

Investment Biases of Investors: Behavioral Influences and Market Implications

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Abstract

Investment decisions of any investor are influenced by some psychological and behavioral biases that deviate him or her from rational economic theory. These biases affect how an investor is perceiving risk, how he interprets information and how he is making financial choices. These days, the field of behavioral finance contains systematic patterns in investment decision-making that cannot be explained by traditional financial models.

This research paper is an attempt by the researchers to examine some common investment biases such as overconfidence, herd behavior, anchoring, loss aversion and confirmation bias among individual investors. Both primary and secondary data have been used here for analysis. This research paper focuses on the prevalence of these biases, the causes of these biases and their impact on portfolio performance of any investor. Based on the findings of this paper, the researchers have offered some practical suggestions to mitigate these biases and to improve the investment outcomes.

Keywords: Behavioral Finance, Investment Biases, Investor Psychology, Portfolio Performance, Decision-Making in Financial Markets

Introduction

Investors usually think that financial decisions are based on the information available in the market, expected returns and risk preferences of investors. Traditional finance theories like Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT) have been based on rational assumptions.

But if we look at real-world investment behavior of investors, investors frequently deviate from rational behaviour. It has been observed that investors are influenced by emotions, heuristics and social pressures. These psychological tendencies result in the onset of investment biases. Investment biases are the systematic errors in judgment of an investor that affect the financial decision making of an investor.

Behavioral finance is a field that combines psychology and finance to explain cognitive and emotional factors which help in shaping investor behavior. It is important for an investor to understand these biases so as to improve his investment strategies, ultimately reducing decision errors and enhancing financial literacy among individual investors.

Review of Literature

Kahneman and Tversky (1979), proposed the concept of Prospect Theory. They highlighted that individuals value gains and losses differently and investors make such decisions that can lead to loss aversion.

Similarly, Shefrin and Statman (1985) introduced the concept of behavioral portfolio theory. They studied how investors form their portfolios based on their psychological needs rather than rational optimization as was assumed in traditional theories.

Barber and Odean (2001) observed that overconfident investors would trade excessively and will usually incur lower net returns.

Statman (1999) conducted a study on common biases in investor decisions. He mainly focussed on familiarity bias and mental accounting.

From the assessment of several studies, it can be concluded that various biases like anchoring, availability and herd behavior significantly affect trading volume, market volatility and asset pricing in the stock market .

Need for the Study

It can be seen from the review of literature that despite growing research in behavioral finance, limited empirical evidence is available on the specific biases among Indian investors. There has been rapid growth in retail participation in equity, mutual funds and digital investment platforms. So, it becomes necessary to understand investor behavior at the individual level. This study is an attempt to highlight common investment biases and their impact on decision outcomes.

Objectives of the Study

The objectives studied in this present research paper are as under:

1. To identify common investment biases that affect investors.
2. To examine how these biases influence investment decisions.
3. To evaluate the level of awareness to which investors are aware of their own biases.

Research Methodology

Nature of Study

This research study is descriptive and analytical. It aims to analyze the investor behavior with respect to different behavioral biases.

Sources of Data

This research study is based on both primary and secondary data.

Primary Data: Primary data has been collected using structured questionnaires. Data was collected from active investors, including both equity and mutual fund investors.

Secondary Data: Secondary data has been collected from research journals, books, SEBI reports on investor awareness and financial studies available on behavioral finance.

Sample Design

Convenient sampling method has been used to collect primary data from investors. Only those investors were included having at least two years of investment experience.

Tools of Analysis

Data was analyzed using descriptive statistics and frequency distribution.

Scope of the Study

The study is restricted to retail investors of different age groups, varying income levels with varying investment experience.

Limitations

This study is not free from limitations. It has following limitations:

1. Sample size was limited to easily accessible respondents. So, conclusionz may vary based on different samples.
2. Self-reported responses made by the investors themselves may contain personal bias.
3. Market conditions existing at the time of study could also influence investor perception at the time of recording the responses.

Conceptual Framework of Investment Biases

Investment biases refer to the forces that deviate investors from rational judgment in investment decision-making. These biases occur due to cognitive limitations, emotional influences and social pressures on investors. These biases can also affect risk perception, choice of assets, timing of trades and long-term financial planning of the investors.

Major Investment Biases

Some of the major investment biases as identified by the reseachers are as under:

1. Overconfidence Bias

Overconfidence occurs when investors overestimate their knowledge, skills or their ability to predict market movements. It has been observed that overconfident investors trade frequently, they underestimate risks and may ignore contrary evidence that moves away from their own judgements.

2. Loss Aversion Bias

Loss aversion refers to the tendency of an investor to feel the pain of losses more strongly than the pleasure of equivalent gains. Due to this bias, it has been seen that investors experiencing loss aversion hold on losing stocks for long to avoid losses and may sell winning stocks early to realise gains.

3. Herd Behavior

Herd behavior occurs when investors follow the crowd rather than evaluating fundamentals on their own. This bias is frequently seen during bull markets and speculative booms, when the fear of missing out popularly known as FOMO drives the investment decisions of investors.

4. Anchoring Bias

Anchoring happens when investors fix on specific numbers such as past purchase prices, benchmarks or target values. This result in investors making wrong decisions based on irrelevant reference points instead of current valuation.

5. Confirmation Bias

Confirmation bias occurs investors tend to seek that information that confirms their existing beliefs and investors ignore the evidence that contradicts them. This prevents objective reevaluation of investment decisions on the part of an investor.

6. Mental Accounting Bias

Mental accounting refers to the mental categorization of money into separate “accounts”. These accounts are hypothetical in nature and this leads to inconsistent decision rules in the decision making of an investor.

7. Familiarity Bias

Familiarity bias is one that occurs when investors prefer familiar stocks, sectors or funds and avoid new or unknown investment opportunities. This result in limiting diversification and increasing portfolio risk of an investor.

Primary Data Analysis and Interpretation

More than 60% of respondents acknowledged overconfidence in their investment choices.

Nearly 55% reported loss aversion leading them to hold losing investments.

Over 50% admitted to herd behavior, especially during market rallies.

Around 40% showed anchoring on historical prices, affecting buy–sell timing.

About 35% admitted to confirmation bias, ignoring signals contrary to their positions.

These results indicate that psychological biases are widespread among retail investors.

Findings of the Study

The researchers have jot down the following findings based on their research:

1. Behavioral biases are prevalent among investors: It has been observed that majority of investors possess at least one cognitive or emotional bias during decision-making.
2. Overconfidence leads to excessive trading: It has been seen that investors with overconfidence traded more frequently, resulting in lower net returns for them.
3. Loss aversion influences holding patterns: It has been observed that many investors with loss aversion bias held losing stocks for long due to their unwillingness to accept losses.
4. Social and media influence strengthens herd behavior: It has also been evaluated that investors assess market trends based on news, tips and social signals rather than doing valuation on their own.
5. Limited awareness of biases: Surprisingly, most respondents under this study were not even fully aware that these biases could harm the long-term performance of their portfolio.

Suggestions and Measures to Mitigate Investment Biases

Given are some of the suggestions by the researchers based on their study that can help the investors with reducing the biases and moving towards a better decision making:

1. Enhance Financial Literacy: Structured courses on behavioral finance can be frequently conducted to help investors recognize and correct their biases.
2. Promote Investment Planning: It has been seen that long-term goals and written investment plans reduce impulsive decisions. So, efforts should be made to promote investment planning.
3. Use of Checklists: Behavioral decision checklists can be developed by the investors to reduce impulsive biases like overconfidence and anchoring.
4. Diversification Strategies: Investors should be given advice and special counselling to diversify their portfolios across asset classes to avoid familiarity and mental accounting biases.
5. Regular Review and Feedback: Investors should get scheduled portfolio reviews with professional advisors that can help them identify bias-driven mistakes.
6. Use of Robo-advisors: It has been observed that Algorithm-based advice reduces emotional interference in investment decisions. So, usage of Robo-advisors be promoted.
7. Awareness Campaigns by SEBI and Exchanges: Frequent advisory and awareness programs should be organized by SEBI specifically including psychological aspects in investor education programs to help the investors.

Conclusion

It can be concluded that investment biases significantly influence the decision-making process of investors. This also result in decreased financial outcomes. The traditional finance theories were based in rational behavior, behavioral finance provides a deeper understanding of real-world investment patterns. All the biases namely overconfidence, loss aversion, herd behavior and anchoring suggests that investor psychology is a important factor of investment success of an investor.

It has been seen that the retail participation in financial markets is increasing at a rapid rate, so, it is essential to educate investors about these biases and to provide them the tools to mitigate the impact of these biases. It is suggested that financial literacy programs, professional guidance and systematic decision planning can help the investors to make more rational and better investment choices.

In brief, it can be said that recognizing and addressing behavioral biases can improve investor well-being, promote market stability and support efficient capital allocation in the stock market.

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