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Title of the dissertation

The Influence of Speculation on Investors

Literature Review

This dissertation aims to understand the special relationship between speculation and investor decision-making. The concept of speculation is discussed in the foundational works of political economy, notable authors including Adam Smith, Keynes and Schumpeter wrote extensively on speculation. However, the term largely remains shrouded in mystery and controversy. Adam Smith's writing on speculation reflected the historic time period and the term largely described merchant speculators. According to Smith the speculator's principle concern is to recover high levels of profits which themselves are proportionate to risk:

'He enters into every trade when he foresees that it is likely to be more than commonly profitably, and he quits it when he foresees that its profits are likely to return to the level of other trades. His profits and losses, therefore, can bear no regular proportion to those of any one established and well-known branch of business' (1998: 111),

Differently, Keynes defined speculation as the 'activity of forecasting the psychology of the market' (1974: 158). In this respect, he concluded that speculators, who consist of institutional investors, as well, 'are concerned, not with what an investment is really worth to a man who buys it 'for keeps', but with what the market will value it at, under the influence of mass psychology, three months or a year hence.' (p: 155).

Turning to the contemporary literature on speculation we find a common axiom that in stable or rising markets, speculation is considered desirable since it provides liquidity and the opportunity to everybody to envision enormous fortunes (Galbraith, 1992; Chancellor, 2000). There are some very important historic cases where policy was introduced to neutralize the high risk associated with this. Prior to the crash of 1929 almost everybody was speculating. However, after the crash the Glass-Steagall Act 1933 was introduced in order to curb the unbridled speculation that was blamed for the great depression. Similarly, during Greenspan's administration of US fiscal policy speculation was praised and promoted by low cost credit and deregulation, however now it is the case that excessive speculation has been universally accused of the crisis.

Minsky (2008) observed that the influence of investors will generally increase market volatility. He argues that investors, particularly in periods of intensive speculation, are assessed on the sole principle of the returns reclaimed, while risk is overlooked. For Minsky this marks an unprecedented period of speculation and the development of contemporary capitalism:

'Capitalism in the United States is now in a new stage, money manager capitalism, in which the proximate owners of a vast proportion of financial instruments are mutual and pension funds. The total return on the portfolio is the only criteria used for judging the performance of the managers of these funds' (Minsky, 1996: 1).

When considering the ownership structure of the DJIA components there is evidence in support of Minsky's view. For example, in only three companies, General Electric Company, 49.1%; Exxon Mobil Corporation, 47.5%; and Wal-Mart Stores Inc. 36.5%, did institutional investors have less than a 50% stake as of the end of December 2009. Noticeably, in nine corporations they owned more than 70% of the share capital, with American Express, Merck & Company Inc. and the Travelers Companies Inc. featuring high on the list with 80%, 80.5% and 89.1% respectively.

Compared with the view of Keynes (1974: 157) illustrated above and who also argued that 'investment based on genuine long-term expectations is so difficult today as to be scarcely practicable', Minsky has also recognised the volatile influence of investors and the transformation of their investment horizons. This view is supported by reference to empirical data, for instance, Patterson points out that 'Getco LLC, a private company with fewer than 250 employees, often accounts for 10% to 20% of the daily trading volume of many U.S. stocks ... including highly traded names such as General Electric Co., Oracle Corp. and Google Inc.' (2009: 3)

There is evidence from the literature that technology is changing our definition of speculation. Consider the fact that Bats Global Market does not need more than 400 microseconds in order to process a trading order. That is 0.0004 seconds and it is "1,000 times faster than humans blink their eyes."²¹ (Ortega et al, 2009: pp. 2-3). Furthermore, the following exact from the New York Times perfectly demonstrates the change in the behaviour pattern of institutional investors, which massively embark on high-frequency trades:

'High-frequency traders often confound other investors by issuing and then cancelling orders almost simultaneously. Loopholes in market rules give high-speed investors an early glance at how others are trading. And their computers can essentially bully slower investors into giving up profits - and then disappear before anyone even knows they were there.' (Duhigg, 2009: 11)

To draw this literature review to a close it is important to note, in order to understand financial markets, it is clear from the literature presented above that we have to study and understand the participants involved. Investor decisions are vital in such a context. According to literature introduced and discussed above the view we will take forward for this research is that decisions are more often not the result of a mathematical formula (Keynes, 1974; Lawson, 2009), that instantly considers new knowledge regarding risk and volatility. Rather, it is useful to draw on the advice of former Fed, Alan Greenspan, to recognise that humans generally do not follow such rational approaches to investing, or as he famously puts it himself: 'The human race has never found a way to confront bubbles'. It is precisely this inability to "confront" one aspect of finance that this research aims to better understand.

Rationale

Modern Finance literature persistently ignores the systemically destabilizing effects of financial bubbles. As a result, periodic speculative excesses, which hugely deviate from the rational models of mainstream finance, are largely unexplored, especially with regard to institutional investors' behaviour in financially euphoric environments.

The implications of speculative bubbles and institutional investors' risk attitude are crucial in understanding the limitations of rational models that prevail in finance. This dissertations will explore investment activity within its social, and frequently, speculative context. In doing so, this study will make an original contribution to understanding the behaviour of investors in speculative markets.

The above rationale therefore prompts the following specific research questions:

How was the speculative bubble formed?

What are the institutional investors' objectives in speculative bubbles?

How are institutional investors affected in speculative bubbles?

How is the risk attitude of institutional investors transformed during the speculative bubble under consideration.

Aim and objectives

General aim:

The overarching objective of this research is to establish how a speculative bubble grew to influence the decisions of professional investors and risk attitude toward speculation.

Objectives:

- To understand and explain how the seeds of speculation were set
- To expose the risk attitude of institutional investors during the speculative bubble
- To examine the fallacies affecting institutional investors in speculative markets
- To reveal the institutional investors' objectives in speculative markets

Methods

Method

Using a series of semi-structured interviews with fund managers that worked during the Cyprus bubble of 1999, this thesis aims to contribute to the limited literature regarding institutional investors' speculation. I draw from Abolafia and Kilduff, Kindleberger, Minsky, and Galbraith in order to provide a descriptive framework of speculative bubbles, in which institutional investors appear to be purposive, contrary to and at the expense of retail investors and the systemic stability.

Research Philosophy

The interview is an interaction process, which no matter how hard we try to objectify it, it remains highly social (Holstein and Gubrium, 2004a, 2004b). From the first stage of identifying the respondents to the last one in which we conduct the interview and thank the respondent for his/her valuable time and input, we engage in social interactions, which unavoidably affect the outcome to various degrees (Warren, 2002). As highlighted by Easterby-Smith et al. (2002: 131) "Even if the interview is highly structured it should be remembered that the interaction is a social process." That does not mean that the researcher is allowed to influence the outcome in ways that serve her presumptions about her object of analysis. It only means that the researcher should be aware of its role in generating the data in order to be able to deal effectively with it. When selecting a qualitative method for generating my data, my intention was to gain access to rich, holistic and relevant data. Miles and Huberman (1994: 10) in their landmark work on qualitative data analysis emphasised the richness and relevance of qualitative data and the potential they offer for 'fruitful explanation'.

"Another feature of qualitative data is their richness and holism, with strong potential for revealing complexity; such data provide "thick descriptions" that are vivid, nested in a real context, and have a ring of truth that has strong impact on the reader."

In the case of my research, in order to understand the 'hows' and 'whys' involved in the 'impact of a speculative stock market on institutional investors' investment behaviour' I needed accounts of experiences, from the actors involved. At the other end of the spectrum of my options were the numbers. However, according to the same authors, "Focusing solely on numbers shifts attention from substance to arithmetic, throwing out the whole notion of "qualities" or "essential characteristics." which are extremely important in understanding the complexity embedded in such phenomena."

The vast majority of research in financial economics over the last 60 years has been exclusively based on numbers and statistical analysis. However, I believe that rich accounts of experiences

provided by the protagonists of the phenomenon under examination are strongly relevant, providing the researchers with the opportunity to 'reveal complexity'. Such data 'are a source of well-grounded, rich descriptions and explanations of processes in identifiable local context. As a result, with qualitative data one can ... derive fruitful explanation' (Miles and Huberman, 1994: 10).

The benefits of semi-structure interviews compared to the in-depth interviews are the relevance of the data collected. "In semi-structure interviews the researcher will have a list of themes and questions to be covered, although these may vary from interview to interview." (Saunders et al, 2007: 312).

Analysis

To conduct the data analysis I followed the framework set out by Carney (1990), Miles and Huberman (1994) and Gummesson (2003). The principle guiding the formation of an analytic framework is raised by Miles and Huberman when they ask 'what methods of analysis can we use that are practical, communicable, and no-self-deluding - in short we get us knowledge that we and others can rely on?' (1994: 1). However, Gummesson states that 'we have endless options, none offering a self-evident choice' (2003: 483). All available analytic frameworks involve interpretative work and so require an element of the researchers intuitive hermeneutic understanding of the participants meaning. For this reason transparency of analytic framework is crucial. Therefore I will stress here that I have adapted the guidelines stated above to the needs of my research, instead of strictly following every step suggested.

For the administrative tasks of the data management I will use NVivo software. This will improve the efficiency of organising and administrating my data (Gummesson, 2003, Bryman and Bell, 2007). The contribution of NVivo can be summarised as follows:

'The computer takes over the physical task of writing marginal codes, making photocopies of transcripts or fieldnotes, cutting out all chunks of text relating to a code, and pasting them together. CAQDAS does not automatically do these things: the analyst must still interpret his or her data, code and then retrieve the data, but the computer takes over the manual labour involved' (Bryman and Bell, 2007).

Limitations

Semi-structure interviews are time consuming for both the researcher and the participant. Therefore, it is the researcher's responsibility to ensure that the time provided by the respondent will be used as productively as possible. Easterby-Smith et al. (2002: 88) discussed this issue and warned the interviewees about the risks of ending up with non- relevant data. They suggested:

"... the researcher should be warned against assuming that a "non-directive" interview, where that interviewee talks freely without interaction or intervention is the way to achieve a clear picture of the interviewee's perspective. That is far from true. It is more likely to produce no clear picture in the mind of the interviewee of what questions or issues the interviewer is interested in, and in the mind of the interviewer, of what questions the interviewee is answering! Too many assumptions of this kind lead to poor data, which is difficult to interpret. Researchers are likely to be more successful if they are clear at the outset about the exact area of their interest."

Ethics

A common concern faced by qualitative researchers is the sensitivity of the issues under examination. People do not feel comfortable in speaking for a corporate failure in which they were involved or for a speculative bubble, which in retrospect seems so predictable.

Timescale

Task	Deadline *
Submission of proposal	March 2013
Review of literature	Early June, 2013
Draft literature review	Mid June, 2013
Draft research methods	End June, 2013
Collection of secondary data	Early July, 2013
Data analysis	Mid-July, 2013
Write up data analysis and results, conclusion and introduction	Early August, 2013
Finish write up, formatting and referencing	Mid August, 2013

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