# Emotional Finance: A New Research Direction

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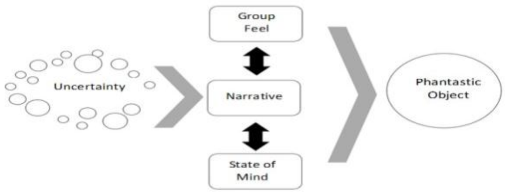
***Abstract-*** **The impact of psychological biases, heuristics, and emotions on the performance and decision-making of investors and managers is examined by behavioural finance and behavioural corporate finance. A significant paradigm change has been brought about by Taffler and Tuckett (2005) with the introduction of a brand-new area of study called emotional finance. This innovative method uses Freud's notion of phantastic objects to examine how unconscious, childlike emotions affect investors' choices. The dominant views that suggest that markets are guided by investors' conscious processes are challenged by the emotional finance hypothesis. It investigates the influence of both conscious and unconscious processes in investment decisions and is based on psychoanalysis. It provides fresh justifications for the origins and foretelling of the numerous crises and bubbles that have occurred, particularly since the 2000s. It uses ideas like narrative, collective feel, states of mind, and phantastic object in this framework that haven't been used in finance studies before. The literature review conducted in the area of emotional finance up until this point has not been as thorough as this study. It examines and models the core ideas of the theory in relation to their causes and effects. It presents findings to aid market regulators, fund managers, and investors in comprehending market bubbles.**

***Keywords-*** **Emotional Finance, Narrative, Collective Feel, State of Mind, Phantastic Object, Psychoanalysis**

## 1. INTRODOCUTION

Taffler and Tuckett (2011) believe that accepting the idea that investment activities have much deeper meaning in unconscious reality than is typically acknowledged and go beyond simply maximising financial return is the first step in understanding investment behaviour. The emotional finance theory contends that unconscious mechanisms significantly influence how people make financial decisions. Emotional finance is the study of the function of unconscious mental processes in financial decision-making, and it is based on psychoanalysis. However, according to emotional finance, uncertainty rules the markets. Traditional financial theories analyse people's behaviour along the risk-return axis. The ideas of risk and uncertainty are fundamentally distinct from one another. According to Knight (1921), the key distinction between risk and uncertainty is that, whereas in the situation of risk, both the potential outcomes and the likelihood that an incident will occur are known, in the case of uncertainty, the potential outcomes are known but not the probabilities. Investors undoubtedly deal with "extreme uncertainty" and informational convergence, according to Tuckett (2012).

Figure 01. Basic concepts of emotional finance and its relationship with each other




Source: Dumanli & Aren (2019), "Role of Narratives in Financial Decision Making from Perspective of Emotional Finance

Emotional finance makes use of ideas like story, collective feel, states of mind, and phantasmagorical objects to explain the unintentional actions of investors operating in an uncertain market. These principles will first be thoroughly presented in the article, after which the studies and research in the area will be discussed.

## 2. BASIC CONCEPTS OF EMOTIONAL FINANCE

### *2.1 Narratives*

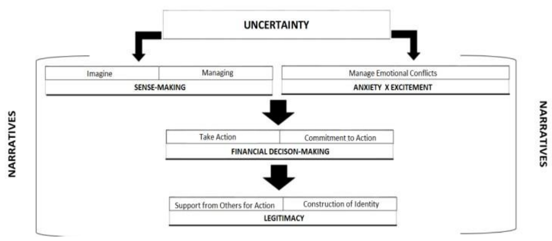
A story is a description of an event told orally or in writing. With the emotional finance approach, narratives have begun to establish a presence in the literature of finance. Shiller (2017) asserts that despite the increased use of narratives across all disciplines, particularly since 2010, the study of narratives in the economics and finance fields only accounts for 5% of all research.

According to emotional finance, people who have to make decisions in the face of uncertainty construct stories to represent that uncertainty. In this situation, narratives serve as a kind of explanation for ambiguity (Dumanl & Aren, 2019). Making sense of one's life and moulding one's experiences is a natural human activity that is aided by narratives (Bruner, 1991). They give us the ability to create events, their significance in daily life, and their causal implications (Tuckett & Nikolic, 2017).

Contrarily, Chong and Tuckett (2015) contend that when people encounter circumstances with unexpected results, feelings of exhilaration and worry over loss are bound to develop. They also contend that people deal with these emotional conflicts by creating narratives. According to Nyman (2015), people make judgements by forming adequate opinions about prospective rewards while suppressing worry and their suspicions of probable loss, and then they act accordingly. In addition to helping, one make sense of the current state of uncertainty, narratives put an end to the struggle between the opposing sensations of excitement and worry.

When uncertainty is made sense of to make it manageable, Dumanl and Aren (2019), who summarise the function narratives play in emotional financial tales, claim that emotional conflicts are also eliminated. They make it possible for people to act and stick with that activity. Investors turn to narratives to support their investment choice both internally and within the social setting.

Figure 02. The role of narratives in emotional finance




Source: Dumanli & Aren (2019), “Role of Narratives in Financial Decision Making from Perspective of Emotional Finance

Studies studying the impact of narratives on financial decision-making gave birth to the Conviction Narrative Theory (CNT), which aims to explain how people, through narratives, make judgements under ambiguity and how they remain committed to such decisions. The CNT is a theory, according to Nyman (2015), that seeks to comprehend and explain how people choose in situations were doing so would not be optimal. Belief and sentence are represented by conviction. The hypothesis holds that people have a deep conviction in narratives and are fascinated by them.

*2.2 Group Feel*

The idea of "group feel" is distinct from the idea of "groupthink," which attempts to explain the reasons for group behaviour in social sciences, and the idea of "herding behaviour," which is used in behavioural finance. All these theories make an effort to explain the origins and consequences of group behaviour, but they fall short in explaining the psychological and emotional factors that underlie such behaviour. It will be helpful to clarify groupthink and herd behaviour before introducing the concept of group feel.

According to research on both herding behaviour and groupthink (Griffin, 2012, Hart, 1991, McCauley, 1998, Fenzl & Pelzman, 2012, Blasco et al., 2012), these approaches show that people interact with their social surroundings when making decisions. While both methods provide different justifications for how people's collective decision-making processes work, they neglect to emphasise the importance of emotions in group activities. Emotional finance takes a psychoanalytical perspective to group processes and tries to understand the group's collective mood and how it affects the market in addition to taking into account why people join groups. Group feel is the phrase used in emotional finance in place of groupthink. A condition known as "group feel" occurs when a group of people, based on a deep and unconscious basis, focus their thoughts and behaviour toward one another in an effort to blend in and feel the same as the other members of the group (Tuckett, 2011). This definition's interesting aspect is that the people' unconsciousness is what causes them to act in such a way. Both the herding behaviour model and the groupthink model view an individual's decisions and desire to join the herd as conscious behaviours.

According to conventional financial theory, markets are made up of individuals operating independently from one another. This is what the work group is known for. But financial markets frequently resemble sizable fundamental assumption groups that abandon individuality in their behaviour (Tuckett & Taffler, 2008). The market transforms into a fundamental assumption group, according to the emotional finance theory, particularly in situations where there are asset price bubbles or financial crises. According to the collective feel concept, people should make decisions based on themselves, their deliberate actions reveal an underlying attitude that they all share in an effort to blend in and to foster positive emotions. The necessary point It's important to note that the market here "unconsciously" transforms into a basic assumption group (Tuckett, 2011). This point introduces "states of thought," another crucial a component of emotional finance.

### *2.3 States of Mind*

Making an investment decision can cause both exhilaration and fear. Regarding the asset's price rising, there is enthusiasm and hope. However, the possibility that the price will decrease makes people anxious. Due to the simultaneous generation of the emotions that cause excitement and fear, this causes an uncomfortable emotional conflict or ambivalence.

In the emotional finance approach, the behaviours of splitting (mentally separating good and bad feelings, repressing bad feelings and making them unconscious), projection (unintentionally attributing undesirable emotions to others), and denial (the individual's denial of the aspects of reality they do not wish to know in order to reduce or prevent the painful effects related to the reality) are very prominent in people who are in a DS (Auchincloss & Samberg, 2012, quoted by Taffler, 2014)

Understanding investor behaviour and the genesis of asset pricing bubbles requires a thorough understanding of the mental states that influence investment decisions.

### *2.4 . Phantastic Object*

The investment process means that an investor engages in an ambivalent emotional relationship with something that can easily let them down (Taffler & Tu ckett, 2011). In other words, investors are required to establish an “object relation” with their investments.

The definition of an object given by Freud serves as the foundation for this idea. This approach is used to pinpoint the "representations" of people, concepts, or objects that exist in our imagination and unconscious mind (Auchincloss & Samberg, 2012; cited by Taffler, 2018). Image is what is intended by representation. Eshraghi and Taffler (2012) assert that if an object points at a picture, different people may experience various versions of the same object in their thoughts.

From a psychoanalytic perspective, buying and selling assets necessitates the creation of fictitious object relations. In such a scenario, judgements regarding whether to buy, hold, or sell an investment must take into account hypothetical relationships aimed at forging or severing emotional bonds with it (Tuckett & Taffler, 2008).

Emotional finance uses the term "phantasy" to describe this process. According to Freud (1908, cited by Spillius, 2001), phantasy is the unconscious activity that satisfies a person's unfulfilled instinctual needs or wishes. The primary reason for the creation of a phantasy, according to Freud (1908, cited by Spillius, 2001), is a desire whose fulfilment was hindered. A covert manifestation and partial fulfilment of such a yearning is fantasy.

Investment instruments are referred to be "phantastic objects" when investors form an object relation with them that is dominated by phantasy. A phantastic object is the object, or its image or equivalent in the person's mind, that fully satisfies the person's deepest wishes at the time and in the manner desired by the person (Tuckett & Taffler, 2008).

The notions of narratives, group feel, and states of mind are directly tied to the creation of phantastic objects and their dominance of the market. Narratives alleviate emotional tensions in markets where phantasmagorical objects are present in addition to giving ambiguity purpose and making it controllable. In this manner, people take action and commit to their actions.

## 3. STUDIES IN EMOTIONAL FINANCE

Studies addressing fundamental principles and empirical studies are two categories under which research in the subject of emotional finance can be categorised. Conversely, in-depth interviews, relative sentiment shift analyses, and questionnaire methods can all be used to conduct empirical studies.

Conceptual studies tackle the four building stones of emotional finance which we had discussed in detail previously, and their correlation with one another. These studies are significant in order to enable understanding of the basic arguments in emotional finance.

Taffler et.al. (2017) have conducted 51 in-depth interviews with fund managers and revealed what kind of anxiety was caused by the uncertainty in the investment process among the fund managers.

According to the findings obtained from the research, fund managers work under significant pressure and, although they are aware of the fact that they cannot beat the market, they repress or ignore this situation in order to be able to continue with their works. This information accords with the defense mechanisms approach. They demonstrated the existence of splitting, projection, and denial mechanisms.

There is only one study conducted by questionnaire method in the field of emotional finance. As a result of this study, a measure for emotional finance has been developed for the first time. Measures for phantasy and the determinants of phantasy were developed in the study performed by Aren and Nayman (2020). Measures were developed for narrative, divided state of mind, group feel, informed herding, uninformed herding, and phantasy, and furthermore, the capability of these determinants to describe phantasy was researched. It was demonstrated that divided state of mind affects phantasy directly, while group feel and narrative are indirectly affected by the informed herding. It was found out that the variables that direct the investment choices of individuals in the periods when asset pricing bubbles are formed are phantasy, group feel, uninformed herding, and divided state of mind. When the studies conducted in the field are evaluated, it is observed that there is no detailed literature review on conceptual studies. The studies conducted by way of in-depth interview have been performed only with fund managers who are professional investors. The studies carried out with RSS methodology have focused generally on periods of crises or asset pricing bubble, leaving the studies aimed at normal market conditions limited. The study performed by way of questionnaire methodology is significant for introducing a measure to the literature.

## 4. CONCLUSION AND DISCUSSION

Particularly during the 2008 financial crisis, studies in the subject of emotional finance received more traction. The basic ideas of emotional finance were attempted to explain the rise and subsequent bust of asset pricing bubbles, which the traditional finance theory had difficulties explaining.

The studies that have been done primarily concentrate on the times when asset pricing crises and bubbles have happened, which is a significant criticism that can be made here. The literature on emotional finance may be criticised as being "crisis literature" in a way similar to how Fama marginalised behavioural finance as "anomaly literature."

A further objection could be made in light of the difficulties in applying the phantastic object method recommended by emotional finance. Financial crises and asset price bubbles are hard to spot as they develop, and it can be difficult to tell when assets or investment instruments turn into phantoms in a healthy market. According to Tuckett et al. (2014), narratives can be used to follow the emergence and growth of phantastic things.

It is anticipated that as more policymakers become interested in monitoring financial stability in the wake of the most recent crisis and as the analysis of market participants' emotions toward assets or the market becomes more crucial, the number of studies on emotional finance will rise in the coming years. If supported by machine learning-based approaches, it is thought that particularly new approaches, like monitoring the stories created by market participants in unstructured data sources and RSS aiming to use emotional changes as precursors, etc., may allow the early detection of potential phantastic objects and enable measures to be taken against bubbles or crises that may emerge.

On the other hand, in addition to the generic RSS, the prospect of forecasting fundamental macroeconomic indicators is enhanced by the development of new series based on more precise rules particular to the subject under study. The description capability and dependability of the indices calculated to measure financial stability will be improved by the inclusion of RSS for general and specialised purposes.

While the measure that is created can be enhanced by the addition of variables such as personality traits, it will also be feasible to show the differences between professional investors and individual investors by using the same measure on professionals. Additionally, it will be feasible to clearly show the cause-and-effect relationship between the recently introduced factors and fundamental ideas.

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