CHAPTER 1

INTRODUCTION

1.1 Research Background

In finance it is crucial to understand human behavior as this has a significant impact on financial markets and the investment decisions taken by investors. Based on traditional finance theory, namely the Efficient Market Hypothesis (EMH) state that investors always act consistently because they have enough information to understand financial markets well. All information available in the market is used by investors to make decisions (Brown, 2020). In an effective market, investors have equal access to information and have the ability to understand it logically (Yafouz & Yet, 2023). However, based on research and observations that have been made, it proves that investors sometimes act irrationally and cause bias. So that many economists reject traditional theory because of the many anomalies found in the market and cannot be explained by EMH theory. This gave rise to the theory of behavioral finance, which builds on a range of concepts and assumptions about economic behavior (Marbun et al., 2020).

The existence of irrational investors is one of the causes of the emergence of behavioral finance theory, where investors make investment decisions driven by bias and emotions rather than rational analysis (Ren, 2024). In studying financial markets, understanding irrational behavior is very important because this behavior can cause anomalies and price distortions. Behavioral finance aims to find economic irregularities in the market and create possible strategies to deal with these irregularities. Investors are often so confident in their decisions that they make overly optimistic assumptions and take unnecessary risks.

Behavioral finance is a rapidly growing field that explains how human psychology, behavior, and thinking can affect investor decision-making in finance. The field combines behavioral and cognitive psychology with traditional finance and economics concepts (Başarir & Yilmaz, 2019). Investors' cognitive biases and psychology play a role in guiding their decision-making (Saputra et al., 2023). Investor psychology, beliefs, and perceptions can change in uncertain market conditions,, leading to behavioral biases in investment ,decision-making such as causing herding behavior to follow other investors' decisions.

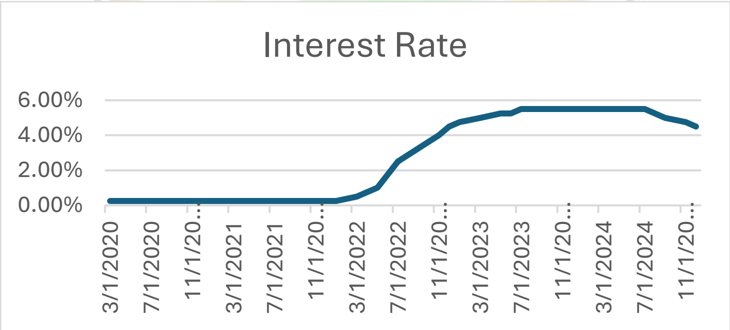
Herding behavior is one form of irrational decisions made by investors (Ratnadi et al., 2020). According to (Senarathne & Jianguo, 2020) herding behavior is a market phenomenon that occurs when investors follow the actions of other investors. Herding behavior is behavior where investors do not conduct their own fundamental analysis in making investment decisions, but rather follow other investors' decisions in making investment decisions, causing the market to be inefficient (Ismiyanti et al., 2021). According to Adem & Sarıoğlu (2020), herding behavior has a great influence on financial markets because this behavior can encourage investors to divert their attention from individual analysis and choose to imitate the actions of their peers. Herding behavior can occur because not all investors have good information analysis skills. According to (Arisanti & Oktavendi, 2020), investors who have limited ability to analyze information tend to follow or imitate the decisions of other investors who have the ability to analyze information quickly and accurately.

The urge to follow the crowd becomes stronger when market volatility increases, this is because when market volatility increases investors feel pressured and cause them to tend to make the wrong decision (Adem & Sarıoğlu, 2020b). In this situation it can lead to panic buying or stock selling behavior, where investors no longer pay attention to fair market prices and choose to follow the actions of the majority in order to avoid great market pressure. Herding behavior has a significant effect on financial markets because it can cause security prices to not provide relevant information so that they deviate from their fundamental price (Adem & Sarıoğlu, 2020b). Herding behavior often appears in emerging financial markets because developing countries tend to be volatile and have unstable money flows (Ramadhansyah et al., 2020). This is evidenced by previous research conducted by (Chang et al., 2000) where the results of his research show that herding is found in developing countries such as Taiwan and South Korea, in this country herding occurs during market stress but herding is not seen in developed countries such as the United States and Hong Kong. Based on previous research, other developing countries that show herding behavior are Vietnam (Nguyen & Vo, 2024), Malaysia (Bougatef & Nejah, 2022; Loang & Ahmad, 2023), and India (Chauhan et al., 2020). From the results of the above research, Indonesia as a developing country also has the potential to experience herding behavior.

Herding behavior often arises in developing countries for several reasons, namely because they have underdeveloped financial systems and regulatory frameworks, few institutional investors, high volatility of international capital flows, and suboptimal market microstructure mechanisms, coupled with a large number of inexperienced small shareholders (Economou et al., 2018). Developing countries are those that have low to medium levels of per capita income and markets in developing countries experience significant fluctuations in the development of their capital markets. This instability can encourage herding behavior (Widyari et al., 2024).

Herding behavior can cause the market to become unstable and cause excessive volatility, where stock prices become inefficient because they do not describe the company's fundamental information precisely and accurately, so that the fundamental economic value of the company is also not well reflected (Adem & Sarıoğlu, 2020b). This causes the market to be in a mispricing condition where the stock price does not reflect the actual condition of the company (Kirimhan et al., 2024). Herding behavior also affects price fluctuations in the market because this behavior makes investment decisions based more on emotions and the desire to follow trends rather than making decisions based on in-depth fundamental analysis. This behavior increases the risk of bubbles and crashes in financial markets. Herding behavior can result in high stock price fluctuations and drastic price declines, thus causing an imbalance between the stock price and its fundamental value and causing the market to become inefficient (Ah Mand et al., 2023).

Herding behavior often arises when certain phenomena or information occurs in the capital market. For example, information on interest rate announcements made by the Federal Reserve. The Federal Reserve or commonly called the Fed is the central bank of the United States which is tasked with overseeing and regulating all forms of finance in the United States. The United States is the fastest growing country in the world so this makes the United States a popular choice for investors in making investment decisions because of its economic data. One of the information that is often used by investors to invest is the interest rate information announced by the Fed. The interest rate set by the US central bank is called the Fed Rate. This interest rate aims to lend funds to commercial banks in the United States.



Source: The Federal Reserve, 2024

Figure 1 The Fed's Interest Decision since 2020

Figure 1 above shows the changes in the Federal Fund Rate during the period 2020 - 2024. In 2020-2022, it can be seen that the average interest rate set by the Fed is 0-0.5%. Then at the beginning of 2022, the interest rate set by the Fed began to show a significant increase. This interest rate increase is a form of US government response to high inflation and also post-pandemic economic challenges. The Fed raised interest rates to curb inflation, slow demand, and ensure economic stability. The rate hike will continue until the end of 2023 when it will reach 5.5%.

After a period of significant increases, the Fed steadily set interest rates at 5.5%, and in 2024 start from September to December the Fed announced its first rate cut since March 2020 or four years ago at the start of Covid-19. The Fed lowered the federal funds rate to a range of 4.25% to 4.5%, down from its previous target range of 4.5% to 4.75%. The Fed lowered the interest rate to maintain economic stability by encouraging economic activity and controlling inflation. In its statement the FOMC explained that US economic indicators showed strong growth but slowing employment growth and rising unemployment so the Fed saw the need to ease monetary policy to balance these economic risks. The Fed is therefore trying to keep inflation in the US below its long-term target of 2%. The Fed hopes to deal with this uncertain economic outlook more flexibly by controlling risks to inflation and employment objectives by lowering interest rates.

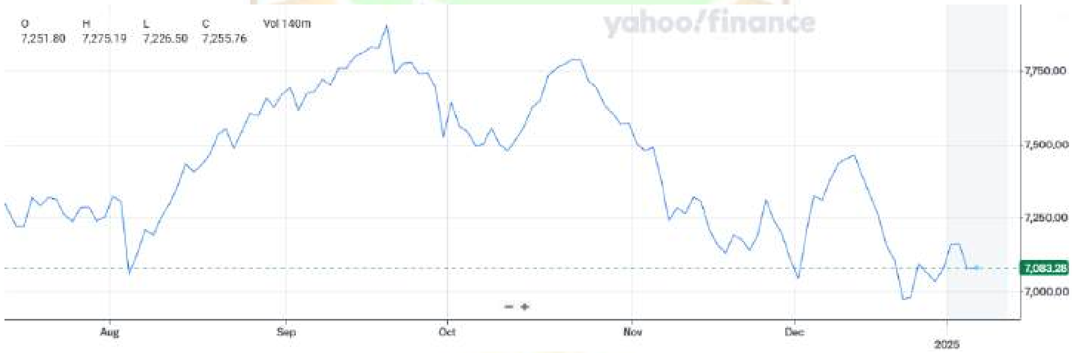
The monetary policy announcement by the Fed not only affected the US stock market, but also had an impact on stock markets in other countries, including Indonesia. As shown in Rahman & Ermawati (2019) research which found that the biggest driving factor of herding found in the Indonesian Stock market is influenced by the Fed Fund Rate. This shows that global policies and domestic conditions are interrelated. Bank Indonesia as the central bank of the Republic of Indonesia often changes its monetary policy in response to these announcements. In line with the Fed, Bank Indonesia (BI) also made a similar decision to the Fed by lowering its benchmark BI Rate from 6.25% to 6%. The goal is also the same as the Fed to maintain rupiah stability, control inflation, and encourage economic growth. But sometimes BI's decision is also influenced by other factors such as domestic economic developments, inflation expectations, and global financial market conditions. The policies decided by BI tend to follow domestic and global economic developments.

Source : Indonesian Central Securities Depository, 2024

Figure 2 Growth of Indonesian Capital Market Investor

The announcement of the Fed's rate cut news was made on September 18, (GMT) after the end of the Federal Open Market Committee (FOMC) meeting which was held for 2 consecutive days every month. Based on the figure 2 it can be seen that there is an increase in investors in September where in this month the announcement of a rate cut was announced by the Fed. The increase in the number of investors in this month can be attributed to the influence of the monetary policy announcement announced by the Fed, which this announcement encouraged global investors, including Indonesia, to increase investment activity in the capital market.

Previous research conducted by (Maharani et al., 2024) examined the response of the Indonesian capital market to the increase in the federal fund rate in several observation periods and found that one of the observation periods had a significant impact on the Indonesian capital market and caused significant changes in investor behavior in the Indonesian stock market. Based on research by (Ridho, 2023), the Fed Fund Rate has a significant impact on the Indonesian capital market through the spillover effect, namely the indirect effect of a country's monetary policy on the economy of other countries. (Rasam et al., 2024) states that the federal fund rate affects the BI Rate, which means that the increase in the Federal Fund Rate tends to be followed by the BI Rate and has a negative impact on liquidity and capital in the Indonesian banking sector. (Bao & Mateus, 2017) also examined the impact of FOMC announcements on capital markets in several Southeast Asian countries including Indonesia, he found that interest rate changes announced by the FOMC had an influence on all five capital markets in Southeast Asia. Any change in interest rates announced by the FOMC affects the overnight return of equities in Southeast Asia.



Source : Yahoo Finance, 2024

Figure 3 Jakarta Composite Index Share Price Movement

The figure 3 above shows the share price movement of the capital market on the Jakarta Composite Index during the research period. The graph shows that stock prices on the Jakarta Composite Index fluctuated. It can be seen that in the observation period, namely September to December, the share price in the Jakarta Composite Index tends to decline. However, ahead of the announcement of the interest rate cut by the Fed, the price tends to rise. This is because changes in interest rates by the Fed have a negative effect on the Jakarta Composite Index (Bakhtiar & Purwani, 2021). This means that a decrease in the fed interest rate can cause an increase in stock prices in the Indonesian capital market or vice versa (Akua Miyanti & Wiagustini, 2018). Stock prices tend to decline due to market response to information coming from the Federal Reserve (Lakdawala & Schaffer, 2019).

Previous research conducted by Rahman & Ermawati (2019) shows that the Fed Fund Rate is one of the factors that influence the existence of herding behavior in the Indonesian stock market. Furthermore, research conducted by (Arisanti, 2020) conducted research to detect herding behavior in the Southeast Asian stock market, especially in the financial sector and found that there was herding behavior especially after the announcement of the Fed Fund Rate in 2018. Meanwhile, research conducted by Yao & Tangjitprom (2019) who detected herding behavior in 6 ASEAN stock markets, one of which was Indonesia, and found that there was no herding behavior in the five ASEAN stock markets but there was in the Vietnamese stock market.

This study focuses on analyzing herding behavior on Jakarta Composite Index in the banking industry at the time around the announcement of the fed funds rate on September 2024. This is because banking industry as part of financial sector is one of the sectors that is sensitive to monetary policy announcements (Drexler, 2024). In addition, the financial sector also represents the collective performance of the company (P. K. Mishra & Mishra, 2023). Previous studies in India also show that the financial sector responds significantly to policy interest rate changes (Padha et al., 2021). Another study shows that the banking industry is more vulnerable to changes in monetary policy (Dang & Nguyen, 2021). Studies conducted by (Musah et al., 2024) show that each sector plays an important role in the development of herding behavior but the most prominent is in the financial services sector because it is dominated by banks. Therefore, research plays a role in understanding the dynamics of herding behavior in the banking industry on the Jakarta Composite Index, especially in the context of Fed Fund Rate policy announcements which are often the main driver of changes in market expectations and investment decisions.

The announcement of the US Fed Funds Rate is one of the most important pieces of information in the global economy. To analyze the impact of this announcement on the market, a relatively short observation period (event window) is used in order to capture market reactions more accurately. This study uses a 30-day event window, which consists of fifteen days before the announcement and fifteen days after the announcement. The timing of the event is chosen based on previous research to facilitate observation, given that market reactions tend to occur quickly around the publication date. In addition, the selection of this time also aims to avoid confounding effects, namely the impact of other events that occur within the window period that coincides with the main event under study.

Based on this background, researchers are interested in conducting research to detect the existence of herding behavior on the Indonesian stock exchange, precisely in banking industry on the period 15 days before the announcement of the Federal Funds Rate and 15 days after the announcement with the title **"Analysis Of Investor Herding Behavior In Banking Industry Stocks Listed On The Jakarta Composite Index Around Fed Fund Rate Announcement On September 2024".**

1.2 Research Question

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

1. Does herding behavior exist among stocks in banking industry on the Jakarta Composite Index (IDX), 15 days before the fed rate cut announcement on September 2024?
2. Does herding behavior exist among stocks in banking industry on the Jakarta Composite Index (IDX), 15 days after the fed rate cut announcement on September 2024?

1.3 Research Objective

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

1. Examine the existence of herding behavior in banking industry stocks listed on the Jakarta Composite Index, 15 days before the fed rate cut announcement on September 2024
2. Examine the existence of herding behavior in banking industry stocks listed on the Jakarta Composite Index, 15 days after the fed rate cut announcement on September 2024

1.4 Contribution of the Research

1. Theoritical Contribution

   Provide empirical evidence on market behavior in emerging stock markets. This research adds to the existing literature and concentrates on how local investors' decisions in the Indonesian capital market are affected by global monetary policy.

2. Practical Contribution

   a. For Investor

      This research helps investors to better understand market behavior around monetary policy announcements such as the Fed Fund Rate in the Indonesian capital market. Investors can use the results of this study to improve their investment strategies by recognizing herding patterns and developing better risk management during significant monetary policy changes.

   b. For Academics

      This research provides the concept of behavioral finance concepts in the context of emerging markets. Academics can use this research as a case study that shows how global economic events or phenomena can affect local market behavior.

   c. For Readers

      The research gives readers interested in financial markets a real insight into how markets act to global economic events. The research can also enhance readers' understanding of market behavior and financial decision-making, especially when there are important economic announcements.

1.5 Scope of the Research

This research focuses on analyzing herding behavior among investors in banking insdustry stocks listed on the Jakarta Composite Index around the Federal Funds Rate cut announcement on September 2024. This study specifically looks at the 30-day window period, which consists of fifteen days before the announcement and fifteen days after the announcement. The total of period observation is 30 day. The dependent variable in this research is Cross Section Absolute Deviation (CSAD), while the independent variable encompasses market return,extracted from the daily closing price data of stocks. The delineation of research limitations in this study is deliberate, aiming to enable the researcher to concentrate on ensuring data validity, specificity, and depth. This approach facilitates a more streamlined development of the data and enhances the overall research process.

1.6 Outline of the Research

This research consists of five chapters while each chapter contains of subsection with the following systematization of writing:

CHAPTER I: INTRODUCTION

Consists of the research background, research question, research objective, research benefit, scope of the research, and outline of the research.

CHAPTER II: LITERATURE REVIEW

Explains the theories related to the topic based on literature, previous research, hypothesis development and research conceptual framework

CHAPTER III: RESEARCH METHODS

This section includes the explanation of the method used in this research, the population sample, they type and source of data, the measurement and definition of the study variables, and the data analysis tools.

CHAPTER IV: RESULTS AND DISCUSSION

Discusses data analysis and discussion consisting of descriptive and data analysis results and hypothesis testing, as well as research implications.

CHAPTER V: CLOSING

Contains conclusions, research limitations, and research suggestions.