

Investor Psychology and Market Bubbles: A Behavioral Finance Perspective

Submitted by
Arshit Gupta
22GSOB1010379

SCHOOL OF BUSINESS

UNDER THE SUPERVISION OF
Dr. Rashmi Mittal
Designation: Faculty, School of Business

GALGOTIAS UNIVERSITY

ABSTRACT

Through the lens of behavioural finance, this study explores the significant impact of investor psychology on irrational decision-making and the formation of market bubbles. Real-world market behaviour frequently reveals a different picture, one that includes emotions, cognitive shortcuts, and psychological biases, in contrast to traditional financial theories that assume investors behave rationally and always aim to maximise returns. Through the use of a mixed-method research design that combines secondary sources like academic literature and real-world case studies with primary data from investor surveys, this paper aims to reveal how emotions like overconfidence, greed, and fear significantly influence financial decisions. The study validates important theories like Prospect Theory and Herd Behaviour by highlighting behavioural patterns like emotional contagion, herd mentality, and loss aversion.

The insights gained are valuable not only for **investors**, but also for **financial advisors**, **educators**, and **policy-makers** who aim to foster more rational and informed investing behavior.

1. INTRODUCTION

Although statistics may rule the financial markets, the underlying currents are frequently driven by human behaviour. The study of how people feel and think when making investment decisions is known as investor psychology. Behavioural finance recognises that actual investors frequently make decisions impacted by emotions, biases, and cognitive shortcuts, in contrast to traditional finance models, which are predicated on the idea that people are rational, self-interested agents.

This essay aims to comprehend how common psychological factors, such as herd mentality, overconfidence in one's knowledge, and fear of losing money, can result in irrational financial decisions. In addition to having an impact on individual investors, these actions can also cause broader market phenomena like speculative bubbles, in which asset values rise sharply above their intrinsic value before plummeting.

Through this exploration, the paper aims to bridge the gap between psychological theory and financial practice, offering a more realistic view of how markets actually function.

2. LITERATURE REVIEW

Over the past few decades, the field of behavioural finance has expanded dramatically as many academics have drawn attention to the ways in which psychological factors skew financial judgement.

Prospect Theory, developed by Kahneman and Tversky in 1979, established the groundwork by demonstrating that people typically fear losses more than they value comparable gains—a phenomenon known as loss aversion.

Through mental accounting, Thaler (1985) deepened our understanding of how people irrationally classify money,

treating bonuses differently than salaries, for example.

Barber and Odean (2001) demonstrated how overconfidence, especially in male investors, frequently leads to excessive trading, which paradoxically lowers returns.

Robert Shiller (2000) popularised the idea of irrational exuberance, blaming emotional investing and widespread overoptimism for significant market bubbles.

- **Bikhchandani et al. (1992)** described **herd behavior**, where investors mimic others' actions even when it's against their own analysis or best interest.

These studies provide strong evidence that psychological factors can lead to widespread market anomalies, contradicting the rational assumptions of traditional finance models such as **Efficient Market Hypothesis (Fama, 1970)**.

3. RESEARCH METHODOLOGY

To investigate the role of psychology in investment behavior, a **mixed-method** approach was adopted:

- A self-administered online questionnaire was used to collect primary data. 51 retail investors, both new and seasoned, were the target of the survey. It included closed-ended questions that measured psychological tendencies using Likert scale and dichotomous (Yes/No) formats.
- A comprehensive analysis of academic publications, peer-reviewed journals, and documented case studies was used as secondary data to give findings a theoretical foundation and compare them to more general trends.

By concentrating on emotional and cognitive factors rather than just economic ones, the descriptive research design made it possible to analyse behavioural patterns among respondents in a straightforward manner.

4. DATA ANALYSIS AND INTERPRETATION

The survey responses uncovered some telling patterns:

- A noteworthy 78.4% of participants stated that their prior investment experiences impacted their present choices, highlighting the importance of emotional memory and anchoring.
- Approximately 63% of respondents acknowledged that they have made some investment decisions due to fear, such as FOMO or fear of losing money.
- Almost half reported feeling anxious during periods of market turbulence, which frequently caused them to forego potentially lucrative opportunities or prematurely withdraw their investments.
- Rather than using only logical analysis, 60.7% of respondents used a combination of reasoning and emotion, underscoring the internal conflict that many investors experience.

These findings resonate with established behavioral finance principles. For example, **loss aversion** was evident in fear-driven decisions, while **emotional contagion**—where widespread anxiety or excitement spreads through investor groups—was reflected in the high incidence of stress during volatile markets.

5. LIMITATIONS

While the study provides valuable insights, several limitations must be acknowledged:

- The non-random sampling technique limited the results' generalisability; the sample size of 51 respondents is small and might not be representative of the larger investor population.
- The validity and reliability of the questionnaire were not examined, which may have impacted the accuracy of the data.

- Because it was self-reported, the data is also susceptible to response biases, where participants may not always disclose their true feelings or past behaviour; the focus was primarily on retail investors, excluding institutional or high-net-worth individuals who may behave differently due to access to more resources and expertise.

6. CONCLUSION

The fundamental principle of behavioural finance—that investors are not always logical—is reaffirmed by this study. Investment behaviour is greatly influenced by psychological biases, especially fear, overconfidence, and herd mentality, which frequently result in irrational decisions and the creation of market bubbles. Building more successful investor education initiatives, creating realistic advisory models, and developing regulatory policies that take human behaviour into consideration all depend on an understanding of these tendencies.

The impact of psychology will probably increase as financial markets become more widely available via social media and digital platforms. Future studies should therefore look into these patterns of behaviour in a variety of investor profiles, including institutional players, and take into account longitudinal research to see how these behaviours change over time.

REFERENCES

- Barber, B. M., & Odean, T. (2001). *Boys will be boys: Gender, overconfidence, and common stock investment. The Quarterly Journal of Economics*, 116(1), 261-292.
- Bikhchandani, S., Hirshleifer, D., & Welch, I. (1992). *A theory of fads, fashion, custom, and cultural change. Journal of Political Economy*, 100(5), 992-1026.
- Fama, E. F. (1970). *Efficient capital markets: A review of theory and empirical work. Journal of Finance*, 25(2), 383-417.
- Kahneman, D., & Tversky, A. (1979). *Prospect theory: An analysis of decision under risk. Econometrica*, 47(2), 263–291.
- Shiller, R. J. (2000). *Irrational Exuberance*. Princeton University Press.
- Thaler, R. H. (1985). *Mental accounting and consumer choice. Marketing Science*, 4(3), 199-214