International Journal of Research in Economics and Social Sciences(IJRESS)
Available online at: http://euroasiapub.org

Vol. 14 Issue 6 , June- 2024
ISSN(o): 2249-7382 | Impact Factor: 8.018
(An open access scholarly, peer-reviewed, interdisciplinary, monthly, and fully refereed journal.)

A STUDY ONBEHAVIORAL FINANCE IN INVESTMENT DECISIONS OF INVESTORS: A REVIW

Md Mahboobur Rahman* and Prof. (Dr.) Ravi Kumar Srivastav**

Abstract
Investment in a wide range of assets and financial products has resulted from the growth of the financial markets. Therefore, behavioural finance has provided insight into the ways in which investors' personalities and worldviews impact their investment goals, strategies, and tactics. We have reviewed the most recent studies on the main elements that influence people's actions and investment decisions. Using bibliometric analysis, this study seeks to provide a thorough method for assessing qualitative elements that impact financial investors' intentions and actions. The research adds to the literature on behavioural finance by examining the tactics and variables that impact the decisions made by individual investors, with a focus on developing economies.

Keywords: Investors' Intention, Behavioural Finance, Investment Decisions, Qualitative Factors.

Introduction
Behavioural finance is an interdisciplinary domain that integrates concepts from psychology and economics to elucidate the reasons behind investors' occasional illogical financial actions. Conventional financial theories, like the Efficient Market Hypothesis (EMH), claim that investors act rationally and that markets operate efficiently. Behavioural finance contests these assumptions by illustrating that investors frequently behave according to cognitive biases and emotions, resulting in predictable behavioural patterns that may cause market inefficiencies. This review seeks to deliver a thorough examination of the fundamental concepts in behavioural finance and their consequences for investment choices. Investors distribute their capital across debt and equity assets according to convention to maximise their potential returns. In light of recent market changes, investors should consider adjusting their portfolios. Investors are compelled to make judgements in an unpredictable and uncertain environment, often relying on traditional heuristics or trial-and-error approaches. The evaluation of investment opportunities takes into account emotional and cognitive factors, which may compromise rational decision-making. The growth of the financial sector has enabled individuals to invest in a diverse array of financial instruments.

Historical Background
The origin of behavioural finance is linked to the studies of psychologists Daniel Kahneman and Amos Tversky in the 1970s. Their groundbreaking research on decision-making under uncertainty led to the development of prospect theory, which clarifies how individuals choose between probabilistic possibilities involving risk. Prospect theory challenged conventional utility theory by illustrating that individuals evaluate gains and losses differently, leading to divergent risk choices.In the following decades, scholars built upon Kahneman and Tversky's discoveries, exploring various cognitive biases and their impact on financial decision-making. Behavioural finance originated in the 1990s due to

the contributions of scholars like as Richard Thaler, Robert Shiller, and Meir Statman. Behavioural finance is already an established field that continually influences both academic research and practical applications in finance.

Key Concepts in Behavioral Finance

1. Heuristics

Heuristics are cognitive shortcuts employed by individuals to streamline decision-making processes. Although heuristics might assist in navigating intricate contexts, they may also result in systematic biases and inaccuracies. Prevalent heuristics influencing investing decisions encompass:

- *Accessibility Heuristic:* Investors assess the probability of an event based on the ease of recalling analogous occurrences. For instance, following a market fall, investors may overrate the likelihood of an additional crash due to the heightened prominence of such occurrences in their recollection.
- *Representativeness Heuristic:* Investors classify scenarios according to previous experiences or stereotypes. This may result in erroneous conclusions, such as presuming that a company exhibiting significant recent growth will sustain its performance indefinitely.
- *Anchoring:* Investors excessively depend on the initial information encountered (the anchor) while making judgements. The original purchase price of a stock can act as an anchor, affecting subsequent decisions on the buying or selling of that stock, regardless of changes in its fundamentals.

2. Overconfidence

Overconfidence is a common cognitive bias when investors overstate their experience, abilities, and the dependability of their information. Overconfident investors frequently trade, underestimating risks and overestimating potential gains. This behaviour may lead to suboptimal portfolio performance due to high transaction costs and poor timing decisions.

3. Loss Aversion

Loss aversion denotes the tendency of individuals to prioritise the prevention of losses over the acquisition of comparable advantages. Prospect theory asserts that losses have a more significant psychological impact than similar gains. This may lead to irrational investment behaviours, such as the lengthy retention of underperforming equities (the disposition effect) or the premature liquidation of profitable stocks to realise gains.

4. Prospect Theory

Prospect theory, developed by Kahneman and Tversky, clarifies the decision-making processes of individuals about risk. The concept posits that individuals evaluate

International Journal of Research in Economics and Social Sciences(IJRESS)
Available online at: http://euroasiapub.org

Vol. 14 Issue 6 , June- 2024
ISSN(o): 2249-7382 | Impact Factor: 8.018
(An open access scholarly, peer-reviewed, interdisciplinary, monthly, and fully refereed journal.)

prospective outcomes relative to a reference point, usually the current state, rather than in absolute terms. Individuals generally demonstrate risk aversion concerning prospective gains and risk-seeking behaviour while striving to avoid losses. This behaviour may result in unpredictable and suboptimal investing decisions.

5. Mental Accounting

Mental accounting denotes the inclination of individuals to categorise their finances into distinct accounts according to subjective criteria, frequently resulting in irrational financial conduct. An investor may differentiate a bonus from normal income, directing it towards riskier investments, notwithstanding the fungibility of money. This may result in erratic risk-taking and inefficient asset allocation.

6. Collective Behaviour

Herd behaviour transpires when investors emulate the activities of a bigger collective, frequently disregarding their own analysis or contradictory evidence. This collective behaviour can precipitate market booms and collapses. Herding is frequently motivated by social pressures and the apprehension of exclusion (FOMO). During the dot-com boom, numerous investors acquired inflated technology stocks just due to the actions of others, resulting in an unsustainable price escalation followed by a precipitous decline.

Table-1 Implications for Investment Decisions

Concept	**Description**	**Example**
Heuristics	Mental shortcuts that simplify decision-making but can lead to biases	Availability heuristic in estimating the probability of events
Overconfidence	Overestimation of one's knowledge, abilities, and precision of information	Excessive trading based on inaccurate information
Loss Aversion	Preference to avoid losses rather than acquire equivalent gains	Holding losing stocks for too long (disposition effect)
Prospect Theory	Evaluating potential outcomes relative to a reference point rather than in absolute terms	Risk-averse for gains, risk-seeking for losses
Mental Accounting	Separating money into different accounts based on subjective criteria	Treating bonus money differently from regular income
Herd Behavior	Following the actions of a larger group, often ignoring individual analysis	Buying stocks during a market bubble because others are doing

Comprehending the psychological biases and errors that affect investor behaviour has significant ramifications for both individual investors and the financial markets at large. By acknowledging these biases, investors can design solutions to alleviate their effects and enhance decision-making.

1. Enhancing Financial Acumen

Instruction in behavioural finance can assist investors in identifying their biases and circumventing prevalent errors. Comprehending the notion of overconfidence may prompt investors to pursue further information and solicit second perspectives prior to making investing choices. Likewise, understanding loss aversion can assist investors in refraining from retaining unprofitable investments for an extended period.

2. Behavioural Portfolio Theory (BPT)

Behavioural Portfolio Theory, introduced by Shefrin and Statman, takes into account the psychological inclinations of investors, proposing that portfolios should be designed to fulfil both the emotional and financial requirements of investors. This differs from the conventional mean-variance optimisation method, which emphasises just risk and return. BPT promotes a stratified portfolio strategy, wherein several layers align with varying objectives and risk appetites, offering a comprehensive perspective on an investor's requirements.

3.Nudging and Choice Architecture

Policymakers and financial planners can employ nudging tactics to steer investors towards more advantageous selections. Nudging entails the discreet modification of the decision-making environment to sway behaviour. Automatically enrolling employees in retirement plans with default contribution rates can markedly enhance participation and savings rates. Additional nudges may encompass streamlining investing options, delivering transparent information on fees and performance, and emphasising the long-term advantages of diversified portfolios.

4. Modifying Investment Approaches

Recognising that markets are frequently inefficient due to behavioural biases facilitates the formulation of tactics that capitalise on these discrepancies. Contrarian methods, which oppose current market trends, might exploit overreactions caused by herd behaviour. Value investing, characterised by the acquisition of inexpensive stocks and the divestment of overvalued ones, is a technique that can capitalise on the identification of market irrationality.

5. Improving Risk Management

Insights from behavioural finance can improve risk management techniques by revealing the cognitive biases that lead to the underappreciation of risks. For instance, overconfident investors may inadequately diversify their portfolios, so exposing themselves to undue risk. By acknowledging these biases, investors can adopt strategies to attain sufficient diversity and risk assessment, leading to more resilient portfolios.

Behavioral Biases in Specific Investment Contexts

1. Individual Investors

Retail investors are especially vulnerable to behavioural biases owing to their restricted experience and resources in contrast to institutional investors. Prevalent biases among retail investors encompass overconfidence, loss aversion, and herd mentality. Retail investors may pursue historical performance by investing in stocks or mutual funds that have recently excelled, neglecting the underlying fundamentals or the potential for mean reversion.

2. Institutional Investors

Although institutional investors tend to be more knowledgeable and possess superior information and analytical resources, they remain susceptible to behavioural biases. Institutional investors can also be influenced by overconfidence, herding behaviour, and short-termism. Portfolio managers may experience pressure to align their activities with those of their colleagues to prevent underperformance against benchmarks, resulting in herd behaviour. Furthermore, the pursuit of quarterly performance objectives may lead to short-termism, when long-term value creation is compromised for immediate benefits.

3. Corporate Finance

Behavioural finance also influences corporate financial decisions, including capital planning, mergers and acquisitions, and dividend policies. Managers' excessive confidence may result in overinvestment and the engagement in unprofitable ventures. Likewise, loss aversion may lead to insufficient investment in inventive yet perilous endeavours. Comprehending these biases can assist organisations in making more sensible decisions that augment shareholder worth.

Practical Applications of Behavioral Finance

1.Financial Consulting Services

Financial advisors can apply behavioural finance principles to get insights into their clients' requirements and prejudices, so offering more customised and effective guidance. By acknowledging the psychological variables that affect their customers' decisions, advisors can assist them in circumventing prevalent mistakes and attaining their financial objectives. Advisors can employ framing approaches to provide information that corresponds with clients' risk preferences and long-term goals.

2.Investment Instruments

Investment firms can create products that consider behavioural biases, facilitating sound decision-making for investors. Target-date funds automatically modify asset allocation as the investor nears retirement, thereby diminishing the necessity for active decision-making and mitigating the effects of biases such as overconfidence and loss aversion. Robo-advisors employ algorithms to construct and oversee portfolios according to an investor's risk tolerance and financial objectives, offering a systematic and impartial investment strategy.

3. Public Policy

Regulators can leverage behavioural finance knowledge to design regulations that safeguard investors and enhance market stability. Mandating explicit and honest disclosure of costs and risks can assist investors in making more informed decisions. Moreover, policies that foster financial knowledge and education can mitigate the effects of behavioural biases and enhance overall financial well-being.

Challenges and Criticisms of Behavioral Finance

Although behavioural finance has substantially advanced the comprehension of investor behaviour, it faces several problems and criticisms. Several significant criticisms encompass:

1.Insufficient Predictive Capability

A primary criticism of behavioural finance is that, although it offers credible explanations for observed behaviours, it frequently lacks predictive capability. In contrast to conventional finance theories that provide explicit models and forecasts, behavioural finance is predominantly descriptive, elucidating the reasons behind irrational investor behaviour rather than predicting the timing and manner of such behaviour.

2. Intricacy and Diversity

The complexity and variability of human behaviour among people complicate the formulation of universal theories and models. Behavioural finance must consider several cognitive biases, emotions, and individual variances, resulting in a more disjointed and less unified body of knowledge.

3. Integration with Conventional Finance

The integration of behavioural finance with conventional finance theories is a significant difficulty. Although behavioural finance provides significant insights, it frequently lacks the stringent mathematical structure and prediction accuracy characteristic of classical

finance. Addressing this disparity necessitates the formulation of models that integrate psychological variables with conventional economic theories, a complex and continuous endeavour.

Future Directions in Behavioral Finance

Notwithstanding these limitations, behavioural finance persists in its evolution and presents interesting avenues for future research and application. Potential opportunities for development encompass:

1.Neurofinance

Neurofinance is a nascent discipline that integrates neuroscience and finance to examine the impact of cerebral activity on financial decision-making. Employing methodologies such as functional magnetic resonance imaging (fMRI) and electroencephalography (EEG), researchers can get profound insights into the brain systems that underpin cognitive biases and emotions. This may result in more accurate models of investor behaviour and innovative techniques for reducing biases.

2.BehaviouralFintech

The emergence of financial technology (fintech) offers novel options to implement behavioural finance ideas. Fintech systems may leverage data analytics and machine learning to detect and mitigate cognitive biases in real-time, offering tailored guidance and automated decision-making tools. Applications that monitor expenditure and savings patterns can encourage users to adopt more prudent financial practices.

3. Intercultural Research

Much of the research in behavioural finance has been undertaken within Western contexts; yet, cultural disparities can profoundly affect financial behaviour. Cross-cultural studies can enhance the understanding of cognitive biases across diverse cultural contexts and facilitate the development of universally applicable theories and interventions.

4. Behavioural Insights in Corporate Governance

Integrating behavioural finance into corporate governance helps enhance decision-making within organisations. Comprehending the psychological aspects affecting executives and board members can enhance governance processes, including more efficient incentive systems, superior risk management, and increased alignment with long-term shareholder interests.

Table 2: Common Cognitive Biases in Investment Decisions

Biases	Description	Impact on Investment Decisions
Anchoring	Relying too heavily on the first piece of information	Using the initial purchase price of a stock to make future buy/sell decisions
Confirmation Bias	Seeking out information that confirms one's beliefs while ignoring contradictory information	Focusing on positive news about a favored stock while ignoring negative news
Hindsight Bias	Believing that past events were predictable and obvious after they have occurred	Overestimating the predictability of past market movements
Representativeness	Categorizing situations based on past experiences or stereotypes	Assuming a stock with high recent growth will continue to grow
Endowment Effect	Valuing owned assets more highly than similar assets that are not owned	Holding onto underperforming investments because they are already owned
Status Quo Bias	Preferring things to stay the same and resisting change	Failing to rebalance a portfolio despite changing market conditions

Table 3: Implications for Investment Strategies

Strategies	Description	Behavioral Finance Insight
Contrarian Strategy	Investing against prevailing market trends	Capitalizes on market overreactions driven by herd behavior
Value Investing	Buying undervalued stocks and selling overvalued ones	Exploits irrational pricing due to cognitive biases
Diversification	Spreading investments across various assets to reduce risk	Mitigates risks associated with overconfidence and loss aversion
Automatic Enrollment	Automatically enrolling employees in retirement plans with default contribution rates	Uses nudging to overcome inertia and status quo bias
Target-Date Funds	Funds that automatically adjust the asset allocation as the investor approaches retirement	Helps investors maintain an appropriate risk level over time, reducing the impact of biases
Robo-Advisors	Using algorithms to create and manage portfolios based on risk tolerance and financial goals	Provides a disciplined and unbiased approach to investing

These tables encapsulate essential elements of behavioural finance, emphasizing significant concepts, biases, ramifications, and practical applications. They provide a concise reference for comprehending the impact of behavioural finance on investing decisions and how these insights might enhance financial outcomes.

Conclusion

Behavioural finance has transformed our comprehension of investor behaviour by emphasizing the psychological biases and cognitive errors that affect financial decision-making. By questioning the premises of conventional finance theories, it offers a more accurate and sophisticated perspective on financial markets. Insights from behavioural finance have practical applications in financial advice services, investment product development, public policy, and corporate governance. As the discipline progresses, forthcoming research and technological innovations are expected to augment our comprehension of investor behaviour and refine financial decision-making. Integrating behavioural finance with traditional finance, establishing novel interdisciplinary methodologies, and investigating emerging fields like as neurofinance and behaviouralfintech can establish a more comprehensive and effective framework for regulating financial decisions and enhancing market stability. Ultimately, behavioural finance emphasises the necessity of acknowledging and resolving the human factors that influence financial markets. By recognising our cognitive biases and striving to reduce their effects, we may enhance our investment decisions, leading to improved financial results for both individuals and society at large.

Reference:-

Articles and Reports:

Baker, M., &Wurgler, J. (2007)."Investor Sentiment in the Stock Market."*Journal of Economic Perspectives*, 21(2), 129-151.
Odean, T. (1998). "Are Investors Reluctant to Realize Their Losses?" *Journal of Finance*, 53(5), 1775-1798.
Barber, B. M., &Odean, T. (2000). "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors." *Journal of Finance*, 55(2), 773-806.
Kahneman, D., &Tversky, A. (1979). "Prospect Theory: An Analysis of Decision under Risk." *Econometrica*, 47(2), 263-291..
Barberis, N., &Thaler, R. (2003)."A Survey of Behavioral Finance."*Handbook of the Economics of Finance*, 1, 1053-1128.
Shiller, R. J. (2003)."From Efficient Markets Theory to Behavioral Finance."*Journal of Economic Perspectives*, 17(1), 83-104.
Statman, M. (1999). "Behavioral Finance: Past Battles and Future Engagements." *Financial Analysts Journal*, 55(6), 18-27..
Shefrin, H., &Statman, M. (2000)."Behavioral Portfolio Theory."*Journal of Financial and Quantitative Analysis*, 35(2), 127-151.

Books:

Deaves, L. A. (2010). *Behavioural Finance: Psychology, Decision-Making, and Markets.* UK: Cengage Learning.

Kahneman, D. (2011). *Thinking Fast and Slow.* UK: Penguin Books Limited.

Sunstein, R. H. (2008). *Nudge: Improving Decisions About Health, Wealth, and Happiness.* New York: Yale University Press.

Thaler, R. h. (2015). *Misbehaving: The Making of Behavioral Economics.* New Yark: Penguin Books Limited.

Websites and Online Resources:

Behavioral Finance at Investopedia.
Nobel Prize Lectures by Daniel Kahneman and Richard Thaler
Behavioral Finance articles on SSRN

*Research Scholar, University Department of Commerce and Management, B.R.A. Bihar University, Muzaffarpur Bihar 842001.

**Professor, Former Dean & Head University Department of Commerce and Management, B.R.A. Bihar University, Muzaffarpur Bihar 842001.