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Analysing Traits between Behavioural Finance and Investment Decision-Making.

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ABSTRACT:

This research paper delves into the intricate relationship between behavioral finance and investment decision-making, aiming to unravel the psychological factors that influence individuals in the financial realm. Traditional economic theories have long assumed rational decision-making, yet behavioral finance provides a nuanced perspective, acknowledging the profound impact of cognitive biases and emotions on financial choices. The paper systematically explores key behavioral concepts such as overconfidence, loss aversion, anchoring, herding behavior, confirmation bias, regret aversion, mental accounting, and recency bias. The impact of these Behavioural biases on investing strategies, portfolio management, and overall financial results is explained in the study. It highlights the propensity of investors to stray from reason, which can result in less-than-ideal choices and occasionally inefficiencies in the market. Investors can develop ways to lessen the effects of cognitive biases and obtain important insights into the workings of the financial markets by comprehending these Behavioural subtleties. The article also covers doable strategies that investors might use to use Behavioural insights to their decision-making. Education becomes a crucial instrument that enables people to identify and overcome prejudices. A long-term outlook, strict adherence to investment plans, and diversification techniques are suggested as useful tools for overcoming the difficulties caused by Behavioural biases.

1. INTRODUCTION:

Making decisions in difficult situations is an art. Selecting an alternative from a range of potential possibilities requires cognitive processing. It is not sufficient to base a decision solely on one's own resources. A vision or a decision-making action may emerge from the process. Making decisions without careful forethought can be reasonable, but things may not work out as planned. Through analysis, a manager's mental approach mediates the various issues that arise in various processes. Making decisions is really a special kind of art that involves selecting one option from a range of options. Furthermore, we can state that it is a procedure that is being carried out by the well examined and assessed alternatives. Managers need to be up to date in a variety of areas if they hope to succeed in the demanding corporate world. (Jahanzeb, Oct 2012). In the intricate landscape of financial markets, the traditional assumption of rational decision-making has long guided economic theories and investment paradigms. However, the realm of finance is undeniably intertwined with the intricate workings of the human mind, where cognitive biases and emotions often wield a profound influence on decision-making processes. This intersection between psychology and finance forms the crux of behavioural finance, a field that challenges the conventional notion of purely rational actors in the financial arena. Conventional finance advises investors to weigh risk and return before making an investment to maximise profits afterward. Behavioural finance, on the other hand, challenges conventional finance by introducing psychological elements that influence decision-making. (Sattar, April 14, 2020). This study aims to explore the complex interrelationships between behavioural finance and investment decision-making by separating out the psychological and economic strands that are interwoven. It is becoming more and more important to comprehend the human variables that influence market dynamics as financial markets continue to grow in complexity. Behavioural finance offers a sophisticated perspective for examining the intricacies involved in making investment decisions, since it focuses on clarifying the behavioural biases that influence financial decisions.

2. OBJECTIVE OF THE STUDY:

- Identify and characterize the specific behavioural traits exhibited by investors in the Indian context within the framework of behavioural finance.
- Investigate whether there are variations in behavioural traits across different sectors within the Indian market and investigate the role of regulatory frameworks in shaping behavioural traits among Indian investors.

3. RESEARCH METHODOLOGY:

First-time data collection is referred to as primary data. Primary data has been gathered via the questionnaire method. Likert scales are used to generate closed-ended questionnaires. The questionnaire responses have given the researcher the ability to forecast this field's future. This is due to the behaviour's

analysis patterns and the degree to which these influence people's and markets' investment decision-making been enabled by the outcomes. One of the goals of this study is to make predictions on the topic of behaviour finance. Additionally, the researcher will be able to comprehend the significance of behaviour finance as a developing. Using this extensive research approach, the study hopes to close the knowledge gap between theory and the real-world application of behavioural finance in India's investment decision-making process by offering detailed insights into the characteristics of these processes.

4. REVIEW OF LITERATURE:

Review of Behavioural finance as an emerging field of investment decision making written by Anjum Raza, published by IOSR Journal of Business and Management (IOSR-JBM), Volume 16, Issue 6. Ver. II (Jun. 2014) (Raza, Jun 2014). Despite having evolved primarily from economics, finance has a tendency to ignore its own academic past. A crucial link between two significant schools of thought, one in finance (behavioural finance) and the other in economics (institutional economics), seems to have been completely neglected, possibly as a result of this lack of focus on its intellectual history. There are a lot of similarities between the two philosophical traditions. A strong financial framework known as behavioural finance is currently being developed. While upholding the scientific rigour that standard finance brought, it substitutes some aspects of standard finance and adds new ones as well as creates links between theory, evidence, and practise.

Application of Behavioural Finance Concepts to Investment Decision-Making: Suggestions for Improving Investment Education Courses by Maleyeff, John published in International Journal of Management; Poole Vol. 30, Is 1, (Mar 2013) (Maleyeff, March 2013) Investors in individual equity funds have historically had significantly lower financial returns in comparison to the equity marketplace. Underperformance by investors has persisted over time and is unaffected the state of the market. Due to its presumption that investors act rationally when making judgements about their investments, classical investment theory is unable to explain this phenomenon. This study investigates the causes of stock investors' poor performance and provides guidance for instructors of beginning investment courses. It employs data-driven decision making and behavioural finance ideas, and for illustrative purposes, it uses daily returns from the Standard & Poor's (S&P) 500 index. Even though beginning investment textbooks typically offer data in the form of historical returns and risk measures of different asset classes, they rarely provide a sophisticated explanation of the statistical behaviour of these data.

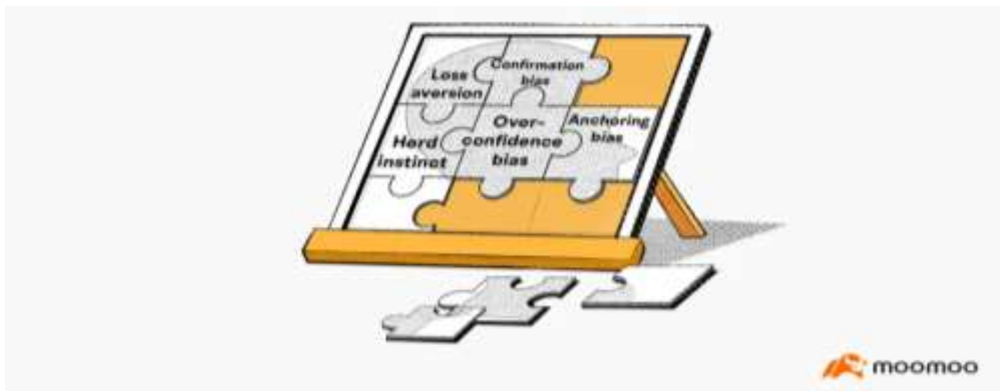
A study by “Geetika Madaan” and “Sanjeet Singh” (Madaan, June 26, 2019) and Empirical research revealed recurring patterns of irrationality that resembled how individual investors make decisions when faced with risk and uncertainty when information is not completely available to them in that situation. The existence of the four common behavioural biases in the stock market and portfolio selection during decision-making has also been documented. Their existence raises the cost of transactions and causes an excessive volume of trade. The current study also sheds light on market psychology, revealing why investors occasionally choose not to buy or sell stocks at all and why making these decisions is the biggest obstacle facing investors.

Role of Behavioural Finance in Investment Decision – A Study of Investment Behaviour in India by Dr. Vinay Kandpal in International Journal of Management Studies Vol.–V, Issue –4(6), October 2018 (Kandpal, october 2018) In India decisions about investments are influenced by perception, word-of-mouth, and past performance. To be honest, long-term investments are not properly planned for or reviewed in detail, and decisions about investments are made swiftly rather than carefully. To address this issue, this study focuses on how various investors' behaviours affected Indian investors' decisions to make investments. In the Indian capital market, behavioural finance is seen as a crucial component of every investment decision. To become a great investor, one must understand their own psychology when it comes to evaluating the various investment options available in the Indian capital market and making the conclusion regarding which one is the best.

5. FIVE BEHAVIOURAL BIASES AFFECTING INVESTMENT DECISIONS:

- **Loss Aversion:** When investors concern more about losses than gains, it is known as loss aversion. Some investors may therefore desire a larger dividend to make up for their losses. Even if an investor with reasonable sense would find the investment's risk tolerable, they may attempt to prevent losses entirely if the big reward is unlikely. When investors sell their successes and hold onto their losers, a phenomenon known as the "disposition effect" might result from loss aversion. Investors seeking rapid returns take this action. However, many would prefer to hang onto an investment when it is losing money to recover their initial outlay.
- **Anchoring Bias:** It indicates that certain investors have a propensity to rely too much on an arbitrary benchmark, like the sticker price or purchase price. Due to their tendency to attach their fair value estimate to the original purchase price rather than to fundamentals, market participants who exhibit anchoring bias often maintain investments that have lost value.
- **Herd Instinct:** The phenomenon known as "herd instinct" occurs when people join organisations and imitate others' behaviour because they believe that other people have already done their study. In the financial industry as well as other spheres of society, investors frequently succumb to herd tendencies and follow the actions of their peers instead of completing independent research. It is thought that herd instinct at scale manifests itself in asset bubbles or market crashes caused by panic buying and panic selling.
- **Overconfidence Bias:** Being overconfident in our skills leads us to take unwarranted risks, which is known as overconfidence bias. This bias can have a significant impact on capital markets and is prevalent in behavioural finance. Being overconfident involves two things: believing that the knowledge you have is accurate and that you can act on it promptly to maximise your benefits.

- **Confirmation Bias:** In cognitive psychology, the term "confirmation bias" refers to people's innate preference for information that supports their preexisting ideas. Behavioural finance specialists have discovered that market participants are particularly affected by this basic idea. Investors look for evidence or facts that support their preexisting beliefs, disregarding contrary information. Their own cognitive biases may thereby lessen the significance of their choices. (Moomoo, 2023)



Source: (Moomoo, 2023)

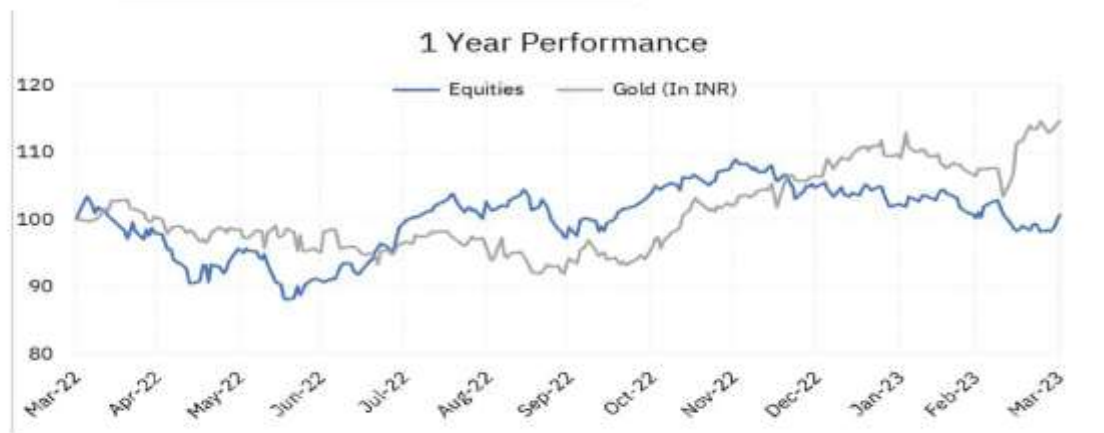
6. STRATEGIES TO OVERCOME BEHAVIOURAL BIASES THAT AFFECT INVESTMENT DECISIONS:

- **Overconfidence Bias:** Make more investments and less trades. Recognise that when you trade, you are competing with machines, institutional investors, and people all over the world who have access to greater data and more expertise than you. The chances are stacked heavily in their favour. Taking advantage of dividends, mirroring indexes, and extending your time horizon will probably help you accumulate money over time. Fight the impulse to think that your knowledge and instincts are superior to those of other people in the market. (Parker, 2023)
- **Loss Aversion:** Establish unchangeable trading guidelines. For instance, give up the position if a stock trade loses a specific proportion of its value. Establish a trailing stop that will lock in winnings in the event that the trade loses a predetermined percentage of its gains if the stock moves over a given threshold. Make these levels unbreakable guidelines and avoid making emotional trades. (Parker, 2023)
- **Herd Instinct:** If you spot a trend, chances are the market saw it coming and took advantage of it before you did. Purchasing at the peak or timing your purchase to watch the stock's value decline, carries a risk. Follow Warren Buffett's lead and purchase when people are afraid and sell when they are confident to take advantage of an inefficiency. It's unusual that following the herd pays off in big ways. Humans have a hard time separating themselves from market psychology and herding behaviour. Making an impartial, objective plan and following it through to the conclusion is a smart method to avoid following trends. Establish your departure criteria in advance and don't stray from them. To prevent this prejudice, contrarian approaches or passive indexing can be employed. (Parker, 2023)
- **Anchoring Bias:** People should actively practise awareness and recognise when a certain reference point may be overly affecting their decisions in order to reduce anchoring bias. Accepting the intentional endeavour to weigh several anchors prior to making a choice can assist in releasing the hold on a single point and promote a more thorough assessment. Anchoring bias is further countered by regularly updating information and reevaluating decisions considering new knowledge. By bringing a variety of viewpoints into the decision-making process, seeking feedback from others, and encouraging collaboration at both the individual and institutional levels can lessen the influence of personal biases.
- **Confirmation Bias:** People should actively look for evidence that contradicts their preexisting opinions or preferences to combat confirmation bias. Being a "devil's advocate" and purposefully challenging one's own beliefs helps counteract the inclination to look for data that confirms one's beliefs. A more comprehensive grasp of a problem can be achieved by actively absorbing opposing viewpoints and diversifying your sources of information. Confirmation bias can be recognised and lessened by instituting structured decision-making procedures at both the individual and institutional levels, with an emphasis on objective standards and red teaming—the process by which an impartial group evaluates decisions critically.

7. HOW DOES INVESTORS' PREFERENCE FOR RECENTLY OUTPERFORMING ASSET CLASSES OR INVESTMENT SCHEMES STEM FROM RECENCY BIAS?

It is customary for investors to gravitate towards assets that have lately outperformed one another in the realm of investing. Recency Bias is the term for this tendency, which stems from the brain's innate propensity to seek short cuts while making decisions. For instance, given its recent outperformance, gold will appear to be a better investment if we compare the performance of equities and gold over the last year.

1-year performance of equities and gold (In INR)



Source: (Kaswa, 2023)

Historical performance of equities and gold (In INR) since 1999

Source: (Kaswa, 2023)

But when we pan out and examine these asset classes' long-term performance since 1999, we see that stocks have returned 20x as much as gold has, which is only 14x. This emphasises how crucial it is to invest with a long-term perspective and avoid being influenced by short-term results. It's also critical to keep in mind that creating a well-rounded portfolio requires diversification. Including a variety of asset classes, like gold, can help disperse risk and possibly increase long-term returns.

How can investors make sure that current events don't affect the way they invest?

In order to combat recency bias when making financial decisions:

- Pay more attention to the investment's underlying principles and long-term growth prospects than to passing trends.
- Refrain from excessively monitoring investment results as this may result in rash and emotional choices.
- Look for different viewpoints and insights from reliable sources, such fund managers, financial advisors, or seasoned investors.

8. EXAMINE THE INVESTING DECISION-MAKING PROCESSES FROM BOTH AN INSTITUTIONAL AND AN INDIVIDUAL STANDPOINT.

When considering investment decisions from both an individual and an institutional perspective, complex dynamics are present in the decision-making processes. Emotional elements, such as fear and greed, can significantly impact an individual's sense of risk and return. The landscape of the individual investor is frequently characterised by limited resources, both temporally and financially. This has an impact on the breadth of research and the efficaciousness of diversification. Financial objectives that are short-term in nature, such home ownership or school funding, can influence decisions

made by individuals and highlight a certain time frame. Furthermore, individual investors—who frequently make their own investment decisions—often adopt a hands-on approach. On the other hand, institutional investors, including pension funds and endowments, use a multi-layered, intricate decision-making process that involves expert managers and investing committees. Institutional decision-making is characterised by its long-term orientation and careful planning of strategic asset allocation to satisfy long-term investment horizons. The intricate nature of risk management at the institutional level is highlighted by the need for sophisticated systems and regulatory compliance. Because of economies of scale, institutions may access more investment opportunities, and their decision-making is characterised by a dedication to maximising profits within predetermined risk parameters as well as adherence to fiduciary responsibilities. Notwithstanding these distinctions, to make well-informed judgements, individual and institutional investors alike must traverse the constantly shifting terrain of market conditions, modifying their approaches, and utilising technical tools. Gaining a thorough knowledge of the complex realm of investment decision-making requires an understanding of these various points of view.

9. CONCLUSION:

The detailed interaction of psychological elements in influencing financial decisions is revealed by comparing the characteristics of behavioural finance and investment decision-making. The theoretical underpinnings of behavioural finance have been examined in this study, which has also highlighted the significance of psychological biases and clarified the shortcomings of conventional financial theories. Investigations into behavioural biases, like confirmation and anchoring bias, have yielded important new understandings of how these biases emerge in actual investing situations. Behavioural factors unquestionably impact the decision-making processes of investors, whether they are institutional investors managing large portfolios or individual investors addressing personal financial goals. The emotional aspects, resource constraints, and short-term orientation of individual investors highlight potential obstacles and highlight the importance of awareness and strategic decision-making. However, institutional investors have distinct challenges that call for strict risk management and adherence to fiduciary responsibilities because of their intricate decision-making processes, regulatory commitments, and long-term orient.

There have been stated strategies to counteract confirmation and anchoring biases, from structured decision-making processes to diversified information-seeking and awareness-building. These tactics give institutional and individual investors useful tools to improve the objectivity and rationality of their decision-making. It is becoming more and more important to comprehend the complex interplay between behavioural finance and investment decision-making as financial markets continue to change. The knowledge gained from this study adds to the body of knowledge regarding these dynamics in academia and provides practical suggestions for field practitioners. To promote a more knowledgeable, robust, and adaptable approach to investing decision-making in the future, it will be essential to recognise the existence of behavioural features and put mechanisms in place to combat them. This study emphasises how crucial it is to continue incorporating behavioural insights into the larger field of finance, promoting a comprehensive and nuanced viewpoint that acknowledges the critical influence of human psychology on the financial world.

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