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The Paradox of Losses: Understanding Why Traders Persist in Option Markets Despite High Failure Rates

Miss. Unnati Ritesh Jain
Corresponding Author - Miss. Unnati Ritesh Jain

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Introduction:

The paradox of losses in financial markets, particularly in options trading, presents a profound psychological and behavioural conundrum. While a large proportion of traders in option markets encounters high failure rates, even though many continue to engage in these markets despite recurring losses. This paradox, commonly acknowledged as the "loss-chasing" or "loss aversion" phenomenon,

Options trading, with its high-risk, high-reward potential, amplifies the behavioural dynamics that contribute to traders' continued involvement despite adverse outcomes. The purpose of this research is to explore the root causes of why traders continue to engage in option markets despite the historical patterns of failure. By examining both the cognitive biases and the emotional influence behind these decisions, this study aims to provide a deeper understanding of the paradox of losses.

By understanding this paradox, we can better comprehend the persistence of traders in the face of adversity and develop strategies to mitigate the psychological traps that contribute to such behaviour.

Problem Statement:

Many traders still participate in option markets despite the high failure rates and the possibility of significant financial losses; this is frequently due to the attraction of rapid returns and the volatility of underlying assets. Important queries concerning the psychology and decision-making procedures in financial markets are brought up by this paradox: Despite the overwhelming evidence of the hazards associated with option markets, why do traders continue to participate?

Objectives:

1. To look into the main reasons why people trade options even when failure rates are high.
2. to examine how traders' decision-making is influenced by cognitive biases including overconfidence and the delusion of control.
3. to investigate the effects of social factors on the persistence of trading behavior, such as peer pressure and online trading communities.
4. To offer suggestions for enhancing traders

Literature Review:

SEBI (2021) – *Annual Report on the Indian Securities Market:*

Key Finding: SEBI's annual reports frequently emphasize the growing involvement of retail investors in high-risk products, such as options, and the accompanying risks. Despite regulatory measures and educational efforts, the report indicates a consistent rise in losses among retail traders, with many continuing to engage in trading despite unfavourable results.

Kumar & Goyal (2015) – ***Risk-Taking Behaviour of Individual Investors in the Indian Stock Market***

Key Finding: Kumar and Goyal's study offers an empirical examination of individual investor behaviour in the Indian stock market, focusing on risk tolerance and loss aversion. Their findings indicate that emotional influences, such as fear and greed, significantly impact trading decisions, especially in options markets.

Barber, B. M., & Odean, T. (2001). "Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment." ***Quarterly Journal of Economics*****.**

Key Findings: Traders often overestimate their skills and underestimate risks, leading to persistence despite repeated losses. Studies have linked overconfidence to higher trading activity and lower net returns.

Research Gaps and Contribution:

While significant research has been conducted on behavioural finance and the psychology of trading, there remains a gap in understanding how these factors specifically influence traders in the options market. The high failure rate in options trading, combined with the psychological phenomena outlined in the literature, requires further exploration into how emotional and cognitive biases affect trading decisions and persistence. This research will contribute to filling this gap by providing a deeper understanding of why traders continue to engage in options markets, despite their low probability of success

Research Methodology:

This research employs a mixed-methods approach to thoroughly investigate why traders continue engaging in options trading even with substantial loss rates. The methodology combines qualitative and quantitative techniques to examine motivations, behaviours, and external factors.

Information from brokerage platforms, featuring account performance metrics, trade frequency. Discussions in focus groups with participants from online trading communities to explore the impact of social networks.

Research Method – Descriptive:

Limitations:

- Possible response bias in self-reported information.
- Restricted generalizability resulting from the intentional sampling technique.
- Difficulties in acquiring complete historical trading information because of privacy issues.

Data Analysis:

Recent analysis carried out by the Securities and Exchange Board of India (SEBI) has highlighted the major difficulties encountered by individual traders in India's equity futures and options (F&O) market. The report shows that an astonishing 93% of individual traders faced losses from FY22 to FY24, with total losses surpassing Rs 1.8 lakh crore during this timeframe.

Although foreign portfolio investors (FPIs) and proprietary traders gained profits, individual traders suffered the majority of these losses. In FY24, people experienced a net loss of roughly Rs 75,000 crore.

The research revealed that over 1 crore individual traders, or 92.8% of the total, incurred an average loss of Rs 2 lakh each in F&O trading during the three years. The highest 3.5% of unprofitable traders, totalling approximately 4 lakh individuals, experienced an average loss of Rs. 28 lakhs. The report highlighted that demographiclly, in FY24, 50% of the F&O traders were from four states:

- Maharashtra (1.88 million or 21.7%),
- Gujarat (1.01 million or 11.6%),
- Uttar Pradesh (930,000 or 10.7%),
- Rajasthan (540,000 or 6.2%).

SEBI also pointed out the increasing involvement of traders under 30, which rose to 43% in FY24 from 31% in FY23. Nonetheless, 93% of these young investors experienced losses, surpassing the general average of 91.1%. Furthermore, more than 75% of the individual traders (6.54 million) earned an annual income of below ₹5 lakh in FY24.

Factors contributing in losses:

1. **The Appeal of High Potential Returns:** Trading options offers leverage, enabling traders to manage a substantial position with a comparatively minor investment. This generates the attraction of substantial returns relative to the initial capital put in. Many are attracted to the chance of swiftly accumulating riches, despite the slim likelihood of achieving it.
2. **Behavioural and Psychological Biases**: Investors might overrate their skill in forecasting market shifts or timing the market precisely, causing them to think they will triumph where others have stumbled. Certain traders perceive options like gambling and persist in trading despite setbacks, thinking that their "luck" will eventually improve.9.3. Marketing and Accessibility.
3. **Free Platform**: Brokers usually showcase successful experiences, user-friendly trading platforms, and possible earnings while minimizing risks. This fosters the impression that options trading profitable. The emergence of inexpensive or free platforms attracts more people to trading, frequently without a complete grasp of the associated risks.
4. **Financial Education Gap**: Numerous participants lack a thorough grasp of options, volatility, or the likelihood of failure. Options are fundamentally intricate financial tools, and traders might undervalue the challenge of consistently achieving profitable trades.
5. **Social and Cultural Factors**: Sites such as YouTube, Telegram, and Twitter are abundant with accounts of significant profits from options trading
6. **Cognitive Dissonance and Hope:** Traders frequently hold the belief that they can enhance their abilities or "overcome the odds" through additional practice or learning.

   The possibility of making a profit, despite setbacks, keeps many involved.
7. **Technology and Accessibility Developments in trading platforms and applications:** :simplify options trading, even for newcomers. Numerous platforms provide paper trading (mock trading), which can lead to an unrealistic feeling of assurance prior to trading actual funds.

8. **Excessive Risk-Taking:** Traders might overrate their capacity to accurately foresee price fluctuations (directional bias) or volatility. Options present distinct chances of success. Overconfident traders might overlook these chances, believing they can "overcome the odds."
9. **Overtrading:** Overconfident traders might participate in numerous, high frequency trades, convinced they can precisely time the market or respond to every slight change.
10. **Complex Analysis as Control:** Traders might think that performing thorough analysis (such as chart patterns) allows them to influence the results of their trades. Although analysis holds significance options prices are affected by unforeseen elements such as macroeconomic events or market sentiment.
11. **FOMO (Fear of Missing Out):** Participants in online trading groups are frequently swayed by anxiety of missing a lucrative opportunity. For instance, a trader could initiate a high-risk options strategy on a popular stock due to the excitement generated by the community.
12. **Partial Knowledge:** Having knowledge of certain elements of options trading (such as the Greeks or fundamental strategies) can give traders a sense of control, even if they do not fully grasp the associated risks. Traders might concentrate on previous wins that bolster their confidence in managing results while overlooking their losses.
13. **Overcrowded Trades:** When an excess number of traders utilize the same strategy (for instance, selling covered calls on a well-known stock), the success of that strategy could decrease.
14. **Unrealistic Expectations:** Observing others share screenshots of significant profits can set unattainable expectations for novice traders, resulting in disappointment or reckless actions when they cannot achieve similar outcomes.
15. **Reinforcement of Cognitive Biase:** Social trading enhances biases such as overconfidence, herd behaviour, and confirmation bias. For instance, traders might overlook opposing evidence as it contradicts the dominant sentiment of the community.
16. **Overemphasis on Speculation:** Numerous communities romanticize high-risk speculative investments (such as purchasing far-out-of-the-money weekly options), causing traders to undervalue the significance of risk management.

Suggestions:

1. Maintain a Trading Journal: Document every trade, including the reasons for entering and exiting, results, and insights. This offers an unbiased account and aids in recognizing trends of overconfidence.
2. Emphasize Risk Management: Implement techniques such as position-sizing, stop-loss orders, and diversification to minimize possible losses.
3. Understand the Greeks and Probabilities: Gaining a comprehensive understanding of options mechanics (e.g., delta, gamma, theta) can create realistic expectations for trades.

4. Acknowledge Randomness: Realize that the prices of options are affected by unforeseen elements such as news developments or market feelings, which are beyond your influence.
5. Utilize Automation: Automate certain aspects of your trading procedure (e.g., stop-loss settings, limit orders) to decrease the urge to over-adjust trades.
6. Establish Clear Guidelines: Develop a rule-oriented trading framework that specifies when to enter, exit, or modify a trade, minimizing subjective judgment.
7. Foster Independent Thought: - Perform your own research and evaluation before engaging in any trade mentioned in an online group. Refrain from uncritically adopting trade concepts without comprehending the reasoning behind them.
8. Emphasize Risk Management; - Employ methods such as position sizing, stop-loss orders, risk-reward assessment, money management, odds of success, and portfolio diversification to reduce the dangers of engaging in speculative trades.
9. Concentrate on education rather than income – Prioritize and commit to acquiring knowledge first. Therefore, it will aid in protecting capital, enhancing confidence, and fostering rational decision-making skills.
10. Long term: - Analyse the business of rising sectors and firms, their potential, management practices, and invest for the long term to generate wealth.
11. Goals – Set your own financial goals and purpose of the trade.
12. Meditation – Practice yoga and meditation consistently to enhance performance and reduce stress.

Conclusion:

The determination of traders in options markets, even with significant failure rates, can be linked to several factors such as cognitive biases, emotional influences, and inherent structural features of the options market. By examining essential literature and SEBI reports, this research seeks to deliver a thorough insight into this paradox, laying the groundwork for future research and possible regulatory actions to tackle the problem. The younger generation ought to concentrate on safeguarding capital, dedicating time to learning early on, and should initially invest in low-risk securities.

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