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Stock trading Strategies Shaping Investors Decision Making in Cash Market: A Literature Survey

Nilam Panchal [1],
Associate Professor,
B.K.School of Management, Gujarat University, Gujarat

Vandana N. Poturaju[2]
Lecturer,
Institute of Forensic Science, Gujarat Forensic Sciences University, Gujarat

Naresh N. Poturaju[3]
Assistant Professor,
Institute of Management, Nirma University, Gujarat

Abstract :

The very rationale of investing in stocks is that it should produce superior returns over the comparatively secure government t-bills or t-bonds. To get assured returns from t-bills or t-bonds one just needs to invest funds and wait till maturity but that is not the case with stocks. Timely and adequate investment, regular tracking of market trends and stock prices, taking corrective action like booking profits or loss is to be done to get that desired returns. Thus each investor would have over the years developed some trading strategies which maximizes their profits and in times where the market catches them unaware they must have developed strategies which minimizes their loss. A study on knowing the existence of various trading strategies can be helpful to both existing and want to be investors as existing investors can adjust their trading accordingly and the new entering traders can invest wisely with tried and tested strategies.

An investor allocates his capital with an expectation of financial returns. So investment is a relative subject where the always trades off between risk and uncertainty in order to gain maximum returns. Over the years of trading he develops his own a strategy which varies from investor to investor and situation to situation. The current paper investigates the various trading strategies that investors in cash market follow and its impact on profitablility.

Keywords: - Cash Markets, Day Trading, Delivery Based Trading, Trading Strategies, Profitability

Introduction

It doesn't need more than logic to understand that if a person is successful in stock markets then they must be applying some trading strategy which over the years has been evolved and is still successful and thus providing profitability. Had this not been true then the person would either have exited the market due to low profitability or would turn to mutual funds for passive returns from stock markets. Thus knowing those rules and methods which form the part of an individual's trading strategy will show the path towards inching towards profitability in stock markets. No matter which strategy one applies the trading strategy would consist of the following elements.

a) The Plan for execution of trades.

Plan is an essential element in each aspect of life. The same is true for trading in stocks for profitability. Even in virtual stock trading one applies and executes such plans where actual money is not at stake. So when it comes to real trading the plan for execution of trades would always be made. It may be written or visual, which is in the mind of the investor. But it more or less sets out the amount that would be invested, when to be invested, in how many phases to be invested, when to be withdrawn from the market. It would also include the plan for agility. Which is making day to day or regular changes based on new information being made available along with available historical data? Once this is defined then one has a clear idea of maximum downside and upside potential of their trades and it becomes part of their preparedness with the uncertain nature of stock markets.

b) Keep running to stay stagnant

If an investor feels that they know enough about trading and investing and do not make any effort to update their knowledge then sooner or later they would be faced with a situation where they may underperform their peers. As the portfolio grows so should ones knowledge base regarding the stocks and the functioning of the market. The sky is the limit here and that is why change is the only constant. The more one is updated the better they are prepared in terms of handling the volatility and ambiguity of returns from stocks.

c) Select Right Stocks

From all other decisions to be made selection of the right stocks is the crucial one. As selecting wrong stocks may lead to both opportunity losses and actual losses. Though initially one may not know what right stocks are but it would vary person to person based on what targets one sets from the markets and how much devoted they are to achieving them.

d) Channelize your passion

One should not forget the fact that when they are trading in stocks or investing in stocks along with the money invested are the dreams attached with the profitability of each investment. So not being able to make profit will not only mean lower realisation of monetary value it also affects one's emotions. Trading and investing is all about controlling these emotions and using them to

your advantage. Thus on many occasions you may feel like trading without enough information or even when markets are highly volatile and that is when you need to keep your emotions in the backseat and exercise self-control. The bird in hand is always better than two in the bush. Your rupee not invested on emotional grounds is equivalent to a rupee saved. Also few strategies not working in your favour initially or your predictions going wrong is bound to happen. One should not get dishearten by this and should keep a long term picture in mind. Thus these learning's on non-profitable trades shape ones future trading strategies and thus when committed initially will eventually raise your trading standards.

Review of Literature

Factors affecting investors' trading strategies

The trading performance of different types of investors is of rising interest in terms of market design and for framing regulatory policy. Institutional investors can take the assistance of some powerful tools like sophisticated genetic algorithms and neural networks and tools for liquidity supply placing them at an added advantage over individual investors. Individual investors money is a huge source of capital which provides liquidity to the market. Individual trading is widely influenced by many other external factors which are as follows:

Behaviour of stock broking agents

In the world of electronic trading where heterogeneous investors are widely distributed, the role of stock trading agents have become more complex and challenging for using such domain applications which are dynamic in nature with the unexpected market conditions. As individual investors hugely depend on the advice of the stock brokers or agents & portfolio managers and change their investing decisions based on their opinion.

Thus, the agents need to have good communication and problem solving skills, immense competency for accessing, filtering, retrieving and integrating data from varied information sources. So the stock market agents require constant monitoring of continuously changing stock information, and have the ability to make quick decisions with the changing market environment based on the certain rules.

Delgado et. al. (2000). explored a hybrid learning system using different fuzzy modelling techniques which can provide relevant learning curve registered into the investors mind for use of a given trading strategy. Garcia et. al. (2000) provided with a structured deliberative multi agent system for stock trading domain which can be used as a proactive tool for communicating and executing high level stock trading strategies. Luo and Liu (2002) have given MASST (Multi-agent System for Stock Trading) framework, which is a middle layer agent system between the demand side of information (i.e investors in stock market) and the supply side of information (i.e. the internet). Many decision making support systems in stock trading are coming up to solve the complex problems of the stock agents and enhancing their decision making skills, ultimately

benefitting the final investors. So the brokers behaviour has an immense impact on investors profitability.

Investor sentiment:

Investors momentum have indirect effect on stock market return. Past market returns affects the buying behaviour. Researchers like Grossman and Stiglitz (1980), Black (1986), and Hong and Stein (1999) have explained the importance of investor sentiment or behaviour and market returns.

Economic links or news:

Cohen and Frazzini (2008) have explained that with investors attention stock prices do not promptly incorporate news about economically related firms and its stakeholders. Market news and industry unrelated news have a strong distracting effect on the investors trading strategy, supporting investor distraction hypothesis. (Hirshleifer et. al. 2009)

Tax rate:

Constantinides (1984) has emphasized that the benefit of optimal tax trading on medium and high variance stocks outweighs even large transaction costs for those investors who can distinguish between short term and long term tax rates and predicting a seasonal pattern in trading volume and stock prices for the January anomaly, keeping investors behaviour as ignorant and irrational.

Friday drift:

Investors sentiment towards the weekend is low also known as Friday drift, compared to weekdays. So the earning announcements on fridays go unnoticed by the investors supporting the inattention hypothesis. A portfolio that invests in the differential Friday drift earns substantial abnormal returns. (Dellavigna and Pollet 2009)

3.Trading strategies

Contrarian Trading

The usual preferred strategy is to buy stocks and hold till the target price is achieved and then book profits, however the returns from such strategies have been low compared to its parametric contrarian investment strategies in the U.S. Balvers et.al. (2000). Expected returns effect on the contrarian portfolio shows that June end portfolio ends negative returns comparing to December end portfolio (Ball et.al. 1995). Conrad and Kaul (1998) concluded that the long horizon contrarian strategies are more profitable than momentum strategy. The Contrarian and Momentum strategies have effect on stock returns of myopic investors of Istanbul Stock Exchange Bildik et.al. (2007). When it comes to using momentum investing as trading strategy Lui (1999) found that factors such as average returns, such as size, stock price, book to market ratio and cash earnings to price ration do not explain momentum profits for UK stocks. Momentum trading

strategy has given good returns in some industries in Indian stock market between 2000-2013. Garg and Varshney (2015)

The traders who use technical analysis as a part of their stock trading strategy believe themselves to be at a superior level than the other traders. However earlier studies conducted by Fama and Blume (1966) had concrete proof of no contribution of technical analysis in mainstream finance.

Passive net buying gives negative returns and aggressive buying increases overall cash flows which contribute to market efficiency. Kelley and Tetlock (2013). But when similar study was carried out for small cap and large cap stocks Malkiel (2003) found that passive investing strategy works for small cap and large cap equities in U.S as well as international markets for bonds and stocks.

Just like any risk free investments provide relatively assured returns but the amount received on maturity has reinvestment risk and how well it is utilized thereafter leads to wealth creation similarly the stock trading strategies yield returns but profitability of such strategies varies substantially over the time Gelly (2016). Investor sentiment and market sentiment is a reflection of collective trading strategy being executed on that day. Such investor sentiment influences the fluctuation in discounts of stock prices which is correlated with price of other securities (Lee et.al.,1999)

Buying and Selling Strategies

Humans have a complex behavior which can be reflected in the trading decisions which sometimes leads to crisis in financial markets. (Pries, 2013). The cost of use of wrong trading strategy by the majority investors should not be overlooked. Bikchandani and Sharma (2000) concluded that herd instinct is the primary cause of bubbles in finance and such investor behavior can often cause large unsubstantiated rallies or selloffs based on little fundamental evidence to justify it. Moving average and trading range break was the trading strategy followed in U.S. between 1897 to 1986. Brock et.al. 1992. Though speculative trading strategies have the highest returns they also bring in the highest cuts in profits. The high speculations in short term trades adds more transaction costs and taxes on investors (Summers and summers, 1990)

The time of entering into the market classifies investors into three categories namely buying when prices rise, buying when prices are steady and buying when prices fall. Kaniel et. al (2008) found that individuals buy stocks when prices fall and sell when it increases. By use of this trading strategy these risk averse investors provide liquidity to meet the institutional demand. With imperfect markets investors buy stocks now with an aim to sell later for more, which is very complex but can do arbitraging and reap more capital gains (Harrison and Kreps, 1978). Strategy of buying stocks and that have performed well in past and selling which have poorly performed has a positive correlation with their returns (Jegadeesh and Titman, 1993)

Noise Traders:

Market predictions are sometimes not at all correct due to the presence of large number of traders

who make decisions about their trades without using fundamental data. Such traders are popularly referred as noise traders. The media's role in providing news has an impact on stock market's volatility and strategies of noise traders. Tetlok (2007). Noise traders follow positive feedback strategies which has a correlation with assets returns. (Long et.al. 1989) Such irrational noise traders with their stochastic beliefs affect prices and earn higher expected returns (Long et.al. 1990).

Herd Instinct

Ask a math student that there are fifty sheeps on this side of the fence if one sheep is moved to the other side of the fence, how many sheep shall be here. Most obviously the reply may be fifty minus one equals to forty nine. But ask the same question to the shepard and he would immediately reply the answer to be zero. As when the first sheep jumps on the other side of the fence all remaining sheeps shall follow. This phenomenon is called as herd tendency or herd instinct. In institutional herding strategy there has been seen a positive correlation between institutional trading and short term returns. (Dasgupta et. al. 2011). Heard tendency provides profit when markets are rising but when there is correction these type of strategy bear the highest loss. Industry momentum investment strategy which emphasizes on buying past winners and selling past losers giving high profitable returns. (Moskowitz and Grinblatt 1999)

Conclusion

Thus forming a stock trading strategy is like a financial rollercoaster ride where everyone aims for finding good stocks and avoiding the bad ones. There is no fixed formula or any magic wand to get instant wealth but it is set on certain based criteria's by the investors to acquire more return than the average market return. Framing a strategy depends upon the investor with his personal outlook with respect to time frame, amount to be invested, risk tolerance, devoting time in picking and investing in stocks and thus forming his own learning curve against the experience gained. Whether the investors make trading decisions rationally or irrationally (superstitiously) but all try to find out a successful way and try to curve a fixed formula for themselves to multiple their overall returns and wealth.

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