The Impact of the Herd Effect on Individual Investment Decisions

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Abstract. The herding effect is widespread in the financial market, which not only has an important impact on individual investment decisions, but also often causes financial market volatility. Therefore, the purpose of this paper is to explore what specific effects of the herd effect on individuals and the market, and hope that it can help to avoid the disadvantages of the herd effect and better utilize the herd effect. Based on the current existing articles on the study of the herd effect, this study combs and summarizes the impact of the herd effect on individuals and the market, respectively. By reviewing the literature, this paper ultimately finds that the impact of the herd effect on individual investment decisions is both favorable and unfavorable, while the impact on the market is usually negative. The results of this research can be a favorable tool for investors to identify and rationally utilize the herd effect, which is of great practical significance for the healthy development of the market.

Keywords: Herd effect, Behavioral finance, Investment decisions.

1 Introduction

The herd effect is an important phenomenon in behavioral finance that refers to the tendency of individuals to imitate or follow the behavior of others when making decisions, rather than basing them on their own independent judgment. This effect is widespread in society and is particularly common in financial markets. By affecting the investment behavior of individuals, the herd effect triggers the group effect, which not only affects the investment returns of individuals, but also causes fluctuations in the financial market, and may even trigger financial crises. Therefore, an in-depth study of the impact of the herd effect on individual investment is of great significance for understanding market behavior, formulating reasonable investment strategies, as well as maintaining the stability of the financial market and promoting the healthy development of the financial market.

A great deal of current research focuses on the existence of the herding effect, aiming to confirm the existence of the herding effect in a given financial market through the construction and analysis of data models. For example, Chiang, Thomas C. and Dazhi Zheng in 2020 examined the herding effect in financial markets of 18 countries, and the study of these two scholars found significant evidence of the

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existence of the herding effect in the financial markets of most of the countries [1]. The results of the analysis by Adik Duwi Rahayu et al. in 2020 also showed that the herding effect occurs in almost all the world's all stock markets [2]. At the same time, the reasons for the herd effect have also received attention from researchers. Bhoomika Trehan and Amit Kumar Sinha explained the psychology behind the herd effect [3]. Liu Xiaqing and Liu Baiyu analyzed in detail in their article Analyzing the Herd Effect in Individual Investing that they believe that there are two main reasons for the herd effect, i.e. incomplete information and reputation and rewards [4]. However, there is not much in-depth research on the impact of the herding effect on individual investors and financial markets, and relatively few studies are involved.

This paper will analyze and summarize the research results of the existing research on the herd effect, and will also explore the specific impact of the herd effect on individuals and the market, so as to find ways to guide individuals to effectively identify and utilize the herd effect to enhance their investment returns, and to fill in the gaps in the current research on the herd effect, with a view to providing references to the research in related fields.

2 The Concept of the Herd Effect

To make sense of the concept of herd effect, current papers generally agree on the need to distinguish between two sets of concepts, namely, true and pseudo-herd effects, and rational and irrational herd effects.

The true herd effect is defined as having a clear intention to imitate or follow the behavior of others, if the investor plans to emulate the actions of other investors. It is worth mentioning that the true herd effect consists of following the practices of others, even if the information one receives points to a different decision, and choosing to suppress one's own thoughts and follow the choice of the market majority even when one disagrees with the decision made by the market majority [5,6]. In contrast, the pseudo-herd effect is when the same decision happens to be made, but there is no mimicry in this, but only an unintentional similar decision is made [7]. This may be based on similar actions taken after judging similar information obtained, and similar behavioral patterns arise when people have access to an identical information source and perceive it in comparable ways [6, 8]. Alternatively, Gavriilidis et al. contend that a number of traits shared by financial experts could cause them to make comparable investment choices, creating a herd effect without deliberate copying behavior [9].

Rational herd effect refers to the perspective of benefit maximization, which believes that the group's decision based on certain reasons is the most beneficial [3]. An irrational herd effect, on the other hand, is one that does not work from the perspective of benefit maximization and focuses solely on imitating the behavior of others [10]. Liu xiaqing et al. argued that the true herd effect is rational because the purpose of imitating others is to maximize benefits [4]. Kim and McKenzie, on the other hand, disagreed, contending that the real herd effect occurs when investors deliberately mimic the actions of other investors, irrespective of whether those investors make smart investment selections [11]. This paper argues that the true herd effect can be either rational or irrational, depending on the situation. This makes a difference in the impact of the herd effect, which is explained in more detail later in the paper.

3 Reasons for the Herd Effect

One of the widely mentioned reasons for the herding effect that can be found in the paper is incomplete information, which is also one of its main causes. Individuals' limited access to information and the inability to pay for the different economic costs of information make incomplete information widely available in the process of making investment decisions, and this largely contributes to the herding effect. As early as Bikhchandani et al. pointed out that investment decisions are often made without having complete information, and Lin et al. also suggested that investors who lack proper information and risk assessment are more prone to give up making their own decisions and start imitating other investors' actions without question [7, 12]. In the face of complex information human information processing capacity is limited, so the limited processing capacity is dealt with by using simplified decision making but sacrificing the accuracy of information use [13]. Adik Duwi Rahayu et al. emphasized that the financial or economic crisis serves as one among the many elements causing herd mentality in the stock market [2]. Poshakwale and Mandal's survey showed that herding effect is more likely to occur in emerging markets and bear markets, also because there is more information asymmetry in this situation [14]. At the same time, institutional investors are also susceptible to the herd effect because they know their peers and have a higher ability to infer information, so they are more likely to follow what others do. However, it may be the case that the imitated person's judgment is actually unfounded, which makes it more likely to cause the market to follow trends and fluctuations.

The second reason is reputation, which is usually specific to investment managers. The investment manager chooses to make the same decisions as the industry benchmark or the person who made the decision in the first place in order to maintain his or her own reputation and to avoid being questioned by clients about his or her competence after an error in judgment. This way, even if investment returns are damaged, the manager's reputation is not affected much.

Individual investor's emotions also largely affect investment decisions. Bhoomika has observed the phenomenon of investors feeling disappointed after a single investment loss and thus choosing to follow others in their subsequent investment decisions during the experiments. This is the herd effect caused by investor's emotions [3]. Maxime et al. also pointed out that unfavorable performances seem to reduce the information gathering motivation, and when faced with a negative situation, investors (especially unsophisticated investors) tend to engage in herd behavior in the next period [15].

Investors' psychology, such as speculative behavior, is also one of the causes of the herd effect. Liu Xiaqing et al. pointed out that short-term investors usually buy low and sell high in order to obtain high benefits quickly, so they may be more inclined to adopt extreme strategies and may make decisions to follow the herd when encouraged by the market [4].

4 Impact of the herd effect

4.1 Impact on Individuals

The effect of herd effect on investors is usually considered as both beneficial and detrimental. The results of Ahmad. M. et al. showed that the herd effect influences individual investors' decisions in a favorable way [16]. Additionally, Bertel and Kirli noted that the majority of studies now in existence highlight the significance of herd behavior in unclear and convoluted situations because it successfully utilizes the environment's information structure to direct decision-makers' information searches [17]. As this paper mentioned above, information gathering is difficult and barriers, and individual investors can easily feel the difficulty of making investment decisions due to incomplete information. Therefore, investors at this point in time from the maximization of benefits, a reasonable choice to follow the more powerful investors to make reputable investment decisions may achieve a higher return than making decisions independently. The positive impact of the herd effect on individual investment can also be reflected in the wisdom of the group, sometimes the majority of people together to make decisions may be the embodiment of the wisdom of the group, at the moment the wisdom of the group may bring higher than the individual wisdom of the benefits.

The study by Ahmad. M. also demonstrates that the herding effect has some detrimental effects on individual investors, and the outcomes of their conjectured prediction demonstrate a negative correlation between herding behavior and individual investors' investment decisions [16]. Fuzzy analytic hierarchical approach was utilized by Jain Walia, and Gupta to investigate how behavioral bias affects the choices made by individual equities investors [18]. The results similarly show that the herding effect has a significant negative impact on the decision making of individual equity investors. Investors in herding effect overestimate the expected profits and over-trade, thus earning lower profits or returns than the market. According to Bikhchandani, overtrading occurs in stock exchanges and due to herd behavior of investors, it results in lower returns for them [7].

4.2 Impact on Markets

Investors' choices on stock exchanges play a key role in determining the development of the market. Herd effect has an impact on the market by affecting individual investments and institutional investors and in turn, and currently available studies usually think that this impact is negative [19]. Ahmad. M's study confirms that the herd effect is negatively correlated with the market efficiency of the individual investor, and that irrational decisions made by the investor may lead to market overreacting or underreacting, and in both cases the market becomes more inefficient [16]. Bertel and Kirlik also emphasized that individual investment management activities under the herd effect have a detrimental effect on the efficiency of the market [17]. According to Ahmad M, decision makers may fail to diversify their portfolios as a result of the herd effect, which would have a negative effect [16]. Herd trading causes stock prices and other financial assets, such currencies, to fluctuate in value relative to their underlying value, which in turn distorts the financial markets. Market players' tendency to follow one another creates instability, increases volatility, and makes the financial system more vulnerable. At the same time severe herding effects can lead to systemic risk, bubble phenomena and asymmetric volatility in financial markets [20].

5 Conclusion

This paper reveals the complexity and multifaceted nature of the herd effect in investment decision-making by exploring in detail the concept of the herd effect, the reasons for its emergence, and its impact on individual investors and the market. The herd effect is not just a single behavioral pattern, but includes multiple levels of expression, both true and pseudo, rational and irrational. This multilevel manifestation makes the herd effect potentially bring positive effects, such as avoiding the risk of information asymmetry by mimicking the successful strategies of other investors, as well as lead to negative outcomes, such as over-trading and reduced market efficiency.

The herd effect has many different and intricate causes, including inadequate information, reputational concerns, investor mood and psychology. The herd effect is far more probable to materialize and have a big effect on the market, especially in a setting where information is unequal. Although herd behaviour may sometimes maximize profits by exploiting group intelligence, its potential risks and negative impacts should not be ignored, especially in financial markets, where it may lead to increased market volatility and systemic risk.

Future research can further explore how individual investors can identify the traps of the herd effect, avoid the irrational herd effect, and reduce the investment losses caused by blind imitation behavior. As well as how individual investors can rationally utilize the herd effect, enrich the channels and ways of obtaining information, enhance the information basis for investment decisions, thereby improving the quality of investment decisions and increasing investment returns. In the future, it is hoped there will be more research in this regard. In addition, the market can further explore how to reduce the occurrence of irrational herd behavior by improving the information disclosure mechanism, so as to alleviate the negative impact of the herd effect and reduce irrational behavior and unnecessary volatility in the market.

In conclusion, the herd effect, as a widespread behavioral phenomenon, is both a tool for investors to cope with complex market environments and a source of potential risk. Understanding and managing this phenomenon is critical for both individual investors and market regulators.

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