

Behavioural Finance – How Psychology Influences Investment Decisions

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ABSTRACT

Behavioural finance is a sophisticated area of study that interlaces the science of psychology with traditional finance theory and delivers a thorough, rational explanation of how individual, and therefore collective, feelings, biases, and mental heuristics adulterate financial choices. As compared to the old theories of finance, where monied participants would use rational decision-making in case of unlimited information availability, behavioural finance illustrates the ways in which regularly psychology's tug entices investors into making illogical decisions leading to usual patterns and irregular activity by the market. This paper elaborates on the fundamental psychological processes guiding investment behaviour such as overconfidence, loss aversion, herding, anchoring, and mental accounting. These behavioural prejudices are akin to suboptimal investment decisions, market over-fluctuation, and bubbles. This research, with empirical observations and real-world examples, underscores the importance of behavioural finance in explaining market forces and investor conduct. In addition, it illustrates how private investors and professional money managers can utilize these results to improve risk management techniques, diversification of portfolios, and decision-making. The relevance of this work underscores the importance of the assimilation of psychological insight into investment practice and hence wiser and stronger financial behaviour in a more complex and affective marketplace.

KEYWORDS: Behavioural Finance, Overconfidence, Loss Aversion, Herding Behaviour, Anchoring, Mental Accounting, Market Anomalies, Portfolio Diversification.

INTRODUCTION

The world economy of the past decades has been an extremely unstable and complicated arena. In this situation, investors are constantly faced with the dilemma of making dangerous financial choices under uncertain circumstances, not only in light of objective market information but also in consideration of subjective psychological conditions. Mainstream finance theory, especially that based on the Efficient Market Hypothesis (EMH), takes it that investors are rational choice-makers who take in all information given and act logically consistent and utility-maximizing choices.

The rationalist assumption, the theory goes on, suggests efficient markets and always adjusting asset prices their intrinsic value.

But experience with real world events like asset bubbles, crashes in the market, and episodes of irrational exuberance have cast monolithic doubts over such a rationalist assumption. Such market deviants have exposed the inadequacies of traditional finance, opening the way to a new interdisciplinary area called behavioural finance. This area combines ideas from psychology, sociology, and neuroscience with orthodox economic theory to give a more sophisticated explanation of investor behaviour. Behavioural finance assumes that investors are not necessarily rational; instead, they are vulnerable to cognitive distortion, emotional choice, and social pressure, all of which can cause systematic and predictable errors in decision-making.

Heuristics—mental short cuts that simplify difficult choices—have a tendency to distort investor perceptions of reward and risk. Affecting choices are strong emotions such as fear, greed, and regret. And then there is the strength of peer influence, or herding, that induces most investors to follow the crowd rather than to exercise independent reasoning. Market prices therefore diverge considerably from intrinsic values, and market efficiency exists more in theory than in fact.

This study attempts to examine the extent to which psychological elements drive individual and collective investment choices to conclusions that are not necessarily economically rational. Through an examination of some of the fundamental behavioural principles like overconfidence, loss aversion, anchoring, and herding, this study attempts to shed light on some of the inherent psychological processes in investor choices. In addition, the paper also addresses pragmatic approaches that can be employed by institutions and investors in an attempt to identify and counteract the influence of behavioural biases in an effort to improve the quality and consistency of financial decision-making.

LITERATURE REVIEW

- The foundation of behavioural finance was laid by the trailblazing research of Daniel Kahneman and Amos Tversky, whose Prospect Theory (1979) demonstrated that individuals make distinct judgments regarding gains and losses that lead to risk-averse or risk-taking behaviour depending on the situation. Their work challenged the conventional supposition of utility maximization and loss aversion, where the pain caused by loss is psychologically larger than the enjoyment of a similar gain.
- Richard Thaler further advanced the field by describing key behavioural phenomena such as mental accounting, endowment effect, and status quo bias, illustrating that people prefer to partition their money into unrelated mental accounts, value owned goods more than equally valued ones that they do not own, and resist change even when it is in their own best interests.
- Barberis and Thaler (2003) provided a complete characterization of the interface between cognitive psychology and financial behaviour, with heuristics—mental rules of thumb that simplify decision making but often create overconfidence and representativeness-type biases—dominating.
- Another significant piece of work is the theory of herd behaviour, where investors imitate others rather than a unilateral decision, leading to market bubbles and crashes. This was largest featured in the dot-com bubble and the financial crisis of 2008.
- Recent studies have explored the neuroeconomic aspects of behavioural finance, using brain imaging to identify how emotions like fear and excitement influence risk-taking. Further, data analytics advancements have enabled researchers to chart behavioural patterns across investor groups and develop predictive models for market behaviour.
- In summary, the literature concludes that behavioural finance provides crucial insight into why markets do not conform to theoretical efficiency and how psychological considerations should be incorporated in individual investment strategies as well as financial policy-making.

OBJECTIVE OF THE STUDY:

1. To investigate the impact of emotional and cognitive biases on individual investing behaviour. This means examining the ways in which psychological traits such as emotion, overconfidence, and heuristics influence financial decision-making.
2. To define and list the key terms used in behavioural finance, such as anchoring, herd behaviour, and loss aversion. Giving detailed insight into the most powerful behavioural biases that cause a divergence from logical investing is the aim.

3. To offer suggestions on how investors and financial institutions can recognise and lessen the impact of behavioural biases. This would entail suggesting doable actions to improve sound investment practices and decision-making.

KEY PRINCIPLES OF BEHAVIOURAL FINANCE

Behavioural finance relies on a collection of basic psychological principles that outline how investors truly act in states of irrationality. They explain the persistent tendencies which still drive investment decisions, generating market inefficiencies and anomalies. The most widely used among them are:

1. Overconfidence Bias

Investors exaggerate their knowledge, ability, or influence over the outcome. The bias leads to over-trading, underestimation of risk, and illusory safety in making decisions, ultimately resulting in bad investment performance.

2. Loss Aversion

As revealed to us by Prospect Theory of Kahneman and Tversky, people experience loss more intensely than they enjoy equal gains. As a consequence, investors will hang on to losing stocks for extremely long periods of time or exit winning stocks too early, as an attempt to avoid regret.

3. Herd Behaviour

Investors track most moves, particularly in times of uncertainty in the market. Social verification and FOMO cause mimicry, which over-estimates market direction, forming a bubble or burst.

4. Anchoring

Anchoring is where investors over-constrain on some benchmark points—e.g., original buying price or previous stock price—while making decisions. It distorts value perception and stops rational revision on new information.

5. Mental Accounting

They respond differently to money depending on its origin, be it a bonus or wage for instance, or whether they invest it in random groups that determine the portfolio performance.

6. Confirmation Bias

Investors would look for evidence supporting their preconceived notions and evade evidence against. Selective perception here can lead the analysis going sour and in favour of low-grade investment propositions.

These principles of behaviour pinpoint why even smart investors make decisions that are contrary to rational expectations. It is crucial to understand and manage such biases if investment performance is to be improved and market stability achieved.

INFLUENCE OVER INVESTMENT CHOICES

The influence of behavioural finance over investment choices is broad and deep. Traditional models of investment depend heavily on rational models and statistical estimates of risk. Behavioural finance introduces the psychological element into the equation, demonstrating how investor actions are more inclined to be guided by biases, emotions, and social pressure rather than objective consideration.

Behavioural biases such as overconfidence will generate excessive trading and risk underestimation and lower net trading returns because of fees and timing. Loss aversion leads investors to hold losing stocks in hopes of recovery rather than cutting their losses early. Anchoring leads investors to anchor on irrelevant information, e.g., past highs or purchase prices, and ignore relevant valuation metrics. In addition, collective behaviour causes irrational buying or selling panics that form bubbles in assets or crashes in markets. These kinds of psychological flaws will lead market indicators to mispriced assets and mysterious volatility. For example, in speculative bubbles, prices rise far in excess of supportable value before brutally bursting upon investor sentiment changes. Boomerang irrationality deflates market efficiency but yields risk and opportunity.

It is necessary to understand the influence of such behavioural forces in order to formulate investment strategies that not only respond to financial data but also take into account the psychological forces driving market activity.

Challenges and Recommendations

While the significance of behavioural finance is growing, there are certain challenges that act as obstacles to its implementation in actual investment management:

1. Lack of Awareness and Education

The majority of money managers and investors don't know about behavioural bias or under-estimate its impact. The majority of finance courses are technical and non-behavioural, and that gives a gigantic gap in investor preparedness.

2. Emotional Choice Under Stress

Even experienced investors succumb to emotional choice rather than rational examination in periods of stress like market decline or unexpected windfalls. Greed and fear continue to prevail in turmoil.

3. Challenges to Self-Regulation

Investors will not be able to keep biases in check even when they acknowledge biases. They require ongoing efforts, feedback cycles, and, in most cases, professional aid.

4. Systemic Imperfections in Investment Advisory

Also, advisors become victims of a lack of awareness or inability to implement behavioural techniques in client advice, especially where they are commissioned or performance-incentive bonus-based.

RECOMMENDATIONS:

- **Strengthen Behavioural Finance Training:** Incorporating behavioural finance elements in academic training and investor education programs can create long-term awareness.
- **Use Structured Decision-Making Tools:** Decision-making tools like checklists, investment diaries, and decision matrices can remove impulsive decisions and bring discipline.
- **Rule-Based and Automated Investment:** Algorithmic portfolios and robot-advisors are solutions that reduce emotional bias by pre-set rules and diversification strategies.
- **Encourage Long-Term Investment Behaviour:** Framing investment goals in a long-term time frame reduces response to short-term market movements at the psychological level.
- **Regular Behavioural Summaries:** Investors and institutions must return to decision-making patterns on a regular basis in an effort to identify repeated biases and correct direction.

CONCLUSION

Behavioural finance demonstrates the nuanced relationship between psychology and finance judgment. Neoclassical finance is based on assumptions of market rationality and efficiency, while behavioural finance demonstrates actual cognitive and emotional processes that result in systematic judgment errors. These results are not only applicable to investor behaviour but to explaining market dynamics in general.

The study discovers that consciousness and management of psychological biases are not an ivory tower exercise per se but a practical imperative to improved financial outcomes. Whether retail investors avoiding traps or institutions crafting safer schemes, the power of behavioural finance can lead to smarter, rational, and more effective decision-making.

As global markets evolve, and as data comes to be more widespread and complex, the value of understanding the human component of finance grows ever more important. Behavioural finance thus stands at the borders between science and psychology, and offers a valuable toolset for navigating the changing characteristics of investments.