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A Model of Regret, Investor Behavior, and Market Turbulence[☆]

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Abstract

This study examines the effects of regret on investor behavior and market turbulence by using a model where investors not only regret wrong actions but also regret inaction. We demonstrate that regret aversion can cause investors to ride a bubble, exit and reenter the market, or choose non-trading. Further, herds and partial herds can occur in the market, and we show that the stronger regret over inaction, the easier it is for herds to occur. The model presented herein also predicts that during the formation of a bubble (crash), bearish (bullish) traders tend to exit and reenter the market, thereby causing a positive (negative) correlation between order volume and order imbalance.

JEL classification: D81, G12

Keywords: Regret over inaction; Regret aversion; Bubble; Herd; Market participation; Order imbalance

[☆] This is an updated version of a paper previously circulated under the title “To trade, or not to trade: a model of regret and investment.”

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