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Behavioural Biases in Investment Decision: A Study of Investor Psychology

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ABSTRACT

Investment decisions are often influenced by psychological biases rather than just rationality. This study looks at several Behavioural biases that affect investment decisions, such as overconfidence, loss aversion, herd mentality, and confirmation bias. This study examines secondary data sources to identify patterns of irrational decision-making and its impact on financial markets. The study highlights how important it is to understand investor psychology in order to improve financial judgment and develop more successful investment plans. The findings illuminate the ways in which prejudices affect both individuals and institutions.

INTRODUCTION

Investing involves more than just math and figures; psychological biases and feelings play a role as well. Rather than using reason, many investors base their choices on emotions, prior experiences, or peer pressure. These psychological elements, known as behavioural biases, have the potential to influence bad investment decisions. Historically, rational economic models have been used to assess investment decisions, presuming that investors behave rationally and base their choices only on the information at hand. However, an increasing amount of behavioural finance research has shown that investor behaviour is greatly influenced by psychological and cognitive biases, which frequently result in irrational financial decisions.

OBJECTIVES OF THE STUDY

The primary objective of this study is to examine the impact of behavioural biases on investment decision-making, with a specific focus on how psychological factors influence investor choices. The study aims to:

- Analyze prevalent cognitive and emotional biases such as overconfidence, herd mentality, loss aversion, confirmation bias, and anchoring that affect investor decisions.
- Evaluate how these biases influence risk-taking, asset allocation, and overall financial performance.
- Explore the psychological tendencies that drive irrational financial decisions and deviations from rational economic theories
- Investigate how behavioural biases vary across different demographics, including age, experience, and risk tolerance

IMPACT

Investors usually make illogical decisions that lead to less-than-ideal investing selections because of biases like herd mentality, loss aversion, and overconfidence. One bias that might cause investors to underestimate risks and overtrade, which can lead to significant losses, is overconfidence. Due to biases like anchoring (relying too heavily on past pricing) and confirmation bias (seeking information that confirms pre-existing notions), investors may hang onto lost assets for too long or miss out on profitable opportunities.

Investors who are too sensitive to short-term losses may panic sell, while those who suffer from biases like regret aversion may find it difficult to make the required portfolio modifications. Market inefficiencies, asset bubbles, or crashes are caused by a large number of investors acting on their biases, which deviates from fundamental valuation notions. Familiarity bias may cause some people to buy just well-known stocks, which would lead to insufficient diversification and higher portfolio risk. Consistently following prejudices leads to poor retirement planning, delayed financial objectives, and poor asset accumulation.

CASE STUDY

Case Study 1: The Dot-Com Bubble (1999-2000)

A major financial event, the dot-com bubble was primarily caused by herd mentality and overconfidence bias. With little consideration for fundamental pricing, investors flocked to technology equities, thinking that the explosive growth of internet-based businesses would last forever. Speculative trading caused the stock prices of numerous companies with weak business models to soar. Extreme market overvaluation ensued, and when investors discovered that many of these businesses were not profitable, there was a sharp decline. Bankruptcies, a change in investor mood, and trillions of dollars in losses followed. This story underscores the significance of basic analysis in investment decision-making and the perils of irrational market excitement.

Case Study 2: The 2008 Financial Crisis

One of the best examples of behavioural biases affecting investment decisions is the financial crisis of 2008. Because both individual and institutional investors undervalued the risks associated with mortgage-backed securities, overconfidence and loss aversion were major factors in the events leading up to the crisis. Excessive borrowing and risk-taking were caused by the assumption that property values would keep rising. Fear-driven selling took over as the housing bubble burst, causing the market to collapse and the entire financial system to melt down. As an example of how behavioural biases play a part in both boom and bust cycles, investors who had earlier disregarded warning indications were suddenly overcome by panic. The significance of risk assessment and critical thinking in investment plans is highlighted by this catastrophe.

FINDING

According to the article Behavioural Biases in Investment Decision: A article of Investor Psychology, investors frequently use psychological biases in addition to strictly rational analysis while making financial decisions. One of the main conclusions is that emotional and cognitive biases have a big influence on investing decisions and cause regular departures from the best course of action. Overconfidence is a common trait among investors, leading them to overestimate their knowledge and underestimate risks, which can lead to excessive trading and possible losses. Furthermore, herd mentality is important because people often imitate the behaviour of others rather than making their own judgments, which can result in market bubbles or crashes

Another significant bias that has been found is loss aversion, which occurs when investors sell winning stocks too soon or hang onto losing equities for too long because they are disproportionately afraid of losses relative to comparable gains. Additionally, anchoring bias was noted, in which investors make judgments based on predetermined benchmarks, like historical stock prices, even in the face of fresh and pertinent information. Hindsight bias was also noticeable since many investors think they could have foreseen market movements in the past, which can lead to overconfidence when making decisions in the future.

The study's overall conclusion is that behavioural biases are pervasive in investment choices and frequently result in less than ideal financial outcomes. By identifying these biases and implementing techniques like diversification, disciplined investing, and financial education, investors can lessen their impact and make more logical and knowledgeable decisions.

CONCLUSION

Behavioural biases have a significant impact on investment decisions and often lead to illogical financial behaviour. Investors can improve market efficiency and make wiser choices by being conscious of these biases. By identifying and addressing psychological factors, investors can make better decisions and achieve better financial outcomes. When developing educational programs and regulatory frameworks that encourage wise investing behaviours, lawmakers and financial advisors should also keep these lessons in mind. Future research can look into behavioural biases in diverse market and cultural contexts to advance our understanding of investor psychology.

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