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INVESTOR PSYCHOLOGY AND BEHAVIOURAL FINANCE: UNDERSTANDING THE HUMAN SIDE OF INVESTMENT DECISIONS

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Abstract

Investment decisions are often assumed to be based on careful analysis, available information and rational expectations. However, in real-world financial markets, investors do not always behave rationally. Emotions, past experiences, personal beliefs, fear, greed and the behaviour of other investors often influence the way people invest their money. Behavioural finance attempts to understand these psychological factors and explains why investors sometimes make decisions that differ from traditional financial theories.

This article examines the relationship between investor psychology and behavioural finance, with particular attention to common behavioural biases such as overconfidence, loss aversion, herd behaviour, anchoring and mental accounting. The study is descriptive in nature and is primarily based on secondary information obtained from academic literature, books, journals and financial studies. The article highlights how psychological influences can affect investment choices and suggests measures that can help investors make more disciplined and informed financial decisions.

Keywords: Behavioural Finance, Investor Psychology, Investment Decisions, Behavioural Biases, Loss Aversion, Herd Behaviour, Financial Markets

Introduction

Investing is not simply about numbers, financial statements and market trends. Behind every investment decision is a person whose emotions, experiences and expectations influence the final choice.

Traditional financial theories generally assume that investors are rational and that they make decisions with the objective of maximising returns while minimising risk. In reality, however, investors may panic when markets fall, become overly confident after earning profits, follow popular market trends without proper analysis or continue holding a losing investment because they are unwilling to accept a loss.

Such behaviour shows that investment decisions are influenced not only by financial information but also by human psychology.

Behavioural finance combines concepts from psychology, economics and finance to understand why investors behave in particular ways. It studies the psychological biases that affect financial decision-making and helps explain market behaviour that cannot always be understood through traditional financial theories.

Understanding investor psychology is particularly important in today's environment, where investors have immediate access to financial news, social media, trading applications and opinions from market participants. While access to information has increased, it has also created greater opportunities for emotional and impulsive investment decisions.

Statement of the Problem

Traditional finance assumes that investors carefully analyse all available information before making investment decisions. However, actual investor behaviour frequently differs from this assumption.

Many investors make decisions based on emotions such as fear, excitement, regret and greed. They may purchase investments because others are buying them, avoid selling an investment because they do not want to accept a loss or believe too strongly in their own ability to predict market movements.

Such psychological influences may result in poor portfolio choices, excessive trading, inappropriate risk-taking and financial losses.

Therefore, it becomes important to understand the psychological factors that influence investors and examine how behavioural biases affect investment decision-making. Studying behavioural finance can help investors recognise these biases and develop more rational and disciplined approaches towards investing.

Objectives of the Study

The major objectives of the study are:

1. To understand the concept of investor psychology and behavioural finance.
2. To identify the major psychological biases influencing investment decisions.
3. To examine the impact of emotions on investor behaviour.
4. To understand the influence of herd behaviour on financial decision-making.
5. To examine the relationship between behavioural biases and investment performance.
6. To suggest measures that can help investors reduce emotionally driven investment decisions.

Concept of Behavioural Finance

Behavioural finance is an area of finance that studies how psychological and emotional factors influence investors and financial markets.

Unlike traditional finance, which assumes that individuals generally behave rationally, behavioural finance recognises that investors can make systematic errors in judgement.

People often depend on shortcuts while making decisions, particularly when they are faced with uncertainty. These shortcuts can sometimes be useful, but they may also lead to predictable behavioural mistakes.

Behavioural finance therefore attempts to answer questions such as:

- Why do investors panic during market declines?
- Why do people hold loss-making investments for too long?
- Why do investors frequently follow market trends?
- Why do some investors trade excessively?

- Why are investors sometimes unwilling to change their opinions even when new information becomes available?

The answers to these questions often lie in investor psychology.

Investor Psychology

Investor psychology refers to the emotions, perceptions, beliefs and mental processes that influence an individual's investment decisions.

Different investors may react differently to exactly the same financial information. For example, when the stock market declines by 10%, one investor may consider it an opportunity to buy quality investments at lower prices. Another investor may become frightened and immediately sell their investments.

The financial situation may be the same, but the psychological response is different.

Investor psychology is generally influenced by factors such as:

- Individual risk tolerance
- Past investment experiences
- Financial knowledge
- Expectations regarding future returns
- Personal financial goals
- Fear of losing money
- Desire to earn quick profits
- Opinions of friends, family and financial influencers
- Market news and social media
- General market sentiment

Understanding these factors is essential for improving financial decision-making.

Major Behavioural Biases Affecting Investors

Overconfidence Bias

Overconfidence occurs when investors believe that their knowledge or ability to predict market movements is greater than it actually is.

For example, an investor who has earned good returns from a few successful trades may begin to believe that they can consistently predict stock prices. As a result, they may trade more frequently or take unnecessary risks.

Excessive confidence can result in poor diversification and increased exposure to financial losses.

Loss Aversion

Loss aversion refers to the tendency of investors to experience the pain of losses more strongly than the satisfaction of equivalent gains.

For instance, the disappointment of losing ₹10,000 may feel significantly greater than the happiness created by earning ₹10,000.

Because of this tendency, investors sometimes continue holding poorly performing investments simply because they do not want to accept a loss. This may prevent them from moving their money into better investment opportunities.

Herd Behaviour

Herd behaviour occurs when investors follow the decisions of a larger group instead of conducting their own analysis.

An investor may purchase a particular stock, cryptocurrency or mutual fund simply because many other people are investing in it.

Herd behaviour often becomes stronger during periods of rapid market growth or decline. When prices increase quickly, investors may fear missing an opportunity. Similarly, when markets fall, panic selling by other investors may encourage individuals to sell their investments.

Anchoring Bias

Anchoring happens when investors rely too heavily on a specific piece of information while making decisions.

For example, an investor may purchase a share for ₹1,000 and continue believing that ₹1,000 represents its true value. Even if the company's financial position changes significantly, the investor may remain focused on the original purchase price.

This may prevent investors from objectively evaluating new information.

Mental Accounting

Mental accounting refers to the tendency of individuals to divide their money into separate categories and treat each category differently.

For example, a person may consider salary income as money that must be saved carefully while treating an investment profit or bonus as money that can be spent freely.

However, financially, money has the same value regardless of its source. Mental accounting can therefore sometimes result in irrational saving, spending or investment decisions.

Confirmation Bias

Confirmation bias occurs when investors search for information that supports their existing beliefs while ignoring information that contradicts them.

For example, an investor who strongly believes that a particular company will perform well may focus only on positive news relating to that company and ignore information suggesting declining profitability or increasing risk.

This can prevent investors from making objective decisions.

Recency Bias

Recency bias occurs when investors give greater importance to recent events than to long-term historical information.

If stock markets have increased significantly during the previous few months, investors may assume that the upward movement will continue indefinitely.

Similarly, after a major market decline, investors may become excessively pessimistic even when the long-term economic outlook remains stable.

Regret Aversion

Investors sometimes avoid making decisions because they are afraid that they may later regret them.

For example, an investor may avoid selling a poorly performing investment because the price might increase immediately after the sale.

Regret aversion can result in investors delaying necessary investment decisions.

Role of Emotions in Investment Decisions

Emotions are among the strongest factors influencing investor behaviour.

Fear

Fear generally increases during periods of economic uncertainty or declining financial markets. Investors may sell good-quality investments simply because prices are falling.

Greed

During periods of rapid market growth, investors may expect unusually high returns and take excessive risks.

Hope

Investors sometimes continue holding unsuccessful investments because they hope that prices will eventually recover.

Regret

Previous investment mistakes may influence future decisions. An investor who has experienced a significant loss may become excessively cautious and avoid potentially beneficial investments.

Therefore, emotional discipline is an important part of successful long-term investing.

Review of Literature

Behavioural finance developed as researchers began questioning the traditional assumption that investors always behave rationally.

Daniel Kahneman and Amos Tversky made important contributions through their work on decision-making under uncertainty. Their Prospect Theory explained that individuals evaluate gains and losses differently and generally experience losses more strongly than equivalent gains.

Richard Thaler further developed behavioural economics by examining how psychological factors affect economic decisions. His research highlighted concepts such as mental accounting and demonstrated that individual financial decisions are not always completely rational.

Robert Shiller examined the role of investor psychology and market sentiment in explaining fluctuations in financial markets. His work demonstrated that financial asset prices can sometimes be influenced by investor expectations, emotions and speculative behaviour.

Several subsequent studies have identified overconfidence, herd behaviour, loss aversion, anchoring and confirmation bias as significant factors influencing investment decisions.

Recent developments in digital investing have made behavioural finance increasingly important. Mobile trading platforms, financial influencers and constant access to market information may encourage investors to make faster and more emotionally influenced financial decisions.

Overall, previous research supports the view that investor psychology plays an important role in determining investment behaviour.

Research Methodology

Research Design

The study follows a **descriptive and conceptual research design**. It aims to describe and understand the psychological factors affecting investor behaviour rather than establish a direct cause-and-effect relationship.

Nature of Data

The study is mainly based on **secondary data**.

Information has been collected from:

- Academic journals
- Research articles
- Books on behavioural finance
- Financial publications
- Reports relating to investor behaviour
- Published studies on psychology and financial decision-making

Method of Analysis

The available literature has been reviewed and interpreted to identify the major behavioural biases affecting investors. The study focuses on understanding recurring patterns of investor behaviour and their possible consequences for investment decisions.

Findings of the Study

The study identifies several important observations regarding investor psychology and behavioural finance.

- First, investment decisions are not always completely rational. Emotional and psychological factors can significantly influence the way individuals respond to financial information.
- Second, loss aversion appears to be one of the strongest psychological influences. Investors may continue holding loss-making investments because accepting an actual loss creates emotional discomfort.
- Third, overconfidence can encourage investors to trade frequently and underestimate financial risks.
- Fourth, herd behaviour is particularly visible during periods of strong market movements. Investors may follow others because they believe that the larger group possesses better information.
- Fifth, investors frequently rely on previous prices, recent market performance and existing beliefs while evaluating investments. This can lead to anchoring, recency bias and confirmation bias.
- The study also finds that emotions such as fear and greed can result in investment decisions that differ significantly from an investor's original financial plan.
- Financial literacy and awareness of behavioural biases can help individuals recognise these psychological tendencies and improve their decision-making process.

Suggestions

Investors can take several steps to reduce the influence of behavioural biases.

- Investors should prepare clear financial objectives before making investment decisions. Having predetermined goals can reduce impulsive decisions caused by short-term market movements.
- A diversified portfolio should be maintained so that an investor does not become excessively dependent on the performance of a single investment.
- Investors should evaluate investments using reliable financial information rather than depending entirely on social media opinions or popular market trends.
- Investment decisions should be reviewed periodically instead of reacting continuously to daily market fluctuations.
- Maintaining an investment journal can also be useful. Recording the reasons behind investment decisions may help investors identify repeated behavioural mistakes.
- Investors should also develop an appropriate risk management strategy based on their financial position, objectives and ability to tolerate losses.
- Financial education should include behavioural finance so that individuals understand not only how investments work but also how their own emotions influence financial decisions.
- Most importantly, investors should recognise that being aware of behavioural biases does not completely eliminate them. However, awareness can help individuals pause, review their reasoning and make more disciplined decisions.

Limitations of the Study

The study has certain limitations.

- The research is primarily based on secondary information and does not involve direct responses from individual investors.
- Investor behaviour may differ according to factors such as age, income, education, financial experience and cultural background, which are not separately examined in this study.
- Financial markets are constantly changing and investor behaviour may vary depending on market conditions.
- Behavioural responses are difficult to measure because emotions and psychological factors can differ significantly among individuals.
- The study focuses mainly on commonly recognised behavioural biases and does not examine every psychological factor that may influence financial decisions.
- Therefore, future research may include primary surveys and empirical analysis involving different categories of investors.

Conclusion

Behavioural finance has changed the way investment decision-making is understood. It recognises a simple but important reality: investors are human beings, and human beings do not always make perfectly rational decisions.

Fear can encourage investors to sell during market declines, while greed may encourage excessive risk-taking when markets are rising. Overconfidence may lead to unnecessary trading, loss aversion may encourage investors to hold unsuccessful investments and herd behaviour may cause individuals to follow market trends without conducting independent analysis.

These behaviours do not necessarily mean that investors lack financial knowledge. Even experienced investors can be influenced by emotions and psychological biases.

The value of behavioural finance lies in helping individuals become more aware of these influences. Investors who understand their own behavioural tendencies may be better prepared to evaluate information objectively, maintain discipline during periods of market uncertainty and make investment decisions that are consistent with their long-term financial goals.

Ultimately, successful investing is not only about understanding markets. It is also about understanding one's own behaviour. By combining financial knowledge with emotional discipline and awareness of psychological biases, investors can develop a more balanced and responsible approach towards wealth creation.

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