Stock Selection Behavior of Individual Equity Investors' in Pakistan

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Abstract: This study examines the stock selection behavior of individual equity investors in Pakistan. The study provides very important information to investment advisor regarding stock selection behavior of small equity investors in Pakistan. The understanding of investors' behavior also enables equity market regulators to improve regulator environment that best suits the stakeholders. It also provides pertinent information to corporations listed in stock markets of Pakistan to attract investors. The study identifies stock attributes including dividend, price trends and volatility, firm's status in the market, source of recommendation, corporate reputation, corporate social performance, firm's visibility in the media having significant on stock selection behavior of individual equity investors in Pakistan.

Key words: Investor behavior · Stock selection behavior · Stock attributes · Pakistan

INTRODUCTION

Behavioral finance is also one of the significant developments in the field of finance in recent times. Behavioral finance uses social cognitive and emotional factors in understanding investor behavior. Behavioral finance has gained notable attention in recent years in explaining influence of investor psychology on investment decision making. Studies focusing individual investor behavior were firstly appeared around 1980s. Its main focus is on psychological aspects employed by investor to make investment decision. Theory which defines behavioral finance is presented by [1]. Kahneman, D. and A.Tversky, 1979 [2] hold that investor may not appear to be as rational for investment as supposed to be. These Behaviorists are of the opinion that investors behave irrationally while making investment decisions. They based investor's decision making process on overconfidence, overreaction, mental accounting, anchoring and herd behavior [3]. Shefrin, H. 2000 [4] defined behavioral finance as "a rapidly developing area that contracts with the influence of psychology on the behavior of financial professionals". Behavioral finance goes on to relax and even in some cases to abandon the theories of traditional finance like rational behavior, efficient market hypothesis and random walk theory. It does not reject the theories offered by traditional finance, but deepens the concepts to comprehend and clarify the investors' behavioral characteristics. Behavioral finance outlines the shortcomings of traditional finance relevant to rational acting of investor. It integrates the psychological and social factors relating to investor in financial models and relates them with situational factors in order to find their relevance to capital market participants.

Plenty of research is documented on investor behavior in the literature of behavioral finance, however, majority of research focus on psychological aspect of investor behavior. Very little research focuses on the stock selection behavior of individual equity investor. This study fills this gap by investigating the stock selection behavior of small equity investor in the context of Pakistan.

Background, Theoretical Framework and Hypotheses: Stock Attributes and Investor Stock Selection Behavior: Numerous studies in behavioral finance literature support the influence of various attributes on stock selection behavior or individual equity investor. For instance, [5, 6] hold that dividend events induce retail investors attention-driven buying and that retail investors exhibit abnormal behavior following dividend announcement. Lee, C. M. C. 1992 [5] also found that small traders buy after earning surprises, weather good or bad and that they react later than large investors do. Shefrin,H.2000[4] inserted that investors enthusiastically and actively

sought those stocks who offer higher dividend and growth, termed as value stock. [7] asserted that dividend could affect the activity of stock at the market. Brav, A. J.R.Graham, C.R.Harvey and R.Michaely, 2005 [8] reported that individual equity investors prefer dividend-paying stocks. Current research also hypothesis that individual equity investor are influences by higher dividend announcements and yields in their investment decision process.

Management competency is another attribute that individual equity investor may consider in making his/her investment decision. The competent management holding good skills is indispensable for the growth of business at higher level of success. Competency and commitment of management can be ensured by a share ownership and other performance based inducements. Managers of demonstrated talent having successful career record conveys clear message to investors to take advantage. [9] also investigated the effects of management competency one of strongest stock attributes that influences the investment behavior of individual equity investor. Literature supports that industry structure is a key factor for growth and effects firm performance and hence provides an incentive for investor to invest in that industry. Industry structure includes intensity of competition among rival firms. Intense competition in any industry can cause price lower than c osts and industry wide losses. Factors contributing towards intensity of rivalry in the industry include diversity of competitors, firm concentration, entry and exit barriers and excess capacity [10]. Dreux, D.R. 1992 [9, 11] also hold that growing industries are evaluated as an attractive investment opportunity by equity investors. Knowledge about company products and services and personal experience of consuming corporate products is also another important attribute that individual equity investor incorporates in their investment decision making. Similarly, satisfied and loyal investors also purchase more products of the same corporations. Antonides, G. N. L. Van Der Sar, 1990 [12] found that investor preferred the stocks of those corporations for which they have personal experience or knowledge they also play more value for knowing company products.

Individual investors usually buy stocks having upward price trends and sell stocks having downwards prices trends without having sufficient fundamental and technical analysis, this is called herding behavior in behavioral finance. Antonides, G. N. L. Van Der Sar, 1990 [4] also suggested that investor are less likely to buy

stocks with prices moving downward and sell stock whose prices are moving upward Lucey, B. M. and M. Dowling, 2005 [13] investigated the relationship between equity prices and investor behavior and argued that equity prices have reciprocal effects on equity investor behavior. Market status refers to growth potentials of corporation as compared to its competitors in the same industry; these highly growing stocks are also known as blue chips and are preferred options for investment. Equity investors evaluate factors that are important for the success of the business and discover the areas in which the firm occupies long term comparative lead on other firms in the same industry or sector. This competitive lead may be towering share in the market, intellectual property, strong brands or technological advantage. Theories of behavioral finance assume that individual equity investors are not always rational and do not incorporate industry, fundamental and technical analysis in investment decision. This has also been documented by many researches that individual investor mostly rely on recommendations of his stock brothers, fellow traders or some friends. Stockbrokers are generally preferred sources of advocate recommendations on which individual equity investor base their investment decisions. This also separates investors from speculators; investor relies on their own technical or fundamental parameters whereas speculators base their investment decisions on speculations and rumors prevailing in the market.

Another attribute that individual investor considers while investing his/her money in stocks of any corporation is the principal place of operation of that corporation. Individual investors tend to be more loyal to their economy and avoid investing in those companies which are not based in their homeland. [14] also found in their survey of Australian investors that individual investor prefer to invest in those companies based in Australia than those companies located abroad. Many authors in different fashions have defined corporation reputation. [15] believed corporate reputation as a set of collectively held beliefs about a company's ability and willingness to satisfy the interest of various stakeholders. [16] presented a general definition and stated that corporate reputation is 'a stakeholders overall evaluation of a company over time'. Corporate reputation can be used to gain favor of various stakeholders including customer, employees and investors. For instance, [1] found significant influence of corporate reputation on customer satisfaction and retention in the cellular industry of Pakistan.

Majority of literature is connecting CSR this with improved financial performance of organization, for instance, [17] argued that corporate environmental considerations improve business performance. [18] also found strong association between CSR accomplishments and corporate financial performance. Other researches on CSR included the influence of CSR on customer behavior. Researchers found that CSR influence customer purchase behavior for instance, [19, 1] also found strong association between corporate social responsibility, investor satisfaction and investor loyalty in the context of Pakistan. Investor relations management experts believe that good investor relations contribute to the fair evaluations of firms by investors. [20, 8] argued that good investor relations are beneficial for attracting investor and lower the cost of capital for corporations. Normally individual retail investors are considered less important for relationship management and more focus is given to large institutional investors. [8] found in their survey that individual investor are difficult to target for investor relations management services because they hard to manage due to their large numbers and low quantity of stock holdings. Firm visibility and publicity or advertising, is also another important factor that influence decision making of individual equity investor. Companies frequently appear in the media not only to attract its customers, but also to communicate important message to its potential future investors. The objective is to memorize the name of corporation to the potential investor and build strong image. [6] shown that small investors are more prone to buy attention clutching stocks. [21] showed significantly positive relationship between annual advertising budget with breadth of share ownership and firm's liquidity, suggesting that investor seems to hold shares of those companies with whom they are more familiar.

Research Hypotheses: On the basis of above theoretical discussion, the following research hypotheses are developed.

H1: Dividend is having significant relationship with investor's stock selection behavior.

H2: Firm's management competence stock attribute is having significant relationship with investor's stock selection behavior.

H3: Firm's growth perception in the industry is having significant relationship with investor's stock selection behavior.

H4: Knowledge of corporation's products stock attribute is having significant relationship with investor's stock selection behavior.

H5: Price trends and volatility influence significantly on investor's stock selection behavior.

H6: Firm's status in the market influence significantly on investor's stock selection behavior.

H7: Investor's stock selection behavior is influenced significantly by recommendations from others.

H8: Investor's stock selection behavior is influenced significantly firm's principal place of operations of the corporation.

H9: Corporate reputation is having significant impact on investor stock selection behaviour.

H10: Individual equity investor's stock selection behaviour is positively affected by social performance of corporations.

H11: Individual equity investor's stock selection behaviour is positively influenced by investor relations management by the corporation.

H12: Individual equity investor's stock selection behaviour is positively affected by visibility or publicity of corporation in the media.

MATERIALS AND METHODS

The study empirically tested the stock selection behavior of individual equity investors. Primary data is collected through personally administered survey technique from 470 individual equity investors trading in all three stock exchanges of Pakistan, namely; Karachi stock exchange, Lahore stock exchange and Islamabad stock exchange. The dependent variable individual equity investor decision making is measured by an instrument adopted from [22]. The instrument to measure stock attributes including dividend, yield, management team competence, industry sector, knowledge about company, price trends and volatility, market status, sources of recommendations, principal place of operations, are adopted from [14] who used conjoint analysis approach to determine question items. The instrument to measure corporate reputation is adopted from [23] who used the instrument development methodology proposed by [9] for

content specification of the construct. The construct of the CSP is adopted from [24]. The instrument contains 5 items incorporating labor practices, environmental, social and stakeholders' aspects. The instrument to measure firm visibility and publicity and investor relations management has been adopted from [8], the instrument contained 10 items. All items are measured on 5 point Likert scale.

RESULTS AND DISCUSSION

The reliability analysis of data is performed through latest version of SPSS and values of Cronbach Alpha [25]. hold that the value of Cronbach alpha should be greater than 0.5 and reflects the acceptable reliability of data in social sciences. The Cronbach alpha of all variables including dividend and yields, management team competence, firm industry/sector, knowledge about company, price trends and volatility, firm's market status, source of recommendations, firm's principal place of operations, corporate reputation, corporate social performance, investor relations management, firm visibility in the media and individual investor behavior are 0.84, 0.77, 0.76, 0.83, 0.88, 0.74, 0.75, 0.82, 0.89, 0.85, 0.64, 0.89 and 0.74 respectively. Therefore, all scales used in this study are found reliable and can be used for analysis purposes.

The results of Structural Equation Model presented in Table 1 show the decisions of hypotheses testing. Hypothesis 1 in this study is related to influence of dividend and yield stock attribute on individual equity investor's decision making process. The SEM path between dividend and yields and investor decisionmaking process shows positive and significant relationship with P value (.044) which is less than

0.05 with positive values of estimate and standard error, we therefore accept our *H1*. The result shows that stocks offering higher dividend and yields influence individual equity investor's decision making behavior. The second path represents the relationship between firm's management team competence and individual equity investor's behavior. The SEM results for this path shows insignificant influence of firm's management team competence on individual equity investor's trading behavior P value (0.194), we therefore, reject our *H3*. This implies that individual equity investors do not consider firm's management team competence stock attribute in their equity investment decision making. The third path in SEM analysis is related to firm's industry or sector from which it belongs and its influence on equity investor's behavior as depicted in our H3. SEM results shows positive and significant influence of firm's industry or sector on individual equity investor's decision making behavior P value (0.039), leaving our *H3* accepted as well. This result implies that industry or sector having higher growth potentials are seen positively by equity investors and individual equity investors of Pakistan also consider firm's industry of sector before making their equity investment decisions.

Next SEM path elaborates the influence of investor's knowledge about company products or services on his/her investment decision making as presented in our hypothesis 4. The result presented in Table 4.14 depicts insignificant P value (0.192) means that investor's knowledge about company's products or services has no influence on equity investor's decision making, we therefore reject our *H4*. Hypothesis 5 proposes the influence of price trends and volatility stock attribute on individual equity investor's behavior. The SEM results show positive and significant influence of price trends

Table 1: Regression Weights

Paths			Hypotheses	Estimate	S.E	P	Decision
I.D. Making	<---	Dividend and Yields	H1	.064	.038	.044	Supported
I.D. Making	<---	Management Team Competence	H2	.053	.041	.194	Not Supported
I.D. Making	<---	Firm's Industry/Sector	H3	.096	.047	.039	Supported
I.D. Making	<---	Knowledge about Company	H4	.051	.039	.192	Not Supported
I.D. Making	<---	Price Trends and Volatility	H5	.089	.037	.015	Supported
I.D. Making	<---	Firm's Market Status	H6	.119	.049	.019	Supported
I.D. Making	<---	Source of Recommendations	H7	.306	.043	.000	Supported
I.D. Making	<---	Principal Place of Operation	H8	.037	.034	.278	Not Supported
I.D. Making	<---	Corporate Reputation	H9	.126	.038	.001	Supported
I.D. Making	<---	Corporate Social Performance	H10	.090	.035	.010	Supported
I.D. Making	<---	Investor Relations Management	H11	.063	.051	.218	Not Supported
I.D. Making	<---	Firm Visibility in the Media	H12	.072	.035	.039	Supported

and volatility stock attribute on investor behavior (P value 0.015) leaving our *H5* accepted. This finding is quite logical, as equity investors are considered risky investors as compared to investors of other financial assets, for instance, bonds and other financial instruments. Hypothesis 6 proposes the influence of firm's market status stock attribute on individual equity investor's behavior. The SEM results shows positive and significant (P =.019) relationship between firm's market status and equity investor's behavior, leaving our *H6* accepted. This finding shows that firm's enjoy good status in the stock market are given more preferences by equity investors. The next hypothesis proposes the linkage between source of recommendations and equity investor decision making as presented in *H7*. SEM analysis shows positive and highly significant association between source of recommendation and investor decision making (P = 0.00), we therefore accept our *H7*. This shows that source of recommendation is the most significantly influencing factor on individual equity investors' in Pakistan. Hypothesis 8 proposes influence of principal place of operations stock attribute on equity investor's behavior in this study. The SEM results shows insignificant influence of principal place of operation stock attribute on investor behavior (P = 0.278), we therefore reject our *H8*. This implies that individual equity investors in Pakistan do not consider place of operations of company and are willing to invest in any corporations having their principal operations any country. The next hypothesis in this study links the path between corporate reputation and equity investor behavior. The SEM result for this path depicts positive and significant (P =.001) influence of corporate reputation on individual equity investor's decision making, we accept our *H9* therefore. Analysis shows that corporate reputation is the stock attribute having second highest influence on investor's behavior after source or recommendation.

Next hypothesis 10 is related to influence of corporate social performance on individual equity investor's decision making behavior. The SEM results also shows significantly positive influence of corporate social performance on individual equity investor's behavior (P =.010) leaving our *H10* accepted as well. This finding is very pertinent in this study, it implies that individual equity investors' consider social performance of corporations in their equity investment decision making. The next, hypothesis proposes the influence of investor relations management on investor's behavior. The SEM results shows insignificant (P = 0.218) influence of investor relations management on individual equity

investor's decision making behavior, resulting rejection of our *H11*. The final path in our model is related to influence of firm's visibility in the media stock attribute on individual equity investor's decision making in the context of Pakistan. The SEM results provides positively significant influence of firm's visibility in the media on individual equity investor decision making, we therefore accept our *H12* as well.

CONCLUSION

The objective of this study is to investigate the stock selection behavior of individual equity investor and the influence of various stock attributes on investor behavior. The study identifies stock attributes including dividend, price trends and volatility, firm's status in the market, source of recommendation, corporate reputation, corporate social performance, firm's visibility in the media having significant on stock selection behavior of individual equity investors in Pakistan. However, some stock attributes including; management team competence, knowledge about company products and services, firm's principal place of operation and investor relations management do not have significant influence on stock selection behavior of individual equity investors for the case of Pakistan. The study provides important information to investment professionals, stock market regulators and companies listed on stock exchanges of Pakistan. The findings of this study can be used to attract investors and increase their participation in equity market of Pakistan.

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