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Behavioural Biases and Investment Decision-Making: An Overview

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Abstract:

This research paper provides an overview of behavioral biases and their impact on investment decision-making. Behavioral biases refer to the systematic errors and cognitive shortcuts that individuals often exhibit when making investment decisions. These biases can lead to suboptimal investment choices and have significant implications for portfolio performance. This paper reviews the major behavioral biases observed in the field of finance and discusses their effects on investment decision-making. The paper explores the underlying psychological mechanisms behind these biases and offers insights into how investors can mitigate their influence. The findings highlight the importance of understanding behavioral biases in order to make informed investment decisions and achieve better financial outcomes.

Keywords: Behavioural fiancé, Cognitive bias, Emotional Biases, investors, Investment decisions, Social Biases , Herding Biases

1 INTRODUCTION

1.1 Background of the study :

For every individual investment decision-making is a complex process that involves assessing various factors. Traditional economic theories assume that such a decision is the outcome of financial analysis, market analysis, and risk analysis. However, the latest studies show that decisions are also influenced by various psychological factors. Behavioral fiancé studies that these factors and behavioral biases can distort their decision-making. Understanding these biases and their effects on investment choices is crucial for both individual investors and financial professionals

1.2 Objective of the study :

The primary objective of this paper is to provide an overview of behavioral biases and their impact on investment decision-making. The purpose of the study is to examine the key biases observed in finance and exploring their psychological mechanisms. This study aims to enhance understanding of affect of biases in investment outcomes.

1.3 Scope of the Study:

This study focuses on the behavioral biases that affect investing decision-making the most frequently. Its goal is to give a thorough understanding of these biases and their results. In order to shed light on why investors are susceptible to these biases, the research emphasizes the psychological mechanisms that underlie them. The report offers general tips on how to lessen the effects of behavioral biases rather than offering particular financial advice. This study paper wants to add to the body of knowledge in behavioral finance by examining the connection between behavioral biases and investing decision-making. It also aims to offer insightful information for investors, financial

2 BEHAVIOURAL FINANCE

Behavioural finance is a field of study that utilizes psychology to understand how investors make financial decisions, both individually and as a whole while challenging the “rationality,” “self-interest,” and “perfect information” of traditional economic theory.Behavioral finance, a subfield of behavioural economics put forwards that financial decisions and investment decisions are not always rational as traditional finance theory proposes. Behavioural finance helps us to understand how financial decisions like investments, payments, and risk management, are greatly influenced by behavioural biases. It analysis to what extent human emotion, own judgment cognitive limitations of the mind influence the processing of investment decisions. The field challenges the traditional approach, where investors seem to be rational. For example; behavioral fiancé explains that movement in stock price reflects all known information about the companies, and having expertise in fundamental and technical analysis is good enough for investors. This area of finance contributes and affects finance in multiple ways as it evaluates human desire and the motivating factors that influence investment decisions, thereby contributing to the value maximization of investments made

Traditional fiancé believes s that both the market and investors are perfectly rational, Investors truly care about utilitarian characteristics, Investors have perfect self-control, and they are not confused by cognitive errors or information processing errors. As per behavioral finance, Investors are not always rational and influenced by their own biases. Investors make cognitive errors that can lead to wrong decisions. It also differs in various other aspects. For instance when an investor considers: risk”, standard finance theory considers risk as an objective term that risk can be quantified where risk can be calculated as beta, or risk can be calculated from the standard deviation. However, behavioural finance theories say that risk is subjective. One person can have a different level of risk-taking capacity than another person, and it is difficult to measure.

In terms of returns, standard finance assumes that risk and return have a linear relationship; that is, if risk increases, the return will also increase but behavioral finance says that there is an inverse relationship between perceived risk and perceived return.

The most prominent view of behavioural fiancé is behavior of the investor. Standard finance theories say that the decision-maker is rational. In contrast, the behavioral finance theory states that human beings are irrational, and he would take all the decisions based on irrationality.

3 BEHAVIORAL BIASES IN INVESTMENT DECISION-MAKING

Behavioural biases encompass both cognitive and emotional biases. While cognitive biases are from statistical, information processing, or memory errors, an emotional bias stems from impulse or intuition and results in action based on feelings instead of facts. Behavioural finance seeks an understanding of the impact of personal biases on investors. Jason Zweig, a columnist for The Wall Street Journal and author of Your Money and Your Brain, notes, “Investing isn’t about beating others at their game. It’s about controlling yourself at your own game.

Behavioral bias can result from either internal or external factors. Internal actors include cognitive and emotional biases. A cognitive bias is a type of error in thinking that occurs when people are collecting, processing, and interpreting information. It is a deficiency or limitation in how people think. Such biases can result from attempting to simplify information processing and may or may not be factual. Investors make costly mistakes due to various cognitive biases that affect their decisions.5 Some cognitive biases are built into the brain and hence subconsciously influence investor behavior. These biases result from either an investor’s inability to analyze all information or basing decisions on incomplete information An emotional bias is a distortion in cognition and decision-making due to emotional factors. Unlike cognitive behavioral biases, finding a solution to emotional biases requires great care because they are tied deeply to personal sentiments. Humans have emotional biases that inevitably lead to poor investment decision-making. behavioral bias may also result from external factors called social bias. These social influences include not only the media and the Internet but also friends, colleagues, culture, and other factors. Here is the summary of types of behavioural biases

3.1 TYPES OF BIASES

	Types of Biases	Feature
Cognitive Biases	Confirmation bias	Confirmation bias is the tendency to notice, seek out, or evaluate information in a way that supports one's existing thinking
	Representative bias	It is the presumption that once people or events are categorized, they share all the features of other members in that category
	Conservatism bias	It is the tendency to revise one's beliefs insufficiently when presented
	Illusion of control bias	It is the tendency to overestimate one's degree of control or influence over external events
	Hindsight bias	It is the tendency to see past events as having been predictable and reasonable to expect before they occurred.
	Anchoring bias,	Under this bias an investors prefer to stick close to the references with which they feel most comfortable
	Mental accounting	It refers to the tendency to treat one sum of money differently from another equal-sized sum based on how the money is categorized.
	Framing bias	Framing is the tendency to behave differently depending on how a situation is presented or framed.
	Availability bias	It is the tendency to give greater weight to easily recalled and recent information over information that is less recallable or harder to understand.
	Outcome bias	It is the tendency to judge a decision by its eventual outcome without regard to how past events developed
	Recency bias	This refers to the tendency to use recent experience as the baseline
Emotional Biases	loss aversion	It refers to the tendency to prefer avoiding losses to acquiring gains
	Regret aversion	It is the indecision and failure to take action due to fear of bad outcomes.
	Status quo bias	It is the tendency to do nothing or maintain a previous decision unless some compelling incentive exists to change
	endowment effect	It is the tendency for investors to overvalue assets that they already hold over those that they do not
	Self-deception	These biases examine how mistakes that arise from people's desire for a positive self-image affect their reasoning and decision-making
	Self-Attribution Bias	This behavioral pattern influences them to exaggerate their abilities and ignore their mistakes
	Herding Behavior	Herding refers to the tendency to flock together, especially under conditions of uncertainty

Source: - Investment Traps Exposed, consolidated by Author

Behavioral biases are classical forms of dysfunctional psychology directly applied to the investment area. Understanding how and why investors make decisions is fascinating and complex because irrationality and bias can lead to making decisions.

3.2IMPACT OF BEHAVIOURAL BIASES

One example of how to comprehend the impact of behavioural biases is the Dotcom Bubble. The dot-com bubble was a speculative frenzy that surrounded internet-based businesses in the late 1990s. By ignoring conventional valuation indicators and falling for the excitement surrounding these companies, many investors displayed confirmation bias. They ignored the warning indications of overvaluation and unstable company structures in favor of success tales and upbeat predictions. As a result, many investors experienced large financial losses in 2000 when the bubble burst.

Herding behaviour fuelled the housing bubble that existed before the world financial crisis of 2008. With the expectation that the trend would last forever, investors and financial institutions chased rising home values. As more people followed the pattern, the market overheated and real estate prices rose to unaffordable levels. But when the subprime mortgage crisis caused the bubble to burst, the housing market crashed and there was a major worldwide financial catastrophe.

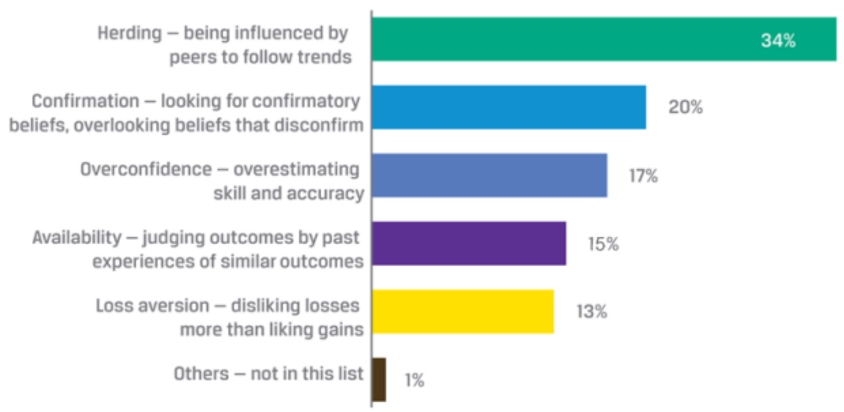
Behavioural bias has a substantial impact on financial choices, which can result in poor judgment, higher risk, and lost opportunities. Investors can improve their decision-making processes and the overall results of their investing plans by recognizing and addressing this bias. Long-term investment success depends on developing a disciplined and objective method of information evaluation.

3.4 EFFECTS OF BEHAVIORAL BIASES ON INVESTMENT PERFORMANCE

Behavioural biases frequently cause illogical decision-making, which leads to poor investing decisions. Overconfidence, anchoring, and other biases like confirmation bias can skew judgment, causing people to make poor financial decisions, take excessive risks, or miss warning signs. Investment returns may be significantly impacted by behavioral biases. Missed chances, holding onto underperforming assets for too long, or pursuing speculative investments are all possible outcomes of biased decision-making. When compared to an investment strategy that is more logical and disciplined, these acts may result in poorer overall results. The volatility and risk in investment portfolios can also be influenced by behavioral biases. Emotionally or cognitively biased decisions may result in excessive trading, efforts at market timing, or concentration in particular assets or sectors.

CFA Institute Financial News Brief administered a survey asking readers to select the behavioural bias that affects investment decisions the most. The survey generated responses from 724 practitioners from across the world. As shown in the graph below, herding garnered 34% of the votes and stood out as the topmost bias affecting investment decision-making in the eyes of poll participants.

BEHAVIORAL BIAS THAT AFFECTS INVESTMENT DECISIONS



Source .cfainstitute.org/investor/2015/08/06/

CONCLUSION

Human nature is complex, and behavioural finance studies how emotional, cognitive, and psychological factors influence investment decisions. Behavioural finance helps to explain the difference between expectations of efficient, rational investor behaviour and actual behaviour.

In the midst of market volatility, advisors will need to focus on behavioural aspects of wealth management and develop a greater understanding of how biases can affect clients' investment decisions. Incorporating behavioural finance into their practice is the key to enhancing the client experience, deepening relationships, retaining clients, and potentially delivering better outcomes.

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