



# A Study On The Effects Of Behavioural Finance On Investment Decision-Making

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## ABSTRACT

Behavioural finance offers a critical perspective on how psychological influences and cognitive biases impact investor behaviour and financial decision-making. Departing from traditional finance theories that assume rationality and market efficiency, behavioural finance integrates insights from psychology to explain why investors often make suboptimal decisions. This study investigates the effects of key behavioural factors—such as overconfidence, loss aversion, herding behaviour, and anchoring—on individual investment choices. By combining a review of relevant literature with empirical analysis, the research highlights how these behavioural tendencies can lead to inconsistent investment patterns and market inefficiencies. The study further examines how these behavioural tendencies are amplified during periods of market volatility and uncertainty, such as economic downturns or speculative bubbles. Findings suggest that behavioural biases not only influence individual portfolio choices but also contribute to collective market anomalies. The implications of this research highlight the importance of incorporating behavioural insights into investment advisory practices, policy-making, and financial education programs. By recognizing and mitigating these biases, investors and financial professionals can enhance the quality and consistency of investment decisions. The findings suggest that a deeper understanding of behavioural finance can enhance decision-making quality and reduce the influence of irrational biases, ultimately promoting more stable and informed financial practices.

**Keywords:** Behavioural finance, investment decision-making, psychological biases, investor behaviour, overconfidence, loss aversion, herding, cognitive bias, market inefficiencies.

## INTRODUCTION

Investment decision-making has traditionally been examined through the lens of classical financial theories, which assume that investors act rationally and markets operate efficiently. According to these models, individuals evaluate all available information logically and make decisions that maximize their expected utility. However, real-world investment behaviour often contradicts these assumptions. Investors frequently rely on intuition, exhibit inconsistent risk preferences, and are influenced by emotional and psychological factors. These deviations from rationality have led to the emergence of behavioural finance—an interdisciplinary field that combines principles from psychology and economics to better understand the decision-making patterns of investors. Behavioural finance posits that individual investors are prone to cognitive biases and emotional responses that systematically affect their financial choices. Common biases such as overconfidence, loss aversion, herding behaviour, anchoring, and mental accounting can lead to flawed investment strategies and market anomalies. These psychological factors are especially pronounced during periods of market volatility or uncertainty, where emotions often override objective analysis. Consequently, behavioural finance provides a more realistic framework for understanding how investment decisions are made in practice.

## RELEVANCE OF THE STUDY

According to a 2023 report by the World Economic Forum, retail investors accounted for approximately 23% of all equity trading volume in the U.S., up from just 10% a decade earlier. This sharp increase highlights the need to understand how individual investors make decisions, especially given that many lack formal financial education or training. At the same time, platforms like Robinhood and Zerodha have seen exponential growth, with Robinhood reaching over 22 million users by 2023, many of whom are first-time investors aged between 18 and 35. Global economic instability—marked by events like post-pandemic recovery, inflationary pressures, and geopolitical tensions—has only heightened the influence of behavioural biases. Investors are increasingly driven by fear, overconfidence, or speculative momentum rather than fundamental analysis. These patterns contribute to increased market volatility and financial vulnerability, especially among less experienced investors.

Focusing on the effects of behavioural finance on investment decision-making is particularly relevant today due to the increasing participation of retail investors in financial markets and the growing volatility influenced by global economic uncertainties. The rise of digital trading platforms, mobile investment apps, and real-time market access has made investing more accessible, but also more susceptible to emotionally driven decisions. In this context, understanding behavioural finance is more critical than ever. By identifying the psychological factors that influence investment behaviour, this research aims to contribute toward better financial literacy, improved investor outcomes, and more effective advisory and regulatory

frameworks. It supports the ongoing shift from purely technical financial models to more human-centred approaches in both academic research and practical investment management. This study aims to explore how behavioural biases influence individual investment decisions, with a focus on identifying which psychological factors are most prevalent among investors. The research also investigates the extent to which these biases differ across demographic groups such as age, gender, income level, and investment experience. By analyzing both qualitative insights and quantitative data, this study seeks to bridge the gap between theoretical models and actual investor behaviour. Understanding these behavioural tendencies is crucial not only for individual investors but also for financial advisors, policymakers, and educators. Recognizing and mitigating behavioural biases can lead to more informed financial decisions, improved portfolio performance, and a more stable investment environment. Ultimately, this research contributes to the growing body of knowledge that advocates for integrating behavioural finance into mainstream financial practices and education.

## RESEARCH OBJECTIVES

- ❖ To identify and analyze the key behavioural biases that influence individual investment decision-making.
- ❖ To examine the impact of behavioural biases on investment decisions
- ❖ To assess the implications of behavioural finance on market trends and investor outcomes.

## INFLUENCE OF BEHAVIOURAL BIASES ON INVESTMENT DECISION MAKING

Behavioural biases significantly influence individual investment decisions by causing investors to act irrationally, often deviating from logical and objective financial reasoning. These biases stem from psychological tendencies that affect how people perceive risk, process information, and respond to market events. For instance, overconfidence bias leads investors to overestimate their knowledge or ability to predict market movements, resulting in excessive trading and risk-taking. According to a study by Barber and Odean (2001), overconfident investors trade 45% more frequently than average investors but earn lower net returns due to higher transaction costs and poor timing.

Loss aversion, another prominent bias, describes investors' tendency to fear losses more than they value equivalent gains. Research by Kahneman and Tversky (1979) found that the psychological impact of a loss is approximately twice as powerful as the pleasure of a gain. This often causes investors to hold on to losing stocks in the hope of breaking even, rather than cutting losses and reallocating funds more effectively.

Herding behaviour is also common, where individuals follow the crowd rather than relying on their own analysis. A 2022 survey by the CFA Institute reported that 61% of retail investors admitted to making investment decisions based on trends seen on social media or among peers,

rather than through personal research. This behaviour can contribute to speculative bubbles or irrational market panics.

Anchoring bias causes investors to fixate on specific reference points, such as a stock's purchase price, leading them to make decisions that ignore new, relevant market data. Meanwhile, mental accounting leads individuals to treat money differently based on its origin or intended use, which can result in suboptimal asset allocation.

Overall, these behavioural biases undermine the principles of rational decision-making in finance. They are especially influential in times of market volatility, when emotional responses tend to override analytical thinking. As retail investor participation grows globally—now comprising over 23% of equity trading volume in the U.S. according to the World Economic Forum (2023)—understanding and mitigating the impact of behavioural biases has become more important than ever for promoting sound financial decision-making and market stability.

## **IMPACT OF BIASES ON INVESTMENT DECISIONS**

The impact of behavioural biases on investment decisions is profound and often leads investors to make choices that deviate from rational and optimal financial strategies. These biases, rooted in psychology, can distort judgment, increase risk exposure, and reduce overall portfolio performance.

### ***1. Poor Investment Choices***

Behavioural biases often cause investors to ignore fundamental analysis and make decisions based on emotion or flawed reasoning. For example, overconfidence can lead investors to overestimate their ability to predict market movements, resulting in excessive trading. Studies have shown that such overtrading can reduce net returns due to transaction costs and poor timing.

### ***2. Holding on to Losing Investments***

Loss aversion, a strong tendency to avoid realizing losses, compels investors to hold onto underperforming assets in the hope they will rebound. This behaviour prevents timely reallocation of funds into better-performing investments and often leads to greater losses.

### ***3. Herding and Market Bubbles***

Herding behaviour, where investors mimic the actions of others rather than relying on their own analysis, can contribute to asset bubbles and crashes. When large groups of investors buy into the same stocks based on trends or media influence rather than fundamentals, it can inflate prices irrationally. When reality sets in, sharp sell-offs can follow, causing significant losses.

### ***4. Anchoring and Mispricing***

Anchoring bias leads investors to fixate on irrelevant benchmarks, such as a stock's historical high or their original purchase price. This can cause mispricing in their minds and delay

decisions to sell or re-evaluate investments, even when market conditions have changed significantly.

### ***5. Emotional Decision-Making During Volatility***

During periods of high market volatility—such as recessions, pandemics, or geopolitical crises—behavioural biases become more pronounced. Investors driven by fear may panic-sell, locking in losses, while those driven by greed or optimism may chase high-risk assets without proper analysis. According to a 2023 Morningstar survey, 42% of individual investors admitted to panic selling during sharp market downturns, often missing out on subsequent recoveries.

### ***6. Inefficient Portfolio Management***

Due to biases like mental accounting, investors may treat money in separate “buckets” (e.g., savings, bonuses, investments) and allocate assets irrationally—such as taking more risks with bonuses while being overly conservative with savings. This leads to inefficient diversification and misaligned risk profiles.

## **IMPLICATIONS OF BEHAVIOURAL FINANCE ON DECISION MAKING**

The implications of behavioural finance on market trends and investor outcomes are significant and wide-ranging, affecting not only individual investors but also overall market efficiency, volatility, and long-term financial performance. Behavioural finance highlights the psychological factors and biases that influence decision-making, which in turn have important consequences for both individual investment outcomes and broader market dynamics.

### ***1. Market Inefficiencies***

Traditional financial theories, such as the Efficient Market Hypothesis (EMH), assume that markets are rational and reflect all available information. However, behavioural finance challenges this assumption by revealing that psychological biases often lead to market inefficiencies. Investors' irrational behaviour, driven by biases like overconfidence, herding, and loss aversion, can cause mispricing of assets. For instance, during speculative bubbles (e.g., the dot-com bubble or housing bubble), asset prices can become artificially inflated due to widespread optimism and herd behaviour. This mispricing can distort market signals, making it difficult for investors to correctly assess the true value of assets.

### ***2. Increased Volatility***

Behavioural biases contribute to increased market volatility. Investors often react disproportionately to short-term market movements, driven by emotional responses like fear and greed. When negative news or market downturns occur, loss aversion leads to panic selling, exacerbating price declines. On the other hand, during bullish periods, overconfidence and herding can result in speculative buying, driving prices up beyond reasonable levels. This

creates excessive volatility in asset prices, which can lead to erratic market swings, affecting both individual investors and institutional portfolios.

### **3. Herding Behaviour and Market Bubbles**

Herding behaviour—the tendency of investors to follow the actions of the majority—can lead to market bubbles and subsequent crashes. During periods of optimism, investors are more likely to engage in herd behaviour, buying assets simply because they see others doing so. This can inflate asset prices, creating bubbles that are unsustainable. When these bubbles burst, a sharp market correction often follows, leading to substantial losses for many investors. This was evident in the global financial crisis of 2008, where irrational optimism in housing markets led to a massive speculative bubble, which, once it burst, caused widespread financial instability.

### **4. Impact on Investor Outcomes**

At the individual level, behavioural biases often result in suboptimal investment decisions, negatively impacting investor outcomes. For example:

- Overconfidence leads to excessive trading, which not only increases transaction costs but also reduces returns. Studies have shown that overconfident investors often underperform the market due to poor timing and lack of diversification.
- Loss aversion causes investors to hold on to losing investments longer than necessary, locking in losses and preventing them from rebalancing their portfolios to more profitable opportunities.
- Mental accounting can lead investors to treat funds differently, misallocating capital by taking on too much risk in one area while being overly conservative in another.

These biases reduce the overall effectiveness of investment strategies, leading to lower long-term returns compared to more rational, diversified, and systematic approaches.

### **5. Impact on Financial Markets and Regulatory Frameworks**

The recognition of behavioural biases in finance has implications for financial regulations and investor protection mechanisms. Policymakers and regulators, such as the SEC, are increasingly considering behavioural insights when designing regulations, particularly those related to financial products and market conduct. For instance, disclosure requirements are designed to ensure that investors make decisions based on adequate information, while financial literacy campaigns aim to reduce the impact of biases like overconfidence and loss aversion. Furthermore, behavioral finance has influenced the development of financial products like low-fee index funds, target-date funds, and automated financial advisory services (robo-advisors). These products are designed to help investors overcome biases like anchoring or mental accounting, encouraging diversified, long-term investing strategies and minimizing the risk of emotional decision-making.

## 6. Enhanced Financial Decision-Making and Education

By understanding behavioural biases, investors can make better decisions. Financial education programs and advisory services that incorporate behavioural finance principles can help individuals recognize and mitigate their biases. Financial advisors can design strategies to counteract behavioural tendencies, such as helping clients avoid panic-selling during downturns or encouraging them to diversify and stick to long-term goals.

## CONCLUSION

To summarize, behavioural finance has profound implications for both market trends and investor outcomes. By understanding how psychological biases influence decision-making, we can better explain market inefficiencies, excessive volatility, and speculative bubbles. Moreover, recognizing these biases allows investors to improve their own financial decisions, ultimately leading to better portfolio outcomes. For markets, incorporating behavioural insights into regulatory frameworks can help mitigate the impact of irrational behaviour and contribute to more stable and efficient financial systems.

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