear and greed events, another conclusion derived from the literature is that not all off-the-charts news events fully account for subsequent price movements. This raises the question what else may account for extreme price movements. Prior work has also examined the more pedestrian swings over a longer time period, and most find that past returns along with the change in fear and greed report counts are important in describing the subsequent returns. Past returns are almost universally identified as relevant for determining future price movement. Given that much past work has shown a co movement of broad stock indices, one may wonder whether the price movement of one or a few indices typically, the DJIA and S&P 500 spurs the price movement in another index such as the NASDAQ. The question posed in this work thus is whether the main U.S. markets may differ in their vulnerability, or how exposure to fear and greed events is detected in the major stock indices during the financial crisis.

This is examined whether fear, greed, or trades in general were amplifying or damping. Biases seem present across nearly all the major indices, but particularly pronounced in the DJIA. The new analysis shows that the majority of one-day price swings across indices are likely accounting for in the subsequent price movements, but provide clear evidence of complex dependencies which cross indices. The research is inspired by the approach suggested by (Hoffmann et al., 2011). Recent developments in computational speed make larger U.S. indices accessible without excessive computational costs. The new analysis of the markets is as much about the major market indices, which are typically the Dow Jones Industrial Average (DJIA), Standard and Poor's 500 Composite Index (S&P500), and NASDAQ are examined for their prominent role as indicators of aggregate price movement.

### Cognitive Biases Affecting Retail Investors

Individual investors are subject to numerous cognitive biases that may impact their financial performance. Cognitive biases are "systematic errors in decision making" (Hoffmann et al., 2011) resulting from the human brain's limitations when evaluating information. Behavioral finance incorporates research on cognitive biases into contemporary finance theory, indicating that any deviation from rationality is due to excessive optimism or pessimism about future outcomes.

Cognitive failures are behavioural biases that emerge in ambiguous situations when decision-makers lack sufficient knowledge to judge the true prospects of an event. In investing, they tend to bring underestimation of risk and overestimation of returns. Retail investors generally exhibit a strong tendency to seek information that confirms existing beliefs while dismissing alternative interpretations of the same data. Behavioral biases make it difficult for individuals to incorporate evidence in novel situations and hinder their ability to construct informed viewpoints that can alter their beliefs. In the investment context, this often leads individual investors to infer falsely good returns from bullish news, overestimating return prospects and underestimating risk (Kathpal et al., 2021).



Retail investors also have a strong tendency to seek information confirming existing beliefs, which skews the information set they consume. Simply put, behavioural biases make it difficult for individuals to incorporate evidence in novel situations. Cognitive dissonance prevents individuals from developing informed viewpoints that can alter their beliefs. This insufficient ability to act on new evidence leads individual investors to perceive the Kristal ball better than it actually is, often leading to underestimation of risk and overestimation of returns. Poor performance leads to cognitive dissonance, which retail investors remedy by entering a state of denial about key threats. This results in an exaggerated perception of personal performance and the effectiveness of their strategies during certain periods.

#### **Technology and Retail Investing**

The emergence of the internet and the availability of online trading platforms have revolutionized retail investing. It is estimated that approximately 25% of US retail investors are now involved in trading and investing using algorithmic rules. Retail investors are increasingly relying on new information sources, such as social media, to inform their financial decisions, in a world where they are inundated with news relative to almost any other time. The amount of information available to an individual and its size, speed, and potential consequences have variously been characterized (Hoffmann et al., 2011). Indeed, the speed of dissemination has recently garnered attention from investors and financial traders alike. They are producing and responding to an environment in which context and attention are critical, as they attend to rational and emotive considerations simultaneously.

Online platforms have benefited from this innovation in data collection, with the social media environment becoming one of the main sources of news for practitioners. A wide array of platforms is now used by retail investors, ranging from those extensively dedicated to financial information and those historically focused on communication. Individual retail investors that dominate coverage of these platforms are finding it difficult, given that financial analysts are limited in their responses to mostly only explicit decisions that have been taken, to quickly and accurately perceive the implications and nature of vast volumes of new data.

#### • Role of Online Trading Platforms

The study of how and why investors trade securities is pertinent in understanding their psyches and behaviour during economic instability. This quantitative study looks at how the financial crisis of 2007-09 affected individual investor behaviour at the level of retail investing. The focus is specifically on how investors reduced their risk exposure in the aftermath of the crisis, as well as their later re-engagement with equity markets at increasing levels of investment risk. This leads to a discussion of how individual investors then relied upon changing stock trading perceptions and risk tolerance profiles, changes in trading frequency, and how online trading platforms were used during the transition to, and beyond, the crisis. Online trading platforms were indeed a useful support network for retail stock investors who were both continuously and intermittently engaged in trading before, during, and after the crisis. The online forums provided valuable information peers could rely on when constructing stock trading action plans (Hoffmann et al., 2011). From the early stages of the crisis to its resolution, the emergence of new online platforms or the use of established platforms promulgated public discourse on uncertainty and fear. The online discussion shifted toward framing stock trading as gambling, and information became less actionable or reliable. While tools or platforms at the beginning of the crisis aided investors in wealth accumulation and stock selection based on perceived valuation growth opportunities, they were eclipsed by polling-type attention grabbing-stimuli late in the period (Tang et al., 2011). Financial distancing also



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occurred post-crisis, as retail investors strived to regain somewhat normality in their stock investing behaviour. During financial distancing, a trade-off between emotional distancing and information sharing created unintentional information silos. Consequently, the equity in the forum was less valued since peers could only afford guesses on stock price directions. This rendered the platforms somewhat unhelpful, unless trading frequency was sufficiently high to induce learning from the mistakes and successes of others. Financial distancing indicated de-risking behaviour in the sense that stock investing moved the avoided periphery of daily investing practice and public discourse. There were substantial delays in re-entering the stock market and renewed engagement was accompanied by significant changes in trading perceptions and risk tolerance profiles.

#### • Influence of Social Media on Investment Choices

Social media technologies and platforms have been ubiquitous in society over the last decade. The growth of social media in recent years has created space for investors to reflect and share their views on a platform that is both public and global (Ritika et al., 2023). However, opinions on social media with respect to investment have a mixed impact going through both interesting and successful stories about investment and loss of capital (Hoffmann et al., 2011). Even though only a few sources currently attract most of the attention, various social media platforms (both public and private) could contribute either positively or negatively to investor choices.

Theories of information dissemination suggest that content sharing (positive or negative) on any topic can spread in an outwards manner and influence perceptions. Therefore, in the case of the pandemic outbreak, individuals could still try their best to manage uncertainty and risk or could interpret it as uncertainty that has the possibility to grow to the risk of losing capital. In either case, some investors would turn to social media to reassure themselves or, alternatively, to polish models in asset selection and timing. This therefore augments the perceptions of uncertainty and risk. In cases where this occurred, the spread of social media innovation and low-state economic growth would promote beliefs in the broadening and deepening of risk rather than alternative views of an economic jolt.

#### **Regulatory Environment**

During the crisis of 2008, firms in all sectors witnessed increased uncertainty, and a decline in overall consumption and investment was recorded. Its effect was pronounced in the housing market and the banking sector, resulting in an unprecedented financial and economic crisis. The financial crisis is a principal reason for the massive losses in stock prices worldwide and a drop in investor sentiment. This event proved to be one of the most important events on financial markets in a century and has profoundly changed the way investors interact in this marketplace. Previous crashes have merely caused corrections that lasted months, but the recent downturn has continued for over a year. This study investigates how and why retail investor behaviour has changed in the Islamic Republic of Iran during this unprecedented event. Its goal is to contribute to the emerging literature on retail investor behaviour during significant financial catastrophes.

As European governments sought to shore up a faltering financial system through leveraged purchases and capital injections, jurists and asset managers alike began to worry about the consequences of more intrusive structures for regulation. The ongoing crisis also invited wholesale reappraisal of shareholders' rights. The prospect of shareholder primacy being diluted by wider representation of stakeholders on boards offered the appeal of a more proportionate distribution of control and the return of risk to core business. Fears that political concerns would take precedence over economics summoned a back-to-



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basics camp which perceived a singular board role in "maximizing shareholder wealth." Whilst many differences of opinion regarding ends were apparent, agreements were also observable regarding means. Dependence on a single entity with power vested for prolonged periods was viewed as bad governance, independently of the entity in question. Collectively acting stakeholders would act more in accord with the common good. Rather than policy shifts to do with "coping with the unjust," the current crisis could be seen in utilitarian terms as an opportunity for or requirement of "fixing the system." Seeing the crisis as a misshapen legacy of an evolving regulatory system could invite reconstruction from within limits set consistent with prior convictions and expectations. Expected improvements were gradual changes in policy and operational practices in line with received approaches to governance and self-regulation preferable to significant institutional shifts as "revolutionary surgery" (Hoffmann et al., 2011).

#### • Impact of Regulations on Retail Investors

As real-world events evolve beyond expectations, question arises whether this market and investor behaviour is severely affected by the same events globally or nationally. A financial crisis in the US started in 2007 has become a worldwide concern only after the Lehman Brothers' bankruptcy in 2008. As a consequence, retail investors have withdrawn money from the stock market. This global shift resembles the development of pre-money laundering laws in the US, which produced sudden shifts in volume and volatility (Hoffmann et al., 2011). Specific questions this raises are whether retail investors are really engaged in the stock market during the financial crisis, whether regulations imposed on initial public offerings (IPOs) and over-the-counter (OTC) markets around the same time lead to sudden shifts in trading activity as well as price formation in illiquid market segments, and how superior price formation could be measured.

Studies found that overly optimistic retail investor sentiment drives the return co movements of individual stocks and industry portfolios. Traditional measures of aggregate retail investor sentiment, which are mainly based on trading volume and market prices, predicted abnormal returns up to two weeks ahead. In recent years, studies suggested that deep financial crises lead to high return co-movements worldwide. In addition, they observed that periods of turmoil lead to a significant impact on the sensitivity of individual stock returns to market movements. Portfolios containing stocks with more analysts increased exponentially in time to the financial crisis. Stable patterns in which improved information supply of analysts reduces market instability were revealed. Furthermore, retail investor trading can influence stock returns.

In an upward market after the 2008 financial crisis, firms are more informative by filing short 8-K nonearnings announcements containing news after disclosure over 24-hour periods. This study aims to investigate the hotter auditors and their auditing opinions on firms' 8-K Non-Earnings Disclosure. For this purpose, the financial crisis, the bias of financial studies on some influential variables, and the willingness of firms to choose hot auditors are studied. It is also proposed that firms' preferences for hot auditors will further lead to different opinions from these auditors, specifically more favourable opinions. Data will be coded according to four-digit standard industrial classification (SIC).

### • Policy Recommendations for Protecting Investors

Based on the research findings, this section offers three policy recommendations to help investor behavioural awareness and protect investors better. First, the results suggest that financial distancing has a large effect on the trading activity of both individual and institutional investors, and this effect appears to be magnified during times of economic uncertainty. Since investors tend to move away from bolder investment styles during economic downturns, policymakers may consider requiring broker-dealers to



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treat aggressive trading styles as a risk factor most relevant to customers' purchases of investment products. In addition to prohibiting fraud, the SEC should take steps to ensure that broker-dealers in new customer accounts disclose an initial set of "extra-risk" risk factors useful for allowing retail investors to confirm that they are reasonably suited to the broker-dealer's products and strategies. FinTech platforms have made many disruptive changes to the securities industry, and important "new" issues must be considered (C. W. Lin, 2011).

Though perhaps "unsexy," policy efforts to require broker-dealers to have better compliance infrastructure in place would likely pay the largest dividends. As firms often juggle competing priorities, there is potentially no "better" time than now for regulators to consider requiring firms to ensure that front-line employees receive systematic training on the possibilities of biased recommendations created from algorithms. The FinTech platforms considered within this article are all "new" and "pro-cyclical," helping retail investors increase their trading activity and experience large losses. All platforms experienced tremendous business success during 2020 and the subsequent "bull" market, with record trading activity in retail options, crypto currency, and SPACs. Despite garnering regulatory scrutiny following the attempt to halt trading in GameStop, these platforms mostly continued to do well during economic uncertainty, though their image would be tainted from the broader macroeconomic concerns over their effects on investor wellbeing.

This study has several limitations. First, many relevant FinTech platforms may be difficult to collect data from, either due to country restrictions or proprietary issues. Second, there are many advanced trading tools common among AI-powered brokers that are not easy to accumulate and test with. New policy: competition, thus encouraging the development of a slew of cheap marketplaces with minimal order requirements for unprofessional retail investors in response to the emergence of such AI-powered day-trading brokers. Market access to this playing field is still difficult for many long-term investors who are being charged large entry costs.

#### Conclusion

We examine how retail investors reacted to a sudden, major economic downturn and whether they adjusted their trading behaviour to mitigate risk, measured as a combination of equity volatility and correlation with the equity market. Using a novel approach based on asset holding data and multi-factor modelling of returns, we find that the rapid economic deterioration caused investors to reduce trading volume and broaden their portfolios, contrary to expectations. Larger investors responded especially strongly to the initial news of COVID-19, reducing both trading volume and risk exposure, yet they adjusted their behaviour again afterwards. The results reflect the behavioural phenomenon of financial distancing (Hoffmann et al., 2011), which describes how retail investors adopt less sophisticated investment styles such as maintaining the status quo in response to the shock of an economic crisis.

Despite the rapidness of the downturn, investors within just a few weeks adjusted their trading behaviour substantially in response to assessment of the changed economic climate, the information source that triggered their perception of the economic crisis, and their investor type. Large investors appeared more cognizant of the shift in economic environment, and challenged by information overload, behaved quite differently compared to their less experienced counterparts. Among the retail investors, behaviour was influenced but took longer to adjust in terms of trading volume. These findings are important to better understand how investors in general react to unexpected shocks in their environment, how they learn from such experiences, and what their expectations are about a return to normal conditions.



The findings enhance understanding of how an economic event becomes a contagion affecting individual investors. It is among the first studies to show a sophisticated measurement of risk-adjusted trading behaviour on a large scale. It will motivate further inquiries into investors' perception of events and their immediate reactions to such conditions and broaden the knowledge on macroeconomic conditions and individual investing behaviour. It should also raise the awareness that in the midst of market turmoil, psychological biases might lead to excessive irrational behaviour, possibly inviting regulatory actions or limit orders to dampen extreme aberration of prices and volatility.

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