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Emotional Finance: A New Paradigm in Investment Decisions

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***Abstract* - Emotional finance explicitly sets out to examine how our emotions, both those of which we are conscious and more importantly, those unconscious, play a key role in all financial decisions. This new perspective in finance formally recognises how the inherent uncertainty in the investment process and associated problems in predicting future outcomes inevitably unleashes powerful feelings of both excitement and anxiety. Emotional finance draws on the psychoanalytic understanding of the human mind and dynamic mental states to describe how unconscious processes drive investment decisions and are an integral part of all financial decision making. This article brings the basic concepts of emotional finance, and how investors take investment decision through psychoanalytic process.**
***Keywords:* Emotional Finance, Psychoanalysis, Bit Coin, Emotions**

I. INTRODUCTION

A. Emotional Finance – Concept: This briefing introduces the concept of 'emotional finance', the idea that unconscious feelings help drive both individual investment decisions and market activity. It provides an overview of the underlying theory and explores how it can be applied to improve our financial understanding. Emotional finance explicitly sets out to examine how our emotions, both those of which we are conscious and more importantly, those unconscious, play a key role in all financial decisions.

This new perspective in finance formally recognises how the inherent uncertainty in the investment process and associated problems in predicting future outcomes inevitably unleashes powerful feelings of both excitement and anxiety. Emotional finance draws on the psychoanalytic understanding of the human mind and dynamic mental states to describe how unconscious processes drive investment decisions and are an integral part of all financial decision making.

Little attention has been paid by financial researchers to how people's unconscious thoughts help drive stock market behaviour and investment decisions. Traditional finance theory assumes that investment is a rational process and that investors can make unbiased forecasts about the future.

In contrast, behavioural finance recognises that investors often behave in an irrational way and are biased in their judgments. It argues that if we understand our biases then we can overcome these.

B. Emotional Finance Theory: Emotional finance theory can be understood with an example. Psychoanalysis divides emotions into two categories - Pleasurable and Unpleasurable, which is reflected in the way that investment decisions create feelings of both excitement and anxiety over potential gains or losses. This conflict between opposing emotions is typically dealt with by the unconscious repression or denial of negative feelings. While rationally an investor 'knows' stocks can go both up and down, in psychic reality the direction is only up. Emotional finance also draws on the psychoanalytic understanding of group dynamics viewing markets as large (virtual) groups with their own emotions, fantasies and collective behaviours. Groups also have a tendency to be carried way into fight or flight, which can help explain the growth and then imploding of asset pricing bubbles, as most recently with Bit coin.

Investment market outcomes are inherently unpredictable and such uncertainty leads to emotional responses of both a neurological and psychological nature. Emotional finance directly explores how unconscious processes help drive investor and market behaviour. The important role of illusion in investment, which from a psychoanalytic perspective is viewed as any belief heavily influenced by wish fulfilment and the distortion of reality is explicitly recognised. People unconsciously feel what they want to be true, rather than what actually is. The psychic, or subjective, reality, of the "inner world" the world of unconscious fantasies and wishes, is very different to the material world of external reality, the actual facts of the matter, with which finance traditionally seeks to deal.

II. EMOTIONAL FINANCE IN PRACTICE

Emotional finance theory can be applied in a number of areas to improve our understanding of investment behaviour. For example: The distribution of likely returns on an investment which is perceived as known and measurable, from the concept of uncertainty - the inability to predict future returns. Conventional models of risk also serve as a psychological defence against uncertainty and the 'real' risk of anxiety and helplessness that stems from this.

The fact that the unpredictability of financial markets inevitably generates anxiety is not always acknowledged. Emotional finance shows how the ability to trust when not knowing the outcome is what enables an investor to enter into a relationship with an asset that can let him or her down. The need for trust and reassurance explains why fund managers place so much emphasis on meeting the managers of companies they plan to invest in, and similarly why investors in mutual funds look for managers and investment houses they can trust. The key role that stories play in promoting this is paramount.

Emotional finance also predicts an unconscious need for stock prices to have already risen for investors to have the confidence and trust to invest in them, which could lead to individual stocks being mispriced. Speculation and unconscious excitement help drive investment behaviour. Emotional finance describes how investing in the stock market generates many of the same emotions experienced by gambling, defined in psychoanalytic terms as the illusion of power and control to defend against helplessness. The reasons that individuals often fail to invest and save adequately for retirement can be explained by emotional finance in terms of their unwillingness to acknowledge the implications of old age and ill health. Unconscious defences can prevent appropriate retirement planning decisions.

III. THE ROLE OF EMOTIONS

Barring a few exceptions (such as passing references to greed and fear and more extensive discussions of loss aversion), emotions have tended to be treated, in both academic and professional circles, as dangerous signs of weakness or sources of embarrassment and anxiety in an investment manager. This approach contrasts with the approach widely used in modern psychology and neuroscience, which has revolutionised the accepted academic understanding of emotion and its ongoing dynamic role in human behaviour. Emotion (‘gut feeling’) is central to all thinking and experience and is particularly important for reliable and accurate decision making. Far from being an unfortunate hindrance, it appears to be an evolved capacity that has enabled human beings to survive because it allows fast and frugal processing of everyday sensations and accords rapid meaning and purpose to all 3 human activity.

Thoughts, feelings, and actions, in other words, are inextricably linked at both the mental and biochemical levels. In light of this evidence, attempts to treat emotionally based decisions as essentially weak or irrational are not simply outdated but are seriously misleading. When we think, we feel. Any attempt to bypass or ignore feelings is likely to lead to poor decision-making outcomes. It may, therefore, be useful to bring the feelings experienced in financial markets out into the open, discuss them frankly in an informed way, and incorporate them, where relevant, into theory and practice.

Professional investors may be forgiven for wondering what all this academic fuss is about. Professional investors know that their everyday experience is dominated by uncertainty and informational ambiguity and that investing is an inherently emotionally arousing process. The basic situation that decision-makers face in financial markets creates conflicts that they have to manage. Such fear of emotion and intuition (or embarrassment about it) probably also reflects the way in which such issues have been treated (ignored) in the academic finance literature. This situation reflects the dominance of old ways of thinking, crude notions of psychology and emotion, and given that both academic finance and the investment profession have been so male dominated, possibly also a gender bias

A. What Are Emotions, And How Do They Influence Behaviour?

Emotion can be defined loosely as a physiological state of arousal triggered by beliefs about something. Arnold (1960) defines emotion as “the felt tendency toward anything intuitively appraised as good or away from anything intuitively appraised as bad”. A strict definition of the term is complex because emotion has cognitive, physiological, social, and behavioural aspects. For many, the substance of an emotion is feeling. But emotions are evaluative rather than purely bodily sensations or cognitive judgments. An emotion may have no cognitive basis whatsoever. Each individual has a personal assessment of whether an object or state is good or bad. Emotions are evaluative in that they evoke positive or negative valences that can be described using bipolar scales that define a continuous spectrum from unpleasantness to pleasantness—for example, unhappy to happy or pessimistic to optimistic

Despite the lack of a unified definition of emotion, there is some agreement on the set of emotions that exist. According to Elster (1998), some states are clearly emotions, including, for instance, anger, hatred, guilt, regret, fear, pride, elation, joy, and love. Elster further argues that these emotional states can be differentiated from other mental states on the basis of six features put forth long ago. These features do not provide a complete definition of emotion because not even one feature is an element of every emotion. Yet these six features remain central to current discussion and provide a frame-work for understanding what an emotion is. The brief descriptions that follow use one emotion.

1. Cognitive antecedents - Emotions are triggered by beliefs. An investor regrets an investment decision because she believes that bad outcomes could have been avoided.
2. Intentional objects - Emotions are about something. The object of an emotion is usually the cognitive antecedent. For example, the poorly performing investment is the object of the regretful investor.
3. Physiological arousal - Changes in hormonal conditions and the autonomic nervous system accompany emotions. The regretful investor may feel pangs, a hollow stomach, or depression.
4. Physiological expressions - Observable expressions characterize emotions. Facial expressions, posture, voice intonation, and outward appearance are

noteworthy. The regretful investor may appear pale, with slumped shoulders.

5. Valence - Emotions can be placed on a scale with pleasure at one extreme and pain at the other. Valence, or the experience of pleasure versus pain, translates to happiness or unhappiness. The regretful investor is decidedly unhappy about the poor investment outcome.
6. Action tendencies - Emotions are associated with a tendency to act. The regretful investor might take actions to avoid being exposed to similar investment opportunities.

IV. AMBIVALENCE AND UNCONSCIOUS CONFLICT

Psychoanalysis views thoughts created by feelings as ultimately being of two types: pleasurable (exciting) or unpleasurable (painful, anxiety generating, or loss provoking) (Freud, 1911). Mental functioning reflects the outcome of an ongoing and never fully resolved struggle between the pleasure principle and the reality principle, the capacity to sense reality as it really is, however painful, rather than how people might wish it to be. Investment decisions create feelings of both excitement (the pleasure of imagined future gain) and anxiety (the pain or unpleasure of potential future loss).

The process of investing means that the investor enters into an emotional attachment, whether conscious or not, with something, a stock or other asset, which can lead to both gain and pain. The investor becomes dependent on its future price, something which is inherently uncertain. There is the wish and hope the stock will go up, which is pleasurable or exciting, but on the other hand it can very easily let the investor down, the thought of which is unpleasurable and anxiety generating. Importantly, since both pleasurable and unpleasurable feelings are generated at the same time, this leads to subjectively painful emotional conflict or ambivalence. For example, professional investors are very aware of the danger of falling in love and idealising a stock or company management which can then do no wrong, which feelings then turn to anger and disgust when they do not perform as expected

V. EMOTIONAL FINANCE AND THE REAL MEANING OF RISK

Investment risk is typically measured by such metrics as variance of returns, tracking error, value at risk (VaR), stock beta and a broad range of characteristic-based factors such as size, value/growth, momentum, yield and earnings variability etc., and viewed as objective and quantifiable. The idea is that risk can be appropriately managed through the application of sophisticated quantitative analysis and experience. However, there is a clear distinction between risk and uncertainty. Risk is recognisable, measurable and known, being based on the idea that the past can, in a sense, be used predict the future. On the other hand, uncertainty is unidentifiable, immeasurable and unknown. Tuckett and Taffler (2012) show in their interview study of elite fund managers that although they are all familiar with conventional measures of risk, what risk really means to them in practice is very different. There are four principal concerns:

(i) Information risk – worries about the quality of the information fund managers rely on to make investment decisions and whether they can trust what company management is telling them
(ii) Anxiety (risk) about the inherent unpredictability of the investment task
(iii) Business risk – the danger of underperformance leading to client loss
(iv) Career risk – threats to compensation and promotion, and even job termination, if the fund manager underperforms for any length of time

VI. EMOTIONAL FINANCE AND THE NEED TO TRUST

As has been pointed out above, investment is synonymous with uncertainty; investors cannot predict with any degree of accuracy the outcomes of their investment decisions. This inevitably leads to anxiety which is often suppressed. Given such unpleasurable affects, how are investors able to enter into ambivalent object relationships with assets that can so easily and painfully let them down?

Emotional finance views this enigma in terms of the key role trust plays in the investment process. Trust permeates all human activity with the ability to trust rooted in the security of early infant experiences and safely in parental physical and emotional dependency relationships. However, there are the inevitable, and often unconscious, conflicts between trust and suspicion, and need and the associated anxiety about being misled or let down, which are experienced as truly frightening in psychic reality. Nonetheless, without the ability to trust (and have faith) investment is not possible, leading to stasis. To invest (act) is to trust. The ability to trust when ‘not knowing’ the outcome generates the conviction to commit to an asset or stock.

A. Bubbles and Financial Crises: An Emotional Finance Perspective: Traditional financial and economic theories find great difficulty in explaining asset pricing bubbles and financial crises in any convincing way. Such models, usually of a highly mathematical nature, revolve around ideas of herding, informational cascades and the “greater fool” theory. Whereas the assumptions of rational economic behaviour are relaxed in more recent theoretical models with market agents allowed to be “irrational” in some stylised way, nonetheless the roles played by unconscious emotions and social and group processes are largely ignored. Because of the failure of conventional economic and financial theories to explain such major events as asset pricing bubbles and financial crises in a convincing way, there is even a tendency among some economists to see these as unavoidable implying trying to understand their causes makes little sense. Accounts of what actually happen in financial crises and asset pricing bubbles are first and foremost descriptions of highly emotional speculative processes.

VII. EMOTIONAL FINANCE AND THE INVESTMENT INDUSTRY

Fund managers work in a highly emotionally charged environment and have to enter into ambivalent object relationships with the assets they buy and sell, which can easily let them down, and where future outcomes are uncertain. Anxiety and denial dominate in their attempt to make sense of what they do. Ultimately they are required to split off and repress what they don't want to "know", i.e., "turning a blind eye". First, the paradox of the industry being built on the idea it is possible to do something which is not possible is explored. Stock markets are environments in which investors' conscious needs and unconscious phantasies are played out. Participants enter into emotionally dependent and ambivalent relationships with their assets, whether consciously aware of this or not, that render them vulnerable and can easily lead to them being let down. The very nature of the unpredictable environment in which fund managers have to operate and the unreasonable demands placed on them to do something which it is not possible to do lead to emotions which oscillate continuously between excitement (pleasure) and anxiety (unpleasure). Feelings of trust, hope and love (i.e., attraction) are continuously pitted against those of worry, disappointment, fear and hate

VIII. CONCLUSION

The central role that unconscious thought processes play in all human activity is worthy of greater attention in finance. The insights of emotional finance can also be applied more generally to help explain asset pricing bubbles and financial crises, including the dot.com bubble in the late 1990s and the 2008 Global Financial Crisis, not just why and how investors invest. Traditional and behavioural finance theories have difficulty in doing so fully because they ignore the unconscious processes at work. Emotional finance is only at the very beginning of its evolution as a research discipline but has the potential significantly to increase our knowledge and understanding of financial activity and market behaviours. While the underlying theory is already reasonably developed, the next stage is to explore the empirical application of emotional finance in more detail, using both quantitative and qualitative methodologies.

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