



---

## **Behavioural Finance Theory; Evidence From Previous Literature**

*Muzafar Ahmad Shah<sup>1</sup>, Sumeer Ahmad Ganie<sup>2</sup>, Khursheed Ahmad Bhutt<sup>3</sup>*

<sup>1</sup> Research Scholar, Department of Commerce University of Kashmir

<sup>2</sup> Research Scholar, Department of Commerce University of Kashmir

<sup>3</sup> Professor, Department of Commerce University of Kashmir

---

### **ABSTRACT :**

Behavioral finance systematically studies how investors make investment decisions in the stock market, considering the various available investment avenues. Individual investors, professional investors, and financial service firms engage with different securities to maximize profits and minimize risks. Throughout this process, numerous biases—both conscious and unconscious—affect investors. Standard finance posits that investors make rational decisions based on all available information and that markets are efficient, providing accurate information. However, these assumptions have been increasingly challenged by psychologists who argue that investors often act irrationally, influenced by emotions. This has led to the emergence of behavioral finance, a field that explores the significant role emotions play in investment decision-making.

This paper reviews the literature from various studies to gain a comprehensive understanding of the subject and its importance in financial decision-making. The paper is structured into four chapters: the first chapter introduces the paper, the second chapter outlines its objectives, the third chapter provides a detailed literature review, and the final chapter presents the conclusions.

---

**Keywords:** Behavioral finance, Individual investors, Professional Investors, Financial service firms, investments.

---

### **1. INTRODUCTION :**

Conventional finance theory posits that investors are rational and focused on maximizing wealth. However, real-life behaviors, such as buying lottery tickets in hopes of winning big or participating in chit funds, suggest that emotions, psychology, and social interactions (such as herding) often lead investors to act irrationally or unpredictably. Academics in finance and economics began identifying anomalies and behaviors that existing theories could not explain. While these theories could describe certain "idealized" scenarios, actual market behavior proved to be much more unpredictable. These observations led to the development of "Behavioral Finance," a concept significantly influenced by Daniel Kahneman and Amos Tversky in 1998.

Cognitive psychologists Daniel Kahneman and Amos Tversky are regarded as the pioneers of behavioral economics/finance. Since their initial collaborations in the late 1960s, they have published around 200 works, most of which explore psychological concepts relevant to behavioral finance. In 2002, Kahneman was awarded the Nobel Memorial Prize in Economic Sciences for his contributions to the understanding of rationality in economics.

Behavioral finance theory views investors as "normal," acknowledging that their decision-making is typically influenced by emotions. Investors are guided by sentiments and prone to cognitive errors. They often lack self-control, exhibit overconfidence in their investing abilities, misinterpret market information, and tend to follow the crowd in making financial decisions. These behaviors contribute to market irregularities. Behavioral finance studies how psychological factors influence investors' actions in financial markets.

Several key definitions of behavioral finance include:

- Sewell (2007): "Behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets." This field involves theories and experiments that examine what happens when investors make decisions based on intuition or emotions.
- Shefrin (2000): Describes behavioral finance as "a rapidly growing area that deals with the influence of psychology on the behavior of financial practitioners."
- Belsky and Gilovich (1999): Refer to behavioral finance as "behavioral economics," explaining it as a field that combines psychology and economics to understand why people make seemingly irrational or illogical decisions regarding spending, investing, saving, and borrowing.

In summary, behavioral finance is a field that explains stock market anomalies through identified psychological biases, rather than dismissing them as random outcomes consistent with the market efficiency.

---

## II. OBJECTIVES OF THE STUDY

- 1) To know about Introduction of behavioral finance
- 2) To know about the review of the literature of behavioral finance
- 3) To study the various biases that investors face while investing in the stock market.

### *Scope of the study*

This study contains the introduction of behavioral finance with relevant concepts, Biases and review of literature on the brief concern. The study focuses to know the key changes in investment decisions made by the individual, professional investors and financial services firm.

---

## III. RESEARCH METHODOLOGY

To finding information on behavioral finance used and gathered secondary data from a set of books and documents.

### *Limitations of the study*

1. Limitations of the research related to theoretical and conceptual hence there is no empirical study on the paper.
2. Discussed few reviews on behavioral finance.

### *Behavioral Finance Biases*

#### **Overconfidence and over-optimism**

Individual and group investors often exhibit overconfidence and excessive optimism in their investments, believing they can predict market movements based on their own knowledge and sentiment. This tendency is exacerbated by their reluctance to update their perspectives or compare their insights with those of other investors and traders in the market, leading to an overall climate of overconfidence and over-optimism.

#### **Representativeness**

Investors and traders often foresee different market scenarios, but their decisions are usually based on superficial aspects rather than actual probabilities. This tendency, stemming from past experiences and referred to as stereotyping, results in biased decisions. Instead of considering the present market conditions, investors often rely on their previous experiences. For example, an investor might assume that recent success will persist in the future.

#### **Conservatism**

Market analysts tend to reaffirm their own beliefs when encountering new information about a company, industry, or sector.

#### **Availability bias**

Most investors overestimate the likelihood of success based on their recent trading and investment experiences, adhering to their own principles to make profits. Availability bias causes them to make decisions based on recent information rather than conducting a thorough analysis of past events, leading to a bias toward the latest news. Consequently, investors make decisions based on the most readily available information.

#### **Frame dependence and anchoring**

In the stock market, channel providers generate various pieces of information for trading and investing, which directly and indirectly influence investment decisions. Anchoring refers to the use of irrelevant information as a reference point for evaluating or estimating unknown values. When people anchor, they base their decisions or estimates on known events or values, even if these have no relevance to the actual situation. In investing, this means investors often hold onto losing investments, waiting for them to break even at their purchase price. They anchor the investment's value to its original price and, instead of selling to realize the loss, take on greater risk by hoping it will return to its initial value.

#### **Mental accounting**

Individual and group investors typically trade and invest within their comfort zones, resulting in psychological trading biases in the stock market. They often categorize their money into separate accounts based on subjective criteria such as the source and intended use of the funds. This practice of assigning different functions or values to each asset group can irrationally and negatively impact their consumption decisions and other behaviors.

#### **Regret aversion**

Individuals make their own investment decisions and experience specific emotional distress when trading and investing in the stock market. This psychological error stems from an excessive focus on feelings of regret if their decisions turn out poorly. The primary cause of this error is investors' aversion to admitting their mistakes. For instance, investors are often hesitant to sell losing stocks, holding onto them because selling would mean acknowledging a bad investment decision.

## LOSS AVERSION

Loss aversion is the human tendency to prefer decisions that avoid losses over those that achieve gains. This concept, a key element of prospect theory, is captured by the phrase “losses loom larger than gains” (Kahneman & Tversky, 1979). For example, the pain of losing Rs 800 is significantly greater than the satisfaction of gaining Rs 800. Numerous studies have shown that the perception of loss is about twice as powerful as that of gains.

The psychological impact of losing is thought to be roughly twice as strong as the pleasure of gaining. Consequently, people are more inclined to take risks to avoid a loss, which helps explain the differences between risk-seeking and risk-averse behavior. Loss aversion has been used to explain phenomena such as the endowment effect and the sunk cost fallacy, and it may also contribute to the status quo bias. This principle is sometimes applied in behavior change strategies and can explain why penalty frames are often more effective than reward frames in motivating people (Gächter, Orzen, Renner, & Starmer, 2009).

### Confirmation and Hindsight Biases

People often choose and use information that supports their decisions. This tendency to overweight, seek out, or more easily recall information that confirms our existing beliefs, while undervaluing or ignoring information that contradicts them, is known as confirmation bias. For instance, if someone believes that left-handed people are more creative than right-handed people, they will emphasize encounters with left-handed creative individuals as evidence supporting their belief. They might even seek out further “proof” to reinforce this belief while discounting examples that don't support it.

Hindsight bias is the inclination to perceive an event as having been predictable after it has occurred, even if there was little or no objective basis for predicting it. Many people claim “I knew it all along” even after witnessing an unforeseeable event. Hindsight bias is linked to the discovery of the availability heuristic, a mental shortcut that leads individuals to rely on the information or examples that come to mind most easily when evaluating a specific topic, method, or decision. This theory suggests that if people recall something frequently and place importance on recent or immediate information, it will create a bias towards the latest news, events, and experiences.

### Behavioral Finance Review of Literature

(Modern Portfolio Theory, as described by Markowitz in 1952 and Sharpe in 1964, and the Capital Asset Pricing Model) have significantly influenced the field of behavioral finance and the performance of various investment avenues in the stock market. These theories posit that investors act rationally, incorporating all available information into their decision-making processes. Heuristics, defined as simplified decision-making methods, are particularly useful in navigating complex environments, as noted by Ritter in 2003. These methods involve reducing systematic complexity by assigning probabilities and predicted values to streamline judgments (Kahneman & Tversky, 1974).

Heuristic investment decision-making is especially valuable when time constraints are present (Waweru et al., 2008), although it introduces several biases identified by Kahneman & Tversky (1974) and Ritter (2003). Kahneman & Tversky (1974, 1979) are renowned for their work on heuristics, discussing factors like representativeness, availability bias, and anchoring.

Behavioral finance, influenced by Thaler and Barberis (2002), identifies two significant scenarios: limits to arbitrage and psychology. Limits to arbitrage explain persistent arbitrage opportunities in the stock market despite their theoretical inefficiencies. This coexists with irrational investor behaviors, where profits from market dislocations are often elusive. Understanding these anomalies challenges traditional models, such as the Bayes' law and subjective expected utility theory, which investors often misconstrue or deviate from when reacting to unexpected news events (DeBondt & Thaler, 1995).

Behavioral finance explores how psychological factors shape financial market evolution. It acknowledges that investors' decisions are influenced by various factors, including their understanding, personality, time horizon preferences, and emotional biases. This contrasts with classical finance, which assumes market efficiency, rational investors, and an inability to consistently outperform the market in the long term.

(Waweru et al., 2008) highlight the role of biases such as the Gambler's fallacy and overconfidence, derived from heuristic theory. Prospect theory and expected utility theory provide frameworks for understanding investment decisions across different avenues. Prospect theory emphasizes subjective decision-making, while expected utility theory focuses on rational investor expectations (Filbeck, Hatfield & Horvath, 2005).

Further research by Caparrelli et al. (2004) on herding behavior reveals how investors rely on group advice and peer actions due to information gaps and overconfidence. This behavior, driven by market sentiment and price movements, underscores the impact of emotional and psychological factors on investment decisions.

In conclusion, behavioral finance offers a nuanced understanding of financial markets by integrating psychological factors into investment decision-making processes. It complements traditional financial theories by explaining market anomalies and investor behaviors that are not fully captured by efficient market hypotheses. Sahi, Arora, and Dhameja (2013) provide additional insights into the psychological biases influencing financial investment behavior, reflecting ongoing research into investor sentiment and decision-making dynamics.

---

## IV. CONCLUSION :

Behavioral finance is a scientific study that examines investment sentiments and trading scenarios across different time intervals. It highlights the multitude of biases influencing investment decisions and provides valuable insights for predicting market conditions based on the psychology and behavior of individual investors, professionals, and various financial services in the market.

Investors aim to achieve maximum returns while ensuring the safety and liquidity of their investments. Although investors typically conduct thorough research before investing, not all investments yield desired results. This can be attributed to the fact that while visible and quantifiable aspects of investment products receive due attention, the inherent psychological and emotional biases influencing investment decisions are often overlooked, sometimes even by the investors themselves. As the saying goes, “What the mind doesn't know, the eyes don't see.”

Investors occasionally place undue emphasis on either psychological biases or technical aspects of investments, leading to unfavorable returns. Achieving a balance between these factors is crucial. Understanding and reflecting on behavioral finance can help minimize irrational decisions and

maximize investment gains. It is prudent to identify and mitigate various behavioral biases before making investment decisions, even after conducting thorough due diligence.

---

### Future Course of Action

Based on a review of the literature classified by study nature and publication period, it is evident that researchers are increasingly focusing on behavioral finance, indicating a growing demand for more research to advance the field. Based on this review, the following recommendations are proposed for future research directions:

- 1) While many studies have taken a theoretical approach, there is a need for more empirical research to validate these theories, given the open opportunities for research (Forrester, 2014; Gholizadeh, Shakerinia, and Saber, 2013; Pompian and Longo, 2004; Thi and Ngoc, 2014).
- 2) The majority of studies have been conducted in the UK and US, with fewer studies in Asian countries and particularly scarce research in India. Therefore, there is potential for further research in the Indian context and other global regions.
- 3) Numerous biases have been documented in the literature, focusing on biases such as overconfidence, herd behavior, and risk tolerance. A comparative study could determine the most prominent bias among investors, as well as cross-country comparisons to assess similarities in biases.
- 4) There is a need to evaluate debiasing strategies employed by companies to prevent customers from succumbing to irrational behaviors. These strategies should be tailored to meet the specific requirements of different segments within the capital market.
- 5) Many studies have utilized various models (Chang et al., 2000; Caporale et al., 2009) to measure biases. Empirical validation of these models in different contexts would enhance their utility and reliability.
- 6) Current research predominantly focuses on investor decisions. Exploring the behaviors of other financial market stakeholders such as exchanges, analysts, intermediaries, media, employees, managers, non-managers, and policymakers would provide new insights and broaden the scope of behavioral finance.

In conclusion, behavioral finance offers ample opportunities for further research, with ongoing advancements in techniques for measuring behavioral biases across diverse scenarios. It is essential to adopt a comprehensive approach to address broader issues within behavioral finance beyond the scope of current studies.

---

### Limitations :

While a thorough literature review was conducted using specific keywords for this research, it is possible that some relevant studies were inadvertently overlooked. As a result, certain crucial aspects of decision-making may not have been included in this study. Despite these limitations, a sincere effort has been made to present a comprehensive research overview focusing on several factors. Finally, based on the findings, recommendations have been proposed to explore new avenues for research. There exists a significant opportunity for researchers to contribute substantially to the field of behavioral finance.

---

### REFERENCE :

1. Anderson, J., & Smith, G. (2006). A great company can be a great investment. *Financial Analysts Journal*, 62(4), 86-93.
2. Asness, C. S. (2000). Stocks versus bonds: explaining the equity risk premium. *Financial Analysts Journal*, 56(2), 96-113.
3. Baker, M., & Wurgler, J. (2000). The equity share in new issues and aggregate stock returns. *The Journal of Finance*, 55(5), 2219-2257.
4. Baker, M., & Wurgler, J. (2002). Market timing and capital structure. *The journal of finance*, 57(1), 1-32.
5. Baker, M., & Wurgler, J. (2006). Investor sentiment and the cross-section of stock returns. *The journal of Finance*, 61(4), 1645-1680.
6. Baker, M., Ruback, R. S., & Wurgler, J. (2007). Behavioral corporate finance. In *Handbook of empirical corporate finance* (pp. 145-186). Elsevier.
7. Barber, B. M., & Odean, T. (1999). The courage of misguided convictions. *Financial Analysts Journal*, 55(6), 41-55.
8. Barber, B. M., & Odean, T. (2000). Trading is hazardous to your wealth: The common stock investment performance of individual investors. *The journal of Finance*, 55(2), 773-806.
9. 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.
10. Barber, B. M., & Odean, T. (2002). Online investors: do the slow die first?. *The Review of financial studies*, 15(2), 455-488.
11. Barberis, N., & Thaler, R. (2003). A survey of behavioral finance. *Handbook of the Economics of Finance*, 1, 1053-1128.
12. Barberis, N., Shleifer, A., & Vishny, R. (1998). A model of investor sentiment. *Journal of financial economics*, 49(3), 307-343.
13. Benartzi, S. (2001). Excessive extrapolation and the allocation of 401 (k) accounts to company stock. *The Journal of Finance*, 56(5), 1747-1764.
14. Benartzi, S., & Thaler, R. H. (1995). Myopic loss aversion and the equity premium puzzle. *The quarterly journal of Economics*, 110(1), 73-92.
15. Benartzi, S., & Thaler, R. H. (2001). Naive diversification strategies in defined contribution saving plans. *American economic review*, 91(1), 79-98.
16. Benartzi, S., & Thaler, R. H. (2002). How much is investor autonomy worth?. *The Journal of Finance*, 57(4), 1593-1616.

17. Benartzi, S., and R. Thaler. 1995. "Myopic Loss Aversion and the Equity Premium Puzzle." *Quarterly Journal of Economics*, vol. 110, no. 1 (February):73–92.
18. Brooks, M., & Byrne, A. (2008). *Behavioral finance: Theories and evidence*. The Research Foundation of CFA Institute. University of Edinburgh.
19. Brooks, M., & Byrne, A. (2008). *Behavioral finance: Theories and evidence*. The Research Foundation of CFA Institute. University of Edinburgh.
20. Camerer, C., Loewenstein, G., & Prelec, D. (2005). Neuroeconomics: How neuroscience can inform economics. *Journal of economic Literature*, 43(1), 9-64.
21. Caparrelli, F., D'Arcangelis, A. M., & Cassuto, A. (2004). Herding in the Italian stock market: a case of behavioral finance. *The Journal of Behavioral Finance*, 5(4), 222-230.
22. Clarke, R. G., & Statman, M. (1998). Bullish or bearish?. *Financial Analysts Journal*, 54(3), 63-72.
23. Collins, T. L. (2017). *CFA Institute Research Challenge*.
24. Cooper, M. J., Dimitrov, O., & Rau, P. R. (2001). A rose. com by any other name. *The journal of Finance*, 56(6), 2371-2388.
25. Cooper, M. J., Gulen, H., & Rau, P. R. (2005). Changing names with style: Mutual fund name changes and their effects on fund flows. *The Journal of Finance*, 60(6), 2825-2858.
26. Coval, J. D., & Shumway, T. (2005). Do behavioral biases affect prices?. *The Journal of Finance*, 60(1), 1-34.
27. Daniel, K., Hirshleifer, D., & Subrahmanyam, A. (1998). Investor psychology and security market under-and overreactions. *the Journal of Finance*, 53(6), 1839-1885.
28. Daniel, K., Hirshleifer, D., & Teoh, S. H. (2002). Investor psychology in capital markets: Evidence and policy implications. *Journal of monetary economics*, 49(1), 139-209.
29. Doukas, J. A., & Petmezas, D. (2007). Acquisitions, overconfident managers and self-attribution bias. *European Financial Management*, 13(3), 531-577.
30. Dreman, D. N., & Berry, M. A. (1995). Overreaction, underreaction, and the low-P/E effect. *Financial Analysts Journal*, 51(4), 21-30.
31. Elton, E. J., Gruber, M. J., & Busse, J. A. (2004). Are investors rational? Choices among index funds. *the Journal of Finance*, 59(1), 261-288.
32. Fama, E. F. (1998). Market efficiency, long-term returns, and behavioral finance. *Journal of financial economics*, 49(3), 283-306.
33. Frazzini, A., & Lamont, O. A. (2008). Dumb money: Mutual fund flows and the cross-section of stock returns. *Journal of financial economics*, 88(2), 299-322.
34. Garvey, R., & Murphy, A. (2004). Are professional traders too slow to realize their losses?. *Financial Analysts Journal*, 60(4), 35-43.
35. Mitroi, A., & CFA, M. (2016). Post Behavioral Finance Adolescence. *Annals-Economy Series*, 1, 206-218.
36. Mitroi, D., & CFA, M. (2016). From Behavioral Finance to Ecclesiastes Finance: The Pain of Gain and The Glory of An Investment Loss. *Annals-Economy Series*, 1(1), 240-251.
37. Schwert, G. W. (1983). Size and stock returns, and other empirical regularities. *Journal of financial Economics*, 12(1), 3-12.