# CHAPTER I

INTRODUCTION

1.1   Background of the Research

Investment is one of the financial instruments that have become popular recently, which is in line with the growth in the number of new investors. This growth is driven by various factors, such as the increase in economic needs that lead people to seek additional income apart from their main income. Besides, people decide to invest to maintain the value of their assets while gaining profits.
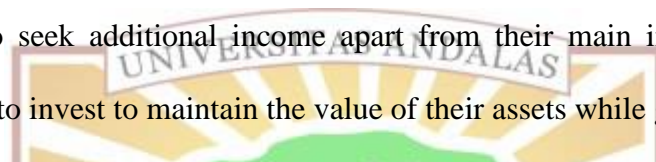
Indonesian Capital Market Investors
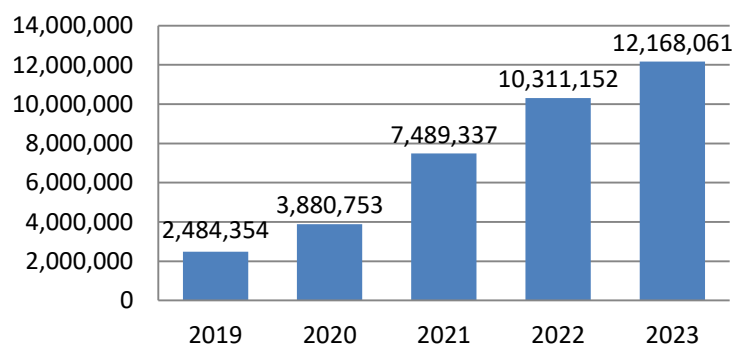
Source: *Kustodian Sentral Efek Indonesia*

Figure 1.1 - Growth of Indonesian Capital Market Investor

In Indonesia, the number of investor has grown significantly over time. Based on data released by Indonesia Central Securities Depository (KSEI) in Figure 1.1, the number of investors in 2023 has grown significantly almost five times more than in 2019, increased from 2.484.354 to 12.168.061 in only five years. However, this growth should be aligned with an understanding related to investment knowledge among investors, such as the risk limits they can face and knowing how to analyze the information by their own.

Investors are required to make the investment decision wisely by considering macroeconomic conditions and company fundamentals in order to gain the expected return. Investors usually does some analysis before investing in a company, such as technical analysis, fundamental analysis, and also analyzes the issues related to the market (Ramadhansyah et al., 2020). Fundamental analysis examines and determines the values of the companies by looking at its economic and financial reports to predict the future growth and Technical analysis is the method to predict future earnings by studying past performance and trends (Sharma et al., 2021). This analysis will result in logical and rational investment decisions because investors do not make bias decisions.

The rationality of investors feeds into one of the traditional theories of finance market which is the Efficient Market Hypothesis (Baker & Nofsinger, 2010). According to the Efficient Market Hypothesis (EMH) proposed by Fama in 1970, the stock price reflects all the available information and instantly reflect new information. Classic theories of financial market explain that investors are consistent and well-informed because they are aware of the financial markets, where all investors have equal access to information and can rationally interpret it in an efficient financial market (Yafouz & Yet, 2023). However, economists began to reject classical financial theories as many anomalies were discovered in the market that contradicted the concept of the EMH Theory. This is related to the emergence of behavioral finance theory. Behavioral finance is established on various ideas and assumptions of economic behavior (Marbun et al., 2020).

Behavioral finance is rapidly growing area that attempts to clarify how human's behaviors, thoughts, and psychology influence financial decisions by combining behavioral and cognitive psychology with traditional finance and economics (Başarir & Yilmaz, 2019). Cognitive aspects and psychological biases owned by investors are related to what they believe as a reference in decision-making (Saputra et al., 2023). When the market is faced with uncertainty, investors' psychology, beliefs and perception can be affected which can lead to behavioral biases in decision-making, such as herding behavior.

Herding is a market phenomenon where investors simply follow upon the decision or actions of other investors in the financial market (Senarathne & Jianguo, 2020). Investors who tend to herd usually suppress their personal analysis and information and then act based on signals received by observing the market consensus. Besides, not all investors have capability to analyze the information they receive. According to Arisanti & Oktavendi (2020), investors who have limited capability to analyze the information (naive investors) will probably lead them to imitate other investors who have capability to analyze information quickly and accurate (sophisticated investors).

When market volatility increases, the emotions to herd becomes particularly strong because investors are under high market stress and prone to make errors (Adem & Sarıoğlu, 2020). This condition will lead to panic in buying or selling shares where they are not concerned about the reasonable market price and choose to herd just because they want to be relieved from the strong pressure. Herding behavior has crucial implications for the financial market. It will result in

the price of the securities not reflecting important information which in the process it may drive away from their fundamental values (Adem & Sarıoğlu, 2020).

Herding behavior is one of investor bias that usually present in emerging markets (Ramadhansyah et al., 2020). This is because the financial sector in emerging countries is volatile and the flow of moneys is unstable. Research conducted by Chang et al. (2000) found that herding behavior occurs in emerging markets, which are Taiwan and South Korea, especially during market stress, and did not occur in United States and Hong Kong which are developed countries. Herding behavior also present in others emerging country which are in Vietnam (Nguyen & Vo, 2023), Malaysia (Bougatef & Nejah, 2022; Loang & Ahmad, 2023), and India (Chauhan et al., 2020). Apart from that, Indonesia is also an emerging market country which is also has the possibility to experience herding behavior.

Source: Yahoo Finance

**Figure 1.2 - Jakarta Stock Exchange Composite Index**

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The stock chart seen in Figure 1.2 above shows the movement of the Indonesian composite stock index. It is experiencing a bearish and bullish market and there is a rebound condition after stock movement rise or fall. Bearish markets are refer to the condition that the market offers a low rates of return, otherwise, bullish markets associated with high rate of return (Ah Mand et al., 2023). In the first quarter of 2020, a bear market was clearly visible where stock price movements fell drastically and started to get better since the third quarter of 2020. In these conditions, volatility can affect investors' psychology where there is a probability that herding behavior will emerge.

Herding behavior can be detected using a popular method in research which is Cross-Sectional Absolute Deviation (CSAD) developed by Chang et al. (2000) as the improvement of the Cross-Sectional Standard Deviation (CSSD) method that only includes the extreme movements (Chrisostomides, 2022). Ramadhansyah et al. (2020) researched herding behavior in Indonesia, Singapore, and Malaysia for the 2016-2019 periods using the CSAD method. They found that there was no indication of investor herding for every kind of market conditions in all countries. Marbun et al. (2020) found that on the LQ-45 index, herding behavior occurs only when the market up condition and for the Jakarta Islamic Index there is no indication of herding in both conditions. Vidya et al. (2023) also found robust evidence of herding behavior in Asian financial markets which are in South Korea, Singapore, and India only when the market bullish and in Vietnam and Indonesia when the market is bullish and bearish.

Generally, in before choosing an investment in the stock market, investors tend to choose shares that have liquid condition which are expected to provide returns based on their expectations. Shares with good financial and fundamental aspects are often targeted by investor because it is easy to trade so they can minimize the risk of losses they may face. Moreover, along with the growing trend of world investment in social environmental and sustainability issues, green investment has become one of the investors' concerns in determining investment. Green investment includes investment instruments that care about sustainability issues by implementing environmental friendly business practices. Socially Responsible Investing (SRI) is an financial decision-making approach that refuse to invest in companies that have an impact in social harm or loss (Tripathi & Kaur, 2022).

Indonesia Stock Exchange have several index that categorize the company's stocks based some criteria. SRI-KEHATI is the only share index that applies environmental, social, and governance (ESG) and Sustainable Responsible Investment (SRI) principles as criteria for company selection. This index assess the performance of 25 companies stock that have high liquidity, good company fundamentals, large market capitalization, and have sustainability principles, and also concern about the environment. The drastic growth in the number of Assets Under Management (AUM) of SRI-KEHATI Index by the end of 2023 reaching seven times compared to 2021, which can be seen in figure 1.3. It shows that Indonesian investors are aware of green investment by investing in companies that are including in the SRI category.
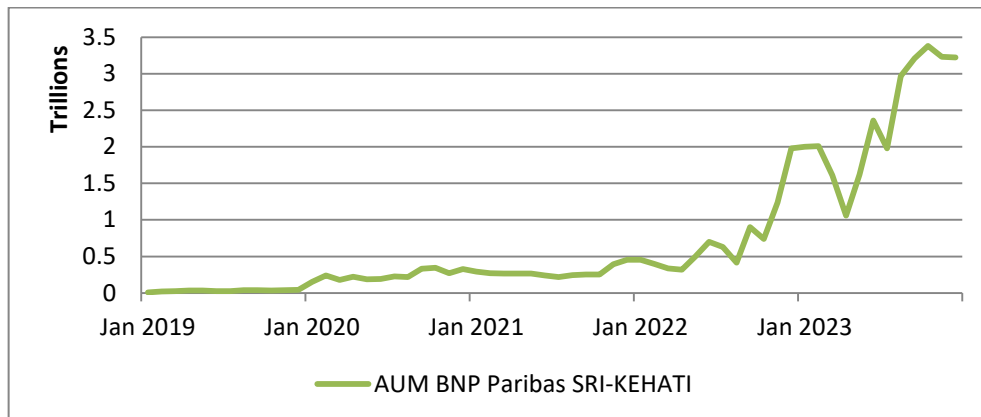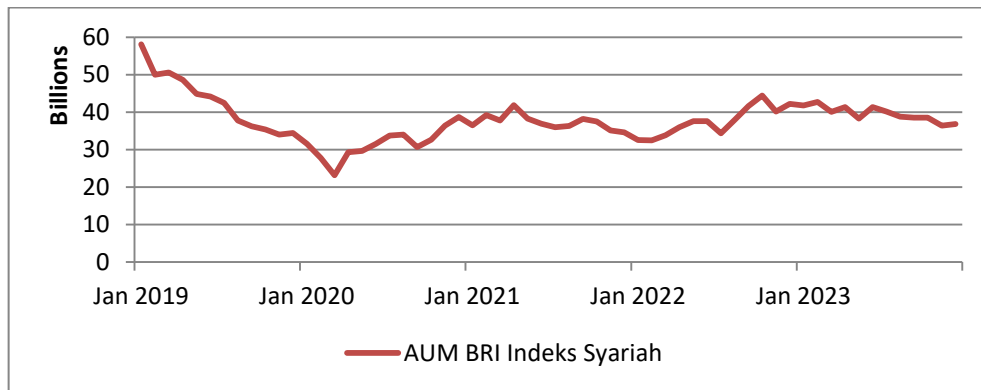
Figure 1.3 - Asset Under Management (AUM) of SRI-KEHATI Index

Apart from that, understanding related to beliefs such as the concept of sharia in Islam is also a consideration for investors in determining investment, especially for sharia compliant investor. Similar to SRI, Sharia Compliance funds screen potential portfolio investments to comply with the law of the Islamic Religion. Unlike Non Sharia Compliance or conventional stocks, Sharia Compliance companies need to obtain returns from investment in real assets with non-interest-bearing (Akguc & Al Rahahleh, 2021).

There are several sharia indexes in Indonesia. Sharia index are an alternative for Muslim investors who intend to invest by comply with Islamic Sharia. Jakarta Islamic Index (JII) is a stock index that assesses the stock performance of 30 sharia shares that have good financial performance and high liquidity. The AUM movements of the JII Index in figure 1.4 shows a decline compared to 2019, however the number of AUM movements did not experience drastic changes in the following year.

Figure 1.4 - Asset Under Management (AUM) of Jakarta Islamic Index

AUM is usually used as one of the criteria for investors to choose an investment manager (IM). A high AUM value can influence investors to invest in a stock, because it shows that the stock is in demand and trusted by the public. However, this decision will certainly lead to herding because investors rely on IM's opinions and biased assessment of AUM movements, especially for new investors who lack of financial and investment knowledge, due to the level of education and investment experience.
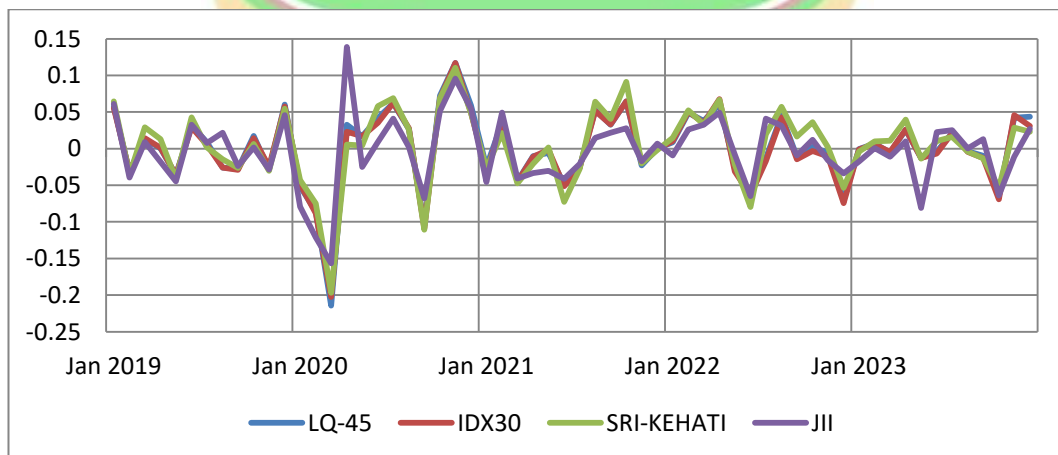
Figure 1.5 - Index Performance of SRI-KEHATI, JII, LQ-45, and IDX 30

The stocks index performance in Indonesia as seen in Figure 1.5 shows that the SRI-KEHATI index has similar performance with other stock index while JII has slight differences. Seeing a good performance index and concern about environmental sustainability are the reasons why the author is interested in researching the SRI-KEHATI index. Besides, the author is also interested in researching stock index with good performance that consider to sharia values which is JII. Another reason the author wants to research related to herding because the differences in previous research results and there is no research that uses the most recent stock period which the Covid-19 pandemic occurred since the last 5 years. Furthermore, the authors wants to see whether there is investor herding behavior on the SRI-KEHATI and JII index in the 2019-2023 to look at the most recent period.

Based on the descriptive above, the researcher intends to investigate the indications of herding behavior when market conditions are bull or bearish in the research title **"Analysis of Investor Herding Behavior in the Indonesia Stock Market in 2019-2023 (Case Study on SRI-KEHATI and Jakarta Islamic Index)".**

1.2 Research Questions

Based on the research background above, the problems in this research can be formulated as follows:

1. Is investors' herding behavior indicated during market condition is *bullish* in shares listed in the SRI-KEHATI index for 2019-2023?

2. Is investors' herding behavior indicated during market condition is *bearish* in shares listed in the SRI-KEHATI index for 2019-2023?

3. Is investors' herding behavior indicated during market condition is *bullish* in shares listed in the Jakarta Islamic index for 2019-2023?

4. Is investors' herding behavior indicated during market condition is *bearish* in shares listed in the Jakarta Islamic index for 2019-2023?

1.3 The Objective of the Research

Based on the formulation of the problem above, the objectives of the research to be achieved in this study are:

1. To analyze the indications of investors' herding behavior during *bullish* market condition in shares listed in the SRI-KEHATI index for 2019-2023.

2. To analyze the indications of investors' herding behavior during *bearish* market condition in shares listed in the SRI-KEHATI index for 2019-2023.

3. To analyze the indications of investors' herding behavior during *bullish* market condition in shares listed in the Jakarta Islamic index for 2019-2023.

4. To analyze the indications of investors' herding behavior during *bearish* market condition in shares listed in the Jakarta Islamic index for 2019-2023.

1.4 The Benefit of the Research

1. Theoretical Benefit

   This study is expected to provide valuable information related to herding behavior and to contribute to knowledge, especially for the financial management field related to investor herding behavior in particular for the Indonesia stock exchange.

2. Practitioner Benefits

   a. For the investors

   This research is expected to help investors understand the concept and impact of herding behavior in investment thus can be used as a reference by investors to act rationally in making decisions and enhance their investment strategy.

   b. For the researchers

   The purpose of the result and contribution of this research is to help researchers learn more regarding the concept of herding behavior which is discussed in this research. This research also expected can offer guidance and valuable insights for future research specially in analyzing investor herding behavior.

   c. For the readers

   The readers are expected to gain information and learn about the herding behavior and its impact in financial management especially in stock market.
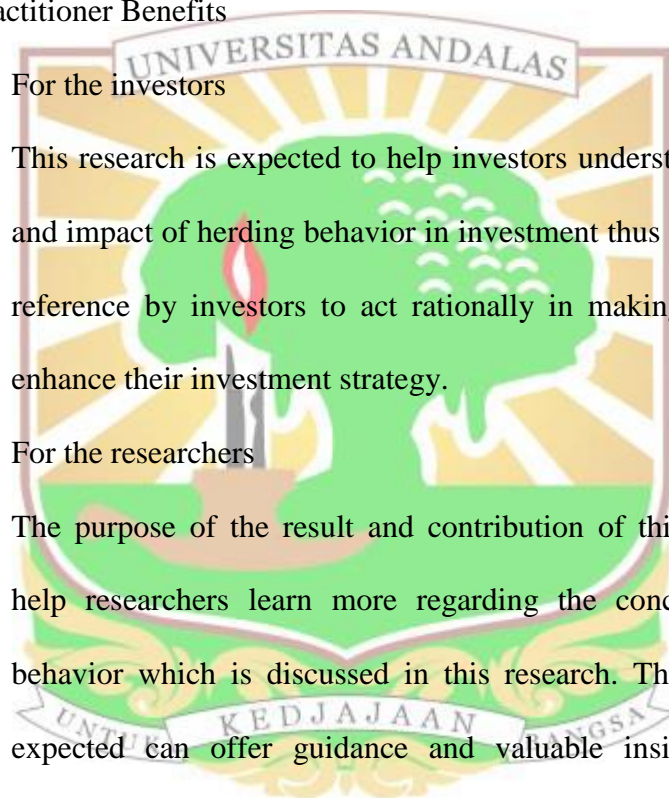
1.5   Scope of the Research

This research scope is limited to only discussing the investors herding behavior in shares listed in SRI-KEHATI and Jakarta Islamic index for 2019-2023 periods. This research will focus on discussing the Cross-Sectional Absolute Deviation (CSAD) as dependent variable (Y), Market Return Absolute and Market Return Squared as independent variables (X). The limitation of this research aim to limit the samples and prevent widespread confusion in the discussion of this research thus researcher can obtain the validity of the data.

1.6   Outline of the Research

CHAPTER I : Introduction

The first chapter contains the background of the research, the problem statement, research objective, research advantages, the scope of the research, and ended with the systematic writing.

CHAPTER II: Literature Review

The second chapter provides a conceptual explanatory and theories that form the basis of the study, previous studies related to the subject matter, hypotheses that will be the basis for consideration in proving the research problem, and the framework for constructing research questions.

CHAPTER III : Research Methods

The third chapter contains research design, research population and samples, research variables, type of sources of data, definitions of research operations, and data analysis methods.
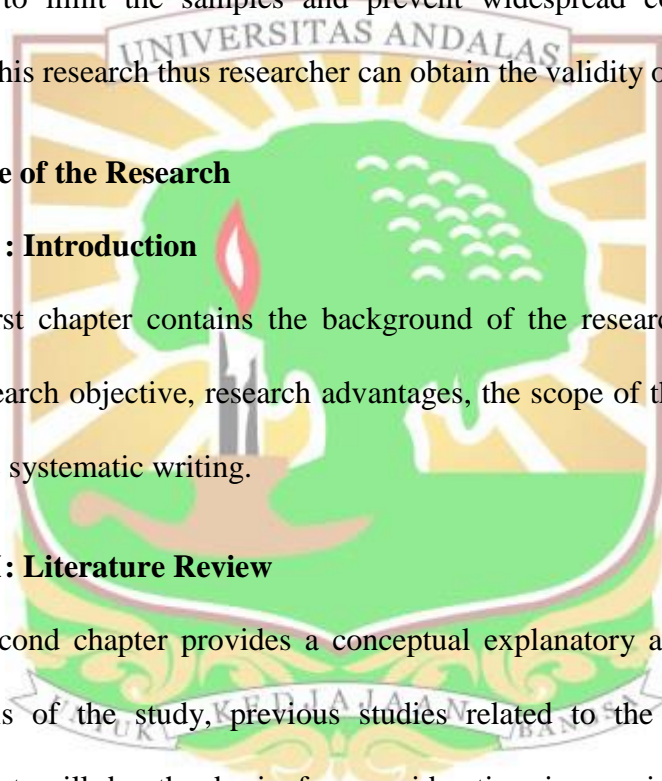
CHAPTER IV : Results and Discussion

The fourth chapter provides an explanatory of the data analysis consist of the result of the data testing and the discussion about the research results to answer the research problems.

CHAPTER V : Closing

The last chapter contains the conclusion, implication, and limitation of the research, and also suggestion for the future research.