

# Behavioural Finance and Investment ‘Decision Making’

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## ABSTRACT

*Behavioral finance is a field that combines psychology and economics to understand how human emotions and biases influence investment decisions. This paper explores the field of behavioral finance and its influence on investment decision-making. It delves into the psychological factors that affect investor behavior, such as cognitive biases and emotions, and examines how these factors can lead to irrational investment decisions.*

**Keywords:** Behavioral finance, Investment decisions, Cognitive biases, Human emotions

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## INTRODUCTION

Investor's behavior plays a crucial role in shaping the asset price behavior and overall market dynamics. Their decisions, such as buying or selling securities, can lead to fluctuations in prices and influence market trends. Additionally, investor sentiment and confidence can impact market behavior, as optimistic or pessimistic outlooks can drive buying or selling activity. For example, if investors are optimistic about a particular stock and perceive it as undervalued, they may start buying it in large numbers. This increased demand will drive up the stock's price, creating a positive feedback loop where more investors are attracted to the stock, further increasing its price. On the contrary, if investors become fearful about the overall market conditions or a specific sector, they may start selling their holdings. This selling pressure can result in a downward spiral where prices decline rapidly, leading to a panic sell-off. This fear-driven selling can be exacerbated by the actions of other investors, causing a domino effect and further driving down prices. As prices continue to fall, more investors may lose confidence and choose to sell, creating a self-reinforcing cycle of selling pressure. This negative sentiment can quickly spread throughout the market, affecting not only the specific sector but also the overall market as a whole.

It is important for investors to carefully monitor market sentiment and adjust their investment strategies accordingly to navigate these volatile periods. Factors affecting the behavior of investors include Demographic factors, Economic factors, Psychological factors, and social factors. Demographic factors: such as age, gender, and income level can significantly impact an investor's behavior. For example, younger investors may be more willing to take risks and invest in high-growth assets, while older investors may prioritize stability and opt for safer investment options. Additionally, an investor's income level can determine their risk tolerance and ability to invest in certain financial products or assets. Economic factors: such as interest rates, inflation, and economic growth can significantly impact investor behavior. For example, when interest rates are low, investors may be more inclined to borrow money to invest in assets with higher returns. On the other hand, high inflation rates can erode the value of investments and lead to a decrease in investor confidence. Additionally, economic growth or recession can also affect investor sentiment as a booming economy may attract more investors while a downturn may cause them to be more cautious. Dividend policy plays a crucial role as it determines the amount of profit that will be distributed to shareholders, thus impacting their overall returns.

Expected corporate earnings also heavily influence investor behavior, as positive projections can attract more investors and drive up stock prices. Additionally, the allure of get-rich-quick schemes can tempt investors into making impulsive decisions, potentially leading to higher risks and volatility in the market. Psychological factors: such as fear, greed, and herd mentality can have a significant impact on investor behavior. These factors can cause investors to make irrational decisions, such as buying or selling stocks based on emotions rather than logical analysis. Additionally, cognitive biases, such as confirmation bias or overconfidence, can also play a role in shaping investor behavior by influencing their perception of information and their decision-making process. Social factors: such as social proof and peer pressure, can also heavily influence investor behavior. For example, if a large number of investors are buying a particular stock, others may feel compelled to do the same in order to not miss out on potential gains. Furthermore,

societal norms and cultural beliefs can also shape investor behavior by influencing their risk tolerance and investment preferences.

Investors are considered irrational according to behavioral finance due to several cognitive biases and emotional factors that influence their decision-making. These biases include overconfidence, where investors tend to overestimate their abilities and underestimate risks. Additionally, investors may exhibit herd mentality, following the actions of others without conducting thorough analysis or independent thinking. These irrational behaviors can lead to market inefficiencies and suboptimal investment decisions.

Behavioral finance is a field that combines principles of psychology and economics to understand how individuals make financial decisions. It explores the impact of cognitive biases, emotions, and social influences on investor behavior and market outcomes. Behavioral finance is a field that challenges the assumptions of traditional finance by recognizing the importance of studying the emotional factors that influence investment decisions. Unlike traditional finance, which assumes that investors are rational and always act in their best interest, behavioral finance acknowledges that human emotions such as fear, greed, and overconfidence can significantly impact investment behavior. In short, the main Critiques of traditional finance theory include its assumption of rationality and efficient markets. Behavioral finance, on the other hand, recognizes that investors are not always rational and that markets are not always efficient. By examining the irrationality and deviations from traditional economic theories, behavioral finance provides valuable insights into understanding the complexities of financial markets. Emotional factors in investment are often overlooked in traditional finance. Traditional finance assumes that investors are rational and make decisions based on logical analysis of available information.

It focuses on factors such as risk and return, market efficiency, and asset pricing models. However, behavioral finance recognizes that emotions play a significant role in investment decision-making. It studies how psychological biases, such as overconfidence, loss aversion, and herd mentality, can impact investor behavior and lead to irrational financial decisions. One assumption of Traditional finance is that investors are rational and make decisions based solely on maximizing their own wealth. On the other hand, behavioral finance recognizes the importance of studying how emotions and cognitive biases can influence investment decisions. Emotional factors such as fear, greed, and overconfidence can lead to irrational behavior and affect investment outcomes. For example, in the stock market, an investor who is driven by greed may make impulsive decisions to buy high-risk stocks without conducting thorough research, leading to potential losses. Conversely, an investor who is fearful may sell their stocks prematurely during a market downturn, missing out on potential long-term gains. These emotional factors can significantly impact investment returns and highlight the need for understanding behavioral finance principles. Therefore, understanding behavioral finance is crucial in order to gain insights into these emotional factors and make more informed investment decisions.

**Influence of emotions on investment choices:** Influence of emotions on investment choices: Emotions play a significant role in shaping investment decisions. Fear and greed, for example, can lead investors to make irrational choices, such as selling low or buying high. The role of fear and greed in market behavior is significant as they can drive investors to make irrational decisions based on their emotions rather than sound investment strategies. These emotions can create a herd mentality, where investors follow the actions of others without considering the long-term consequences. This behavior can contribute to market bubbles and crashes, further exacerbating losses for those driven by fear or greed. Additionally, emotional biases, such as the tendency to follow the crowd or to avoid losses at all costs, can greatly impact investment outcomes. For example, if a stock market is experiencing a period of volatility and uncertainty, investors who are driven by fear may panic and sell their stocks at a loss, fearing further decline. On the other hand, when a market is experiencing a period of growth and optimism, investors driven by greed may be more prone to making risky investments in the hopes of making quick profits. These emotional biases can lead to poor investment decisions and ultimately result in financial losses. In addition to fear and greed, psychological biases related to regret and framing also play a significant role in market behavior. Regret aversion bias refers to the tendency of investors to avoid taking risks that could potentially lead to regretful outcomes. This bias can cause investors to miss out on potential opportunities for growth. Framing bias, on the other hand, occurs when investors make decisions based on how information is presented to them rather than objectively evaluating the information itself. This bias can lead to irrational decision-making and suboptimal investment choices.

**Overconfidence:** Overconfidence is a behavioral bias that refers to individuals' tendency to have excessive confidence in their own abilities and judgments. This bias often leads people to overestimate their knowledge, skills, or the accuracy of their predictions. It can result in taking on excessive risks or making poor financial decisions due to an inflated sense of self-assurance. In the context of investment decisions, overconfidence can lead investors to believe that they possess superior information or skills, causing them to take on more risk than they should. This bias can result in poor investment performance and increased susceptibility to market volatility. Additionally, overconfident investors may be less likely to seek advice or consider alternative viewpoints, further exacerbating their potential for financial losses. Furthermore, overconfidence can also lead to overtrading, as individuals may believe they can accurately predict market movements and make frequent trades to capitalize on these predictions. This excessive trading can result

in higher transaction costs and reduced overall returns. Moreover, overconfidence can create a false sense of security, causing investors to overlook potential risks and fail to adequately diversify their portfolios. This lack of diversification leaves them vulnerable to significant losses if their overly confident assumptions prove to be incorrect.

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