



Understanding Investor Behaviour: Insights from Behavioural Finance in the Indian Context

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ABSTRACT

This study examines how behavioural biases, particularly those related to herd behaviour, loss aversion, and overconfidence, affect individual investors in India. It casts doubt on established financial theories such as the Efficient Market Hypothesis (EMH) and highlights the necessity of incorporating behavioural finance knowledge. The study highlights the value of discipline, awareness, and education in reducing typical biases and their effects on investing decision-making. Based on an extensive examination of the literature, which includes works by Ansari (1994), Kahneman and Tversky (1979), and other scholars, it assesses the theoretical consequences of behavioural finance and provides investors with practical approaches. Insights into changing investor behaviour are gained by examining recent trends such as growing dependence on automated investment services, rise in sustainable investing, and technological integration.

Keywords: Behavioural finance, Investor biases, Investment decision-making, Traditional finance theories, Recent trends.

INTRODUCTION

The administration, development, and study of money, investments, and assets are all included in the vital discipline of finance. It centres on the long-term distribution of resources among people, organisations, and governments. Financial markets are essential for the growth and stability of the economy because they make it easier to exchange assets like stocks and bonds. A fundamental component of finance is investing, which is the allocation of funds to assets with the expectation of profit. Conventional financial models presume that decisions are made rationally, while behavioural finance indicates that decisions can be greatly influenced by psychological biases. This research examines the impact of behavioural characteristics on individual investors in India, specifically focusing on herd behaviour, loss aversion, and overconfidence. Information is crucial because information helps investors identify biases, supports financial advisers in giving tailored advice, helps businesses build new products, and helps regulators create protective measures, enriches academic discourse, and guides policymakers in stabilizing markets.

THEORETICAL IMPLICATIONS OF THE STUDY

Theoretical implications cast doubt on established finance theories, such as the Efficient Market Hypothesis (EMH), which is predicated on rational investor behaviour and market efficiency. The field of behavioural finance applies psychological principles to decision-making, emphasising the role of biases such as anchoring and overconfidence in making predicted mistakes. An alternative to anticipated utility theory called prospect theory demonstrates how different people value gains and losses. These revelations make it necessary to reassess asset pricing methods and comprehend how investors perceive risk. Beyond market anomalies, behavioural finance influences public policy, business decision-making, and market microstructure. Biases can impact market processes, company strategy, governance, and regulatory frameworks. Acknowledging these prejudices results in improved governance frameworks and investor protection laws. By recognising human flaws, behavioural finance expands on conventional finance by improving our comprehension of investor behaviour and market dynamics. It offers a more thorough perspective by including psychological elements, which explains market oddities and directs sensible investment methods and policies. Investment decisions are heavily influenced by behavioural biases such as loss aversion, anchoring, and overconfidence. Loss aversion makes investors prioritise avoiding losses above generating gains, overconfidence fuels excessive trading and market volatility, and anchoring distorts judgement based on preliminary data. Asset booms and collapses are brought on by herd behaviour, which raises market volatility. Finally, by including human behaviour, offering insights into market dynamics, and directing sensible investment plans and policies, behavioural finance challenges conventional finance theories. It is essential for investors, advisers, businesses, regulators, academics, and politicians to comprehend behavioural biases.

OBJECTIVES OF STUDY

1. To comprehensively identify and analyse behavioural biases prevalent among investors.

2. To critically evaluate the impact of these biases on investment decision-making processes.
3. To compare traditional finance theories with behavioural finance insights for a holistic understanding.
4. To offer actionable strategies and tactics for effectively mitigating these behavioural biases.

LITERATURE REVIEW

1. Ansari. M.N.A (1994) – *“Stock market reforms- Replacement of Badla of Future and Options”*- the study makes a comparison of modern-day stock market theory over traditional systems on distinguishing the Badla system and the future and options exploring the factors driving the changes. This study has given valuable insights into financial system evolution offering lessons for market development and issues necessitating reforms in the stock market to support futures and options trading. The study concludes the transition to be the need of market, as economic reforms are the only way for modernization success to deal with risk capital venue for investors.
2. Kahneman D and Tversky A (1979) - *“Prospect Theory: An analysis of decision under risk”* The study makes the case that the expected utility theory falls short of explaining risk-averse decision-making, which inspired the creation of prospect theory, an alternative model. The authors suggest an alternative theory that provides value to gains and losses, replacing probability with decision weights. When there are profits, the value function is concave; when there are losses, it is convex and steeper. Two themes emerge from the analysis of risky options: judgmental principles that regulate the assessment of gains and losses and the weighting of uncertain outcomes, and editing procedures that determine prospect perception.
3. Sarika keswani, Vipra Dhingra & Bharti Wadhwa (2019) - *“Impact of behavioural factors in making investment decisions and performance: Study on investors of national stock exchange”*- the study explores the four behavioural factors on investment decisions on the national stock exchange (NSE). These factors include herding, market, prospect and heuristic variables. The capital markets are been mentioned to be the essential part of financial sector for modern economies to deal with savings and mobilization of economic growth. The findings of the study indicate that, there is cycle of dependency among the behaviour of individual investors where the variables together constitute the decision and decisions in turn influence the performance of the stocks held. While on the other hand, performance determines the rate of return or satisfactory level of investors.
4. Kartasova. J (2013) – *“Factors forming irrational Lithuanian individual investor’s behaviour”* The purpose of the study was to determine the irrational behaviour of investors in Lithuania on considering its forming factors that impact investors decisions and its overall reflection on stock market. The researcher identified the correlation between the investment information factors and the personal traits of investors. The results concluded that the individual investors to be more influenced by basic behavioural biases that are dependent on personal characteristics such as age, experience, gender and profession.
5. Bisen. V and Pandey. M (2013) - *“Applying behavioural finance by analysing investor behaviour in Lucknow city”* – the study investigates psychological factors influencing individual investors decision making with the help of contrasting standard and behavioural theories in finance. With the total of 165 responses and post its hypothesis analysis, the study identifies loss aversion to be the factor emphasizing investors differential behaviour during market losses and gains. The study also reveals the relevance of anchoring theory of Indian investors on recommending a need for holistic analysis and cautious reliance on information.

COMMON BEHAVIORAL BIASES IN INVESTING

Overconfidence is one such bias, when investors frequently overestimate their knowledge, skills, and aptitude for forecasting market moves and making profitable investing choices. Due to this overestimation, investors frequently incur unwarranted risks or place bets based on inaccurate or skewed information. Overconfident investors might get less than ideal results from their investments because they think they have special knowledge or skills that make them stand out from the competition. Another prominent bias that affects investor conduct is loss aversion. The psychological idea that people often experience the anguish of losses more keenly than the joy of comparable gains is the source of this bias. Consequently, investors could be hesitant to sell failing investments and incur losses, preferring to hang onto them in the hopes of breaking even. On the other hand, investors who are afraid of losing money in the future might be eager to sell profitable assets. This loss aversion might skew portfolio management tactics and obstruct the long-term growth of wealth. Anchoring is a cognitive bias that happens when investors, while making financial decisions, become fixated on a certain reference point or first piece of information. Even though this reference point is arbitrary or out of date, it nonetheless has a significant impact on decisions and judgements made later. A fixation on a specific price or value can cause investors to miss out on fresh information or shifting market conditions, resulting in less-than-ideal investment choices influenced more by psychological than by rational considerations. Herd mentality is a behavioural bias that is defined by investors' propensity to do as the herd does rather than performing their own independent research. Herd mentality has the ability to magnify market fluctuations, which can cause asset bubbles to burst or sharp market drops to occur. Regardless of the underlying fundamentals or their own investing goals, investors may feel pressured to purchase or sell assets based on the behaviour of others. Another common behavioural bias that influences investor decision-making is confirmation bias. This bias is the propensity to ignore contradicting facts in favour of information that supports preexisting assumptions or attitudes. It is possible for investors to selectively interpret market data in order to support their preexisting beliefs, which can reinforce biases and cause them to miss opportunities or hazards. These behavioural biases draw attention to the intricate interactions that exist between financial decision-making and human psychology. Investors may reduce the influence of these biases and make more logical, well-informed judgements by being

aware of and cognizant of them. But breaking through entrenched behavioural patterns is a continuous process for investors trying to manage the intricacies of the financial markets; it calls for self-awareness, discipline, and a readiness to question presumptions.

IMPACT OF BEHAVIOURAL BIASES

A number of behavioural biases have a substantial influence on several elements of investing decision-making, including confirmation bias, herd mentality, anchoring, overconfidence, and loss aversion.

➤ Performance of Portfolio

Overconfidence frequently results in speculative and excessive trading, which lowers profits because of higher transaction costs and bad decision-making. Investors that are very defensive due to loss aversion may restrict their prospective returns and impede portfolio diversification.

➤ Hazard Mitigation

Investor risk assessment can be distorted by relying too heavily on arbitrary price objectives or valuation criteria, which may cause them to ignore shifting market conditions or underestimate possible hazards. Herd mentality can increase market volatility and contribute to asset bubbles, which can worsen systemic risk.

➤ Market Volatility

Investors that follow popular trends without doing in-depth analysis may experience exaggerated market fluctuations and heightened volatility due to herd mentality, which is exacerbated by social media and online forums.

➤ Market Efficiency

Online echo chambers and confirmation bias can skew market perceptions and impede information processing, which may result in incorrect pricing and inefficiencies in the market.

➤ Action of the Investor

Individual investor behaviour is influenced by behavioural biases, which have an impact on trading habits, investment choices, and market sentiment in general. For investors to efficiently manage market volatility and make well-informed, logical decisions, they must overcome these prejudices.

➤ Investment Strategies for the Long Term

By drawing investors' attention to transient market swings, behavioural biases have the ability to derail long-term investing strategies by preventing investors from realising substantial gains or from suffering needless losses.

➤ Secularisation

Investors may be less inclined to diversify their portfolios due to biases like loss aversion and overconfidence, which can raise portfolio volatility and prevent them from taking advantage of risk management possibilities.

➤ State of the Market

Due to confirmation bias and herd mentality, behavioural biases can magnify changes in market sentiment and play a role in market booms or collapses.

➤ Time of Investment

Overconfidence and anchoring are two biases that can cause investors to make bad timing decisions when making investments, which can lead to overpaying for assets or selling them too soon during down markets.

➤ Impact on Regulation

The ubiquity of behavioural biases among investors highlights the need of improved investor education programmes and regulatory actions meant to reduce the impact of biases on investment choices and advance market stability.

COMPARING TRADITIONAL FINANCE WITH BEHAVIOURAL FINANCE

Conventional finance theories, such the Capital Asset Pricing Model (CAPM) and the Efficient Market Hypothesis (EMH), function on the presumption that investors act rationally and that markets are efficient. According to these ideas, investors base their decisions on logical analysis in order to maximise utility, and asset prices appropriately represent all available information. On the other hand, behavioural finance incorporates psychological knowledge to comprehend investor behaviour that deviates from reason. The way conventional and behavioural finance view market efficiency is one of their main points of difference. Conventional finance, represented by the Efficient Market Hypothesis (EMH), posits that markets are informationally efficient, meaning that asset prices fully represent all available information, hence precluding sustained outperformance without supplementary risk. On the other hand, behavioural finance recognises the existence of market inefficiencies and attributes them to emotional and cognitive biases that affect investor

conduct. Their presumptions on investor behaviour also set them apart. Conventional finance assumes that investors are logical beings who make choices based on impartial information analysis. Behavioural finance, on the other hand, acknowledges that emotions and cognitive biases may affect how decisions are made. Behavioural theories like as prospect theory and loss aversion, for example, suggest that investors could have different values for profits and losses, which could lead to judgements that deviate from conventional finance models.

The goal of both conventional and behavioural finance, notwithstanding their distinctions, is to comprehend investor conduct in financial markets. While behavioural finance investigates psychological aspects that contribute to departures from rationality, traditional finance places an emphasis on rational decision-making and market efficiency. Investors may make better judgements by gaining a thorough understanding of financial markets through the integration of ideas from both disciplines.

PROVIDING IMPLEMENTABLE TECHNIQUES TO REDUCE BEHAVIOURAL BIASES:

Discipline, awareness, and education are necessary for effectively resolving behavioural biases. Recognising and admitting decision-making biases is one useful strategy. Investors may recognise when biases affect decisions by being aware of typical biases such as overconfidence, loss aversion, and anchoring. Reducing prejudices is mostly dependent on education. Gaining knowledge about cognitive biases that influence judgement and how to overcome them may be very beneficial. This might entail speaking with competent financial advisors and obtaining materials on behavioural finance, such as books, articles, or courses. Self-reflection and mindfulness exercises can also be beneficial in reducing prejudice. Investors can spot illogical behaviour and take appropriate action by objectively assessing cognitive processes and decision-making tendencies.

Furthermore, biases can be lessened by putting rules-based investing techniques into practice. Investors reduce the impact of cognitive and emotional bias by establishing and staying true to predetermined criteria. Lastly, prejudices may be overcome by seeking out different viewpoints and contributions. Seeking input from mentors, advisers, or peers yields insightful information that improves decision-making and lessens the impact of biases. To sum up, overcoming behavioural biases requires awareness, instruction, self-control, and useful tactics. Investors may reduce biases and improve decision-making by identifying their biases, obtaining behavioural finance education, engaging in mindfulness practises, utilising rules-based solutions, and seeking out other viewpoints.

RECENT TRENDS RELATED TO THE TOPIC

The year 2023, global uncertainties and technology advancements had transformed the landscape of behavioural finance, which highlights the complex interplay between investor conduct and larger socio-economic developments. A growing reliance on brokerage services by investors is indicative of herd mentality and faith in authority. This suggests that during times of market instability, professional advice and group activities have a significant impact on decision-making. Loss aversion is highlighted by a persistent interest in life and health insurance investments, when conservative financial decisions are driven by concerns about one's health or life risks. This security-focused approach makes sense in light of the world health crisis and unstable economy. Furthermore, a risk-averse mindset is reflected in the move away from riskier assets like small-cap stocks and towards safer assets like gold and real estate, as well as larger-cap companies. This illustrates behavioural finance concepts like "flight to safety." Investors make safer investing choices in an effort to shield their cash from market volatility. Due in part to representativeness and familiarity biases as well as the rapidity of the digital transition, technology investment is still booming. Due of their continued incorporation into daily life, investors have a preference for industries that are predicted to dominate future economic landscapes.

By 2024, the investment environment will have changed even more as a result of continuous changes in the world and advances in technology. The following significant patterns show how investor behaviour has changed

➤ **Increased Dependence on Automated Investment Services**

Growing confidence in artificial intelligence and technological breakthroughs have led to an increase in the number of investors using robo-advisors for portfolio management and investment choices. These services appeal to both new and seasoned investors who are looking for effective, data-driven investing strategies since they provide automated rebalancing and personalised advice.

➤ **Growth in Sustainable and ESG Investing**

ESG (environment, social, and governance) investing has become a mainstream focus, having previously been a minority interest. The aspiration of investors to generate profits while contributing to a better society has led to a notable influx of capital into sustainable funds and companies that address social justice, climate change, and corporate governance.

➤ **Shift Toward Alternative Assets**

Investors are diversifying their portfolios more than ever in response to the increasing volatility of traditional markets. Investments in commodities, private equity, and cryptocurrency have all increased noticeably. In addition to having reduced correlations with traditional stock and bond markets, these alternative assets have the potential to yield large profits.

➤ **Rise in Personalized and Thematic Investment Options**

Investment platforms are increasingly providing theme portfolios, such as those focused on sustainable energy, technology, or healthcare innovation, to suit certain interests and principles. As a result, investors may focus their investments on industries or subjects they are knowledgeable about or enthusiastic about, using this knowledge to help them make better selections.

➤ **Emphasis on Financial Health and Insurance Product**

Following the epidemic, obtaining financial stability with a range of insurance products is still a top priority. Life and health insurance remain important, but in light of the increased hazards and realities of the digital age, there is also a rising interest in insurance against financial fraud and cyber threats.

➤ **Technology Integration in Every Aspect of Investing**

The use of cutting-edge technology in the investing industry has significantly increased. Examples include blockchain for transaction security, artificial intelligence and machine learning for stock trading, and augmented reality for better financial planning experiences. Precise market research, fraud detection, and an enhanced interactive investor experience are all aided by this connection.

The aforementioned developments suggest a dynamic shift in investment habits as investors adjust to evolving global economic situations and technology improvements while maintaining resilience.

CONCLUSION

To sum up, this research explores the complex world of finance with an emphasis on the influence of behavioural biases on investing choices, especially for Indian individual investors. It illuminates the psychological foundations of financial decisions by examining biases such as herd behaviour, loss aversion, overconfidence, and anchoring. Theoretical implications highlight the need to include behavioural finance insights for a more thorough knowledge of investor conduct, challenging established finance theories such as the Efficient Market Hypothesis. In addition, practical methods for reducing behavioural biases are offered, emphasising the value of awareness, discipline, instruction, and hands-on methods. The current state of the investment environment highlights how investor behaviour is changing due to societal changes, technology improvements, and global uncertainty.

Stakeholders must adjust to the ever-changing investing environment by identifying and resolving behavioural biases, putting creative investment methods into practice, and keeping up with new developments. Stakeholders may improve their comprehension of investor behaviour, maximise investment strategies, and support long-term financial prosperity by adopting behavioural finance concepts.

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