



Behavioral Finance: How Investor Psychology Affects Stock Market Trends

Vidhi Avasthi¹, Dr. Rekha Khosla²

¹Student, Amity University Lucknow

²Professor, Amity University Lucknow

ABSTRACT

Behavioral finance explores how psychological biases and emotions impact financial decision-making and stock market trends. Unlike traditional finance, which assumes that investors act rationally, behavioral finance acknowledges that irrational behaviors, cognitive biases, and emotional influences drive market movements.

This report delves into key behavioral finance theories, including Prospect Theory, Herding Behavior, Mental Accounting, Overconfidence Bias, Anchoring Bias, Regret Aversion, and the Representativeness Heuristic. Each of these theories helps explain why investors make systematic errors in judgment when making financial decisions, often leading to market inefficiencies, bubbles, and crashes.

INTRODUCTION

Behavioral finance examines how psychological factors influence investors' financial decisions and, consequently, stock market trends. Traditional financial theories assume investors are rational decision-makers who always seek to maximize profits. However, real-world market trends often contradict these assumptions due to cognitive biases, emotional influences, and social pressures affecting investor behavior.

Investors are influenced by biases such as overconfidence, herd mentality, loss aversion, anchoring bias, and regret aversion, which lead to irrational market movements. For example, during market bubbles, herd mentality causes investors to buy stocks at inflated prices, while loss aversion leads to panic selling during downturns. Understanding these psychological tendencies helps explain stock market volatility and unpredictability.

This study investigates how investor psychology affects stock market decisions, using a survey-based approach to gather insights from investors across different age groups and experience levels.

LITERATURE REVIEW

1. Investor psychology in the stock market: An empirical study of the impact of overconfidence on firm valuation. (Aljifri, January 2023)

According to behavioral theories, overconfident investors undervalue risk and overvalue the quality of their knowledge. Their strong need for hazardous assets and need for a smaller risk premium drive up asset values and create overvaluation. We look at how overconfidence influences company value in the developing stock market of Saudi Arabia. Our data came from 4004 firm-quarter observations. We applied the dynamic panel data model and the fixed-effects panel data model to guarantee that our findings are strong to unobserved firm-specific heterogeneity and endogeneity concerns. The results indicate that company value is strongly and favorably influenced by overconfidence. Using several overconfidence proxies and swapping the several economic models produces consistent results. Academics, investors, and authorities will find much relevance in this work. It will hopefully help investors to understand better how their psychology affects asset pricing, hence improving the logic of their stock market decisions and so promoting market efficiency.

2. The Investor Psychology and Stock Market Behavior During the Initial Era of COVID-19: A Study of China, Japan, and the United States (Naseem, Mohsin, Hui, Liyan, and Penglai, February 2021)

Dramatically altering the planet with a tragically great loss of human life, COVID-19 is a highly transmissible and pathogenic viral infection. Among patients and healthcare personnel, the pandemic has generated psychological resilience as well as intolerable psychological strain. This paper aims to examine stock market activity and investor psychology during COVID-19. Investor psychological behavior, whether good or bad, toward the stock market can alter the image of the economy. Using principal component analysis, this study investigates Shanghai, Nikkei 225, and Dow Jones stock markets from January 20, 2020, to April 27, 2020. The findings indicated that three chosen stock markets under psychological resilience and pandemic pressure

were inversely associated to investor psychology. Negative feelings and pessimism drive investors to stop stock market financial investment; hence, stock market returns fell. In a fatal epidemic, the people were more worried about their lives and means of subsistence than about wealth and leisure. This study helps to fill the vacuum in the literature on investors' psychological behavior during a pandemic epidemic. The report implies that legislators ought to create a strategy to combat COVID-19. To get over further crises, the government should control the budget of the health sector.

3. The Impact of Investor Psychology on Investment Decisions (Xie, October 2024)

Using overconfidence and risk tolerance theories as case studies, this paper intends to investigate how investor psychology shapes investing choices by examining their influence on decision-making. The study of the investment psychology during the China's 2018 A-share crash emphasizes how vulnerable investors are to psychological biases and emotional responses in reaction to fluctuations in the market. These prejudices include representativeness bias, where investors may rely too heavily on stereotypes, leading to misjudgments; panic, which can trigger impulsive and irrational selling; overconfidence, which causes investors to overestimate their knowledge and abilities; and catastrophic thinking, where investors focus excessively on possible worst-case outcomes. These psychological elements cause more market volatility and may cause illogical decisions and actions by investors. Such conduct harms the stable growth of the market since it might cause asset mispricing and higher chance of misinvestment. The paper underlines the importance of investor psychology in logical decision-making and market efficiency. Investors can use tactics to offset their impact by understanding the personal and environmental motivations of these prejudices. This involves using techniques to control emotional responses to market changes, looking for different points of view, and increasing self-awareness. By promoting market openness and informing investors, policymakers can help to reduce the influence of psychological biases on investment decisions. To create a more stable and efficient investing environment, one must work together to understand and address investor psychology.

RESEARCH METHODOLOGY

Research Objective

The objective of this study is to analyze how psychological biases affect investment decisions and stock market trends. It seeks to:

1. Identify the most common psychological biases among investors.
2. Determine whether age and experience influence susceptibility to these biases.
3. Assess how investor psychology contributes to market volatility.

Research Methodology

The research follows a quantitative approach through a survey-based study. A questionnaire was designed to evaluate investor psychology, focusing on five key biases: Overconfidence, Herd Mentality, Loss Aversion, Anchoring Bias, and Regret Aversion, which are explained as below:

- **Overconfidence Bias:** Investors overestimate their knowledge and ability to predict market trends, often leading to excessive trading.
- **Herd Mentality:** Investors tend to follow the majority, which creates stock market bubbles and crashes.
- **Loss Aversion:** Investors fear losses more than they value gains, often resulting in holding onto losing stocks for too long.
- **Anchoring Bias:** Investors rely too heavily on initial information (e.g., stock purchase price), affecting their decision-making.
- **Regret Aversion:** Fear of making the wrong decision prevents investors from taking necessary risks.

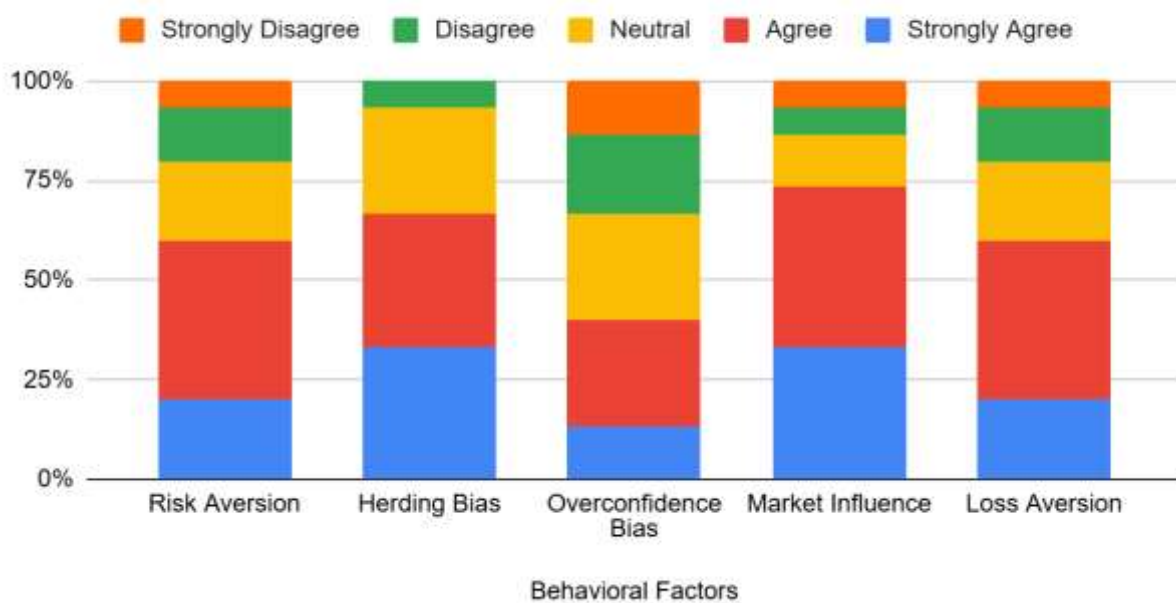
Survey Participants

- **Sample Size:** 15 respondents
- **Demographics:** Investors of various age groups (18-25, 26-40, 41-60) and experience levels (beginners, intermediate, experienced investors).
- **Survey Format:** Online questionnaire using a 5-point Likert scale for responses.

Survey Questions & Responses

Question	Bias Category	Percentage of "Agree" or "Strongly Agree" Responses
"I believe my knowledge and skills allow me to predict stock market movements better than others."	Overconfidence Bias	73%
"I tend to invest in stocks that most people are talking about."	Herd Mentality	67%
"I avoid selling a stock at a loss, even if the price is unlikely to recover."	Loss Aversion	80%
"I often base my stock price expectations on the price at which I first bought the stock."	Anchoring Bias	75%
"I hesitate to invest in new opportunities because I fear making a wrong decision."	Regret Aversion	60%

Strongly Agree, Agree, Neutral, Disagree and Strongly Disagree



DATA ANALYSIS & INTERPRETATION

1. Findings from the Survey

- **Overconfidence Bias (73%):** Many investors, particularly younger ones (18-25), showed overconfidence in their ability to predict stock trends, often leading to high trading frequency.
- **Herd Mentality (67%):** A significant percentage of investors followed market trends based on social influence, particularly those in the 26-40 age group.

- **Loss Aversion (80%):** Investors across all age groups displayed strong aversion to selling stocks at a loss, even when logic suggested exiting the position.
- **Anchoring Bias (75%):** Most investors fixated on their initial stock purchase price, affecting their sell decisions.
- **Regret Aversion (60%):** Investors hesitated to take risks due to fear of making a poor decision, particularly among older investors (41-60).

2. Impact on Stock Market Trends

- **Market Bubbles & Crashes:** The prevalence of herd mentality can cause artificial inflation in stock prices, leading to bubbles and crashes.
- **High Trading Volumes:** Overconfidence leads to excessive trading, increasing market volatility.
- **Stock Holding Patterns:** Loss aversion and anchoring bias result in holding onto declining stocks, affecting market liquidity.

CONCLUSION

This study highlights the profound impact of investor psychology on stock market trends. The findings indicate that overconfidence and herd mentality drive speculative trading, while loss aversion and anchoring bias prevent rational investment decisions. These biases collectively contribute to market inefficiencies, contradicting traditional financial theories that assume rational behavior.

Key Takeaways:

1. Younger investors exhibit overconfidence, leading to frequent trading.
2. Herd mentality is prevalent among mid-career investors, affecting stock demand.
3. Loss aversion & anchoring bias are common across all age groups, preventing timely stock exits.
4. Market inefficiencies arise due to psychological biases, leading to bubbles and crashes.

Recommendations:

1. **Investor Education:** Awareness programs on behavioral biases can help investors make more rational decisions.
2. **Automated Trading Strategies:** Algorithmic trading can reduce the influence of human psychology on stock movements.
3. **Diversification Strategies:** Encouraging investors to diversify can mitigate the effects of loss aversion and anchoring bias.

Understanding behavioral finance is crucial for investors, policymakers, and financial institutions to develop strategies that reduce irrational decision-making and improve market stability.

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