WWW.IJRPR.COM

International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

Exploring the Theoretical Foundations of Behavioural Finance: A Comprehensive Review

Dr. Bisma Shah[1], Prof. Khursheed Ahmad Butt[2]

[1] Designation: Post Doctorate Fellow
Official Address: Department of Management Studies, University of Kashmir, Hazratbal, Srinagar, J&K
Phone No: 9906603943
Email: shah.bisma@yahoo.com
[2] Designation: Professor
Official Address: Department of Commerce, University of Kashmir, Hazratbal, Srinagar, J&K
Phone No: 9419972933
Email: kahmad2012@yahoo.com

ABSTRACT :

Behavioural finance focus on how real people make financial decisions, often influenced by psychology rather than pure logic. Traditional theories assumed that investors always act rationally and markets are efficient, but this view doesn't match how people actually behave. In reality, investors are often influenced by emotions, mental shortcuts, and social pressure, leading to mistakes and unpredictable decisions. This paper explores how behavioural finance developed in response to these gaps in classical theories. It outlines key ideas, explains how psychological factors affect investment choices, and shows why understanding human behaviour is essential for making sense of modern financial markets. By tracing its roots and highlighting major concepts, the study helps clarify why behavioural finance is becoming increasingly important. It also shows how this approach brings academic theory closer to the realities of everyday financial decisions.

Key Words: Behavioural Finance, Investor Psychology, Financial Decision-Making

Introduction

Success in the stock market is often linked to having the right knowledge and making smart investment choices. Many believe that those who understand market trends and pick the right stocks at the right time are the ones who profit the most. Traditional financial theories support this idea by assuming that investors always make logical, well-informed, and calculated decisions (Barberis and Thaler, 2005). These theories are built on the belief that people act rationally and take all available information into account before buying or selling securities.

However, real-life investor behaviour often tells a different story. People are emotional beings with limited attention, memory, and ability to process complex information. As a result, they frequently make decisions that are not entirely logical. Investors may be influenced by personal beliefs, past experiences, or even the emotions they feel at a given moment. This inconsistency between expected rational behaviour and actual human behaviour has led researchers to question the traditional assumptions of finance (Nofsinger, 2017).

This is where behavioural finance comes in. It studies how psychological factors—such as biases, emotions, mental shortcuts, and irrational thinking—affect the financial decisions people make. It shifts the focus from the idea of a completely rational investor to a more realistic view that acknowledges human flaws. Investors may panic during market downturns, become overconfident during rallies, or follow trends blindly without evaluating the risks. All of these behaviours can lead to poor investment choices and, at times, even major market disruptions. Market bubbles, sudden crashes, and erratic trading behaviours are examples of how emotions and biases can shape financial outcomes. These events challenge the traditional belief that markets are always efficient and rational. Behavioural finance attempts to explain these anomalies by studying how human psychology interferes with logical financial decision-making. This area of finance has gained importance because it helps answer questions that conventional finance fails to address. For instance, why do individual investors continue to trade even when data shows that most of them underperform the market? Why do they hold on to losing stocks and sell winning ones too quickly? Why do certain stocks earn high returns without being riskier than others? Traditional finance does not have adequate explanations for such behaviour. Behavioural finance, on the other hand, offers valuable insights by recognizing that real-world decisions are shaped by a variety of human tendencies and errors in judgment (Tversky and Kahneman, 1985). Moreover, the impact of behavioural factors isn't limited to individual investors alone. It also extends to corporate finance, where the attitudes and personality traits of top executives influence major business decisions.

In essence, investors are not emotionless machines. They are influenced by their environment, experiences, confidence levels, and even mood. Behavioural finance emerged as an effort to understand these influences and provide more realistic models of investor behaviour. While psychology has

been studied for centuries, its application to finance is relatively recent. Yet, it has already transformed the way we understand market behaviour and financial decision-making. By incorporating insights from psychology, behavioural finance provides a more comprehensive framework for understanding why investors make mistakes, how market anomalies arise, and what can be done to avoid costly errors. It encourages us to look beyond numbers and consider the human mind behind financial choices—making it a highly relevant and growing field in today's complex financial world.

Traditional finance versus Behavioural Finance: A Conceptual Framework

This study explores how the field of behavioural finance has developed over time. The analysis begins with older theories and gradually moves toward more recent developments. A structured approach was used to examine key ideas and concepts in this area. Sources such as books, scholarly articles, and conference papers covering both traditional and behavioural finance were carefully reviewed. The analysis has been carried out by examining early views which suggested that financial choices are based purely on logic and careful reasoning. Over time, attention shifted toward recognising that actual decision-making is often shaped by feelings, routines, and quick mental judgments. Key principles of behavioural finance are then presented, showing how they affect the way people make investment-related decisions.

Traditional Finance

Earlier financial thinking aimed to explain how individuals make choices when dealing with investments. These ideas were built on the belief that people act wisely, have full awareness of market conditions, prefer to reduce uncertainty, and aim to get the best possible outcome from their decisions. Such a person is expected to adjust their views properly when presented with fresh facts and to make decisions considered logically sound.

However, this approach overlooked many irregularities observed in market behaviour. Unusual patterns in trading activity and findings from real-world studies began to show that people do not always act in thoughtful or expected ways. Personal emotions, moods, and instinctive reactions often play a bigger part in decision-making than previously believed. The occurrence of stock market anomalies and empirical research revealed that investors are not as rational as they are assumed to be. Investor's irrational decisions are mainly because of emotions and feelings (Barberis and Thaler, 2003). In this context, several traditional theories were developed that are summarized in Table 1.

***Table 1*- Conventional Finance Theories**

Author	Year	Theory
Bernoulli Von Neumann and Morgenstern	1738, 1954, 1953	Expected Utility Theory (EUT)
Eugene F. Fama	1970	Efficient Market Hypothesis
Stephen Ross	1976	Arbitrage Pricing Theory
Harry Max Markowitz	1990	Markowitz Portfolio Theory
Jack Treynor, Sharpe, William John Lintner, Black, and Jan Mossin	1962, 1964, 1965, 1972, 1996	Capital Asset Pricing Model

Source: Compiled by the Author

Expected Utility Theory (EUT) is a model that describes how individuals should make decisions when facing uncertain outcomes. It assumes that people make choices logically, preferring safer options over riskier ones if the potential returns are the same. According to this idea, investors carefully weigh the possible results of each option and choose the one that offers the best balance of high return and low risk (Fishburn, 1988). The theory paints a picture of decision-makers as fully rational, able to handle complex information, and always aiming to maximize their financial well-being. Over the years, this framework became the standard for explaining how financial decisions are made under uncertainty, especially in academic and professional settings. However, real-world behaviour often tells a different story. Studies have shown that investors don't always follow this logical path—particularly when risk is involved. As observed by researchers like Kahneman and Tversky (1979), human choices frequently stray from the predictions of EUT, revealing that psychological factors often override purely rational thinking.

The Efficient Market Hypothesis (EMH) is rooted in the principle of price uniformity, suggesting that a single, fair value exists for each asset at any given time, reflecting all available information. The *Efficient Market Hypothesis (EMH)* is a theory that suggests financial markets work in such a way that asset prices always reflect all available information. In other words, the moment new information becomes public—whether it's company news, economic data, or global events—the prices of stocks and other securities adjust instantly. This means that *no investor can consistently outperform the market* by using information that is already known to everyone. From an investment behaviour perspective, EMH assumes that all market participants act rationally and respond to news logically and efficiently. It also implies that strategies like stock picking or market timing have *no real long-term*

*advantage***,** because any potential gains are already "priced in." The theory is generally divided into three forms. One is the *weak form* where all past prices are already reflected in current prices. Second one is the *semi-strong form* where all publicly available information is reflected in prices and lastly, the *strong form* where insider or private information is already included in prices. However, in real life, investor behaviour often *contradicts EMH*. Emotional decisions, overreactions, herd mentality, and biases can all lead to *mispriced securities* and *market anomalies*, such as bubbles or crashes. While EMH provides a clean, logical structure for understanding markets, behavioural finance shows that *markets are not always perfectly efficient* due to human psychology.

Markowitz Portfolio Theory, explains how investors can build a mix of investments in a way that balances risk and return. The key idea is that instead of looking at individual assets in isolation, smart investors should look at how different investments work together in a portfolio. According to this theory, people can reduce the risk of losing money by spreading their investments across various assets, like stocks, bonds, or other securities. This is known as diversification (Markowitz, 1952). When some assets in the portfolio perform poorly, others may do well, which helps stabilize overall returns. In terms of behaviour, the theory assumes that investors are logical and careful. It suggests that they want to get the highest possible return for the level of risk they're willing to take. For example, someone who is risk-averse would choose a safer mix, while someone with a higher risk appetite might include more volatile assets. However, in real life, many investors do not follow this rational strategy. Behavioural studies have shown that people often ignore diversification, hold too many similar assets, or chase recent winners, which increase their risk without improving returns. So, while Markowitz gave a solid foundation for smart investing, actual investor behaviour often drifts away from these principles due to overconfidence, emotional decision-making, or lack of knowledge. Through this method, investors can design a collection of investments that lie on the so-called efficient frontier—portfolios offering the most favourable trade-off between risk and reward (Fabozzi and Grant, 2001). This theory also laid the groundwork for the Capital Asset Pricing Model (CAPM), a foundational tool in modern finance.

The Capital Asset Pricing Model (CAPM) is a financial model that helps figure out how much return an investor should expect from an investment, given how risky it is. The main idea is: *if you take more risk, you should get more return*. But not all risks are the same. CAPM focuses on *market risk*—the kind of risk you can't avoid no matter how much you diversify. This is also called *systematic risk***.** The model uses a formula that includes: i) The *risk-free return* – what you would earn from a completely safe investment ii) The *beta* – a number that shows how sensitive an investment is to the overall market. If beta is high, the asset moves more than the market. If it's low, it moves less and iii) The *market return* – the average return expected from the whole market. Using these, CAPM tells us what a "fair" return on an investment should be. If the expected return is higher than what CAPM says, the investment might be a good opportunity. If it's lower, it might be overpriced. However, over time, experts noticed that real-world returns didn't always match what CAPM predicted (Sharpe, 1964). Because of these *anomalies***,** many moved on to more detailed models, like the *Fama-French three-factor model*, which adds other factors to better explain returns.

Arbitrage Pricing Theory (APT) is a model used to understand what affects the return of an asset, like a stock. Unlike CAPM, which focuses only on market risk, APT says that many different factors can influence an investment's return — such as inflation, interest rates, GDP growth, and more. The theory suggests that each of these economic or financial factors has some impact, and the return on an asset depends on how sensitive it is to each of them. Investors expect a fair return based on these risks. If the price of an asset is not aligned with its risk, traders can take advantage of the difference (this is called arbitrage) to earn a profit and that pressure eventually pushes the price back to a fair level (Ross, 1976). In simple terms, APT is a *multi-factor approach* that explains how the expected return of an asset is influenced by several *macroeconomic variables* that represent broad, unavoidable (systematic) risks. The model assumes a *linear connection* between these factors and the asset's return. A key idea in APT is the *law of one price*, which means that if two assets carry the same level of risk, they should be priced equally in an efficient market. This also means their long-term returns should be alike. One of the advantages of APT is its *flexibility*, as it allows for multiple sources of risk and does not depend on the rigid assumptions required by models like CAPM.

Behavioural Finance Theories

Studies in recent decades have shown that individuals often do not make financial decisions in a purely logical or calculated manner. Instead, their actions tend to be influenced by feelings, habits, mental shortcuts, and personal judgment errors (Nofsinger, 2017). This contradicts the earlier view held by classical financial theories, which assumed that all investors behave in a rational and consistent way. In reality, when people face uncertainty or complex investment choices, they often rely on quick judgments rather than detailed analysis (Tversky and Kahneman, 1974). This gap between theoretical assumptions and real-life behaviour led to the development of a new school of thought called "**Behavioural Finance"**. In the 1980s, Daniel Kahneman and Amos Tversky, both psychologists, became the leading figures in shaping this field. Their pioneering work revealed how human judgment is prone to predictable biases, and they provided evidence that decision-making in financial markets is frequently shaped by psychological factors, not just numbers or logic. Behavioural Finance emerged as a direct challenge to traditional finance, which was built on the belief in rational investors and efficient markets. As financial markets showed patterns that couldn't be explained by classic models—like bubbles, crashes, and overreactions—researchers began to look at the human side of investing. According to Thaler and Barberis (2002), Behavioural Finance is grounded in two essential principles. First is how people think and process information, which relates to psychological functions like perception, memory, and judgment. Second is the concept of limits to arbitrage, which means that even when prices in the market are clearly wrong, not all investors are willing or able to take advantage of the situation—often due to fear, overconfidence, or other irrational factors. As Thaler (1993) aptly put it, this way of understanding markets is simply about being more "open-minded," recognizing that human behaviour doesn't always follow the neat assumptions of economic models. In this context, several traditional theories were developed that are summarized in Table 1.

***Table 11*- Behavioural Finance Theories**

Author	Year	Theory
Simon	1950	Bounded Rationality Theory
Kahneman and Tversky	1974	Heuristics Theory
Kahneman and Tversky	1979	Prospect Theory
Shefrin and Statman	1994	Behavioural Asset Pricing Theory
Shefrin and Statman	2015	Behavioural Portfolio Theory

Source: Compiled by the Author

Adding further depth to the understanding of real-world decision-making, the concept of **Bounded Rationality** offers critical insight into why investors often fall short of making perfect choices. This framework argues that individuals do not possess unlimited mental capacity, time, or access to flawless information. Instead, their choices are shaped and restricted by a variety of practical limitations, including the brain's processing limits, costs involved in gathering and analysing data, and the imperfections in the information available to them. Simon challenged the classical economic notion of the perfectly rational agent by arguing that true rationality is unattainable in complex, uncertain environments. People simply do not have the ability to examine every possible alternative or calculate every outcome. As a result, they do not seek the "best" or optimal outcome, rather, they settle for a solution that is "good enough", which he termed satisficing.

This idea connects closely with behavioural finance, as it supports the view that investors make decisions using shortcuts and approximations—not because they are careless, but because they are human. Bounded rationality helps explain why even well-intentioned individuals can make mistakes, misjudge risks, or overlook important details in the financial world (Selten, 1990). By acknowledging these cognitive and environmental constraints, Simon's theory paved the way for modern approaches that see investors not as flawlessly rational beings, but as real people navigating complexity with limited tools.

The *Behavioural Asset Pricing Model (BAPM)***,** offers a more realistic way to explain how asset prices are determined in the market, especially compared to traditional models like CAPM. Instead of assuming that all investors act rationally and process information perfectly, this model takes into account the *psychological influences* that affect many market participants. According to BAPM, financial markets are shaped by the interaction of *two distinct types of investors* i) The first group consists of *rational investors*, sometimes called *informational traders***.** They rely on solid data, follow logical strategies, and typically align with the assumptions of standard finance models like CAPM. ii) The second group is made up of *noise traders* — individuals whose decisions are affected by *emotions, biases, and incorrect interpretations of market signals***.** These investors do not necessarily follow rational principles, and they may react to news or trends in ways that deviate from logical behaviour. What makes BAPM unique is that it factors in these behavioural differences when estimating the *expected return on investments*. Rather than using traditional beta (as in CAPM), it introduces the idea of *"behavioural beta"***,** which reflects how an asset's return is influenced by the presence of irrational traders and psychological factors in the market (Shefrin and Statman, 1994). In essence, BAPM acknowledges that real-world pricing is not only shaped by risk and return but also by how *human behaviour*, with all its flaws and emotions, plays out in the marketplace.

Behavioural Portfolio Theory (BPT) explains how investors build their portfolios not as a single unit aiming only for maximum return, but rather as a combination of different layers, each designed to meet specific personal goals. Think of it like a pyramid, where every level represents a distinct objective — such as safety, income, or growth — and each is tied to a different level of risk tolerance (Prosad et al., 2015). Unlike traditional theories that assume all investors have a consistent attitude toward risk across their entire portfolio, BPT suggests that investors treat different parts of their money differently, depending on the purpose of that portion. For instance, an individual might invest cautiously in one part of their portfolio to protect their savings, while taking more aggressive risks in another portion to try and build wealth. This theory reflects real-world behaviour more accurately, recognizing that investors are not always purely rational and often mix emotional preferences with financial planning. BPT shows that personal goals, mental framing, and varying comfort with risk all shape how portfolios are actually created.

Prospect Theory, is one of the most influential contributions to understanding how investors actually behave under conditions of risk and uncertainty. It challenges the traditional view that individuals always make rational decisions aimed at maximizing their expected utility. Instead, Prospect Theory suggests that people *evaluate outcomes based on potential gains or losses relative to a reference point*, not on final wealth levels. In investment behaviour, this means that investors are more sensitive to *changes in value* than to absolute outcomes. What stands out most in this theory is the idea that *losses hurt more than equivalent gains feel good* — a concept known as *loss aversion* (Kahneman and Tversky, 1979)**.** For example, the emotional impact of losing ₹10,000 in a stock is much stronger than the pleasure of gaining ₹10,000 from it. This imbalance influences how investors take risks. In general, they become *risk-averse* when dealing with potential gains — preferring a smaller certain gain over a larger but uncertain one, while they become *risk-seeking* when facing losses — often holding on to declining assets longer than they should, hoping to recover. Another key idea in Prospect Theory is the *value function*, which is curved — it rises more slowly for gains and drops sharply for losses, showing how individuals weigh outcomes unevenly. This helps explain behaviours like *holding losers too long***,** *selling winners too early***,** or *avoiding risks that might actually be beneficial* in the long term. In essence, Prospect Theory provides a psychological explanation for why investors often deviate from what traditional

economic models would predict. It has reshaped financial theory by acknowledging that real investment choices are guided not just by logic, but by how people *feel about gains and losses* — even when the actual values are the same.

In the field of investment decision-making, **Heuristics** refer to the mental shortcuts or simplified strategies that individuals use to make quick judgments without engaging in detailed analysis. These rules of thumb are not inherently faulty; in fact, they often help individuals cope with complex and uncertain situations. However, in financial settings, they can lead to predictable errors in judgment and systematic biases. When faced with overwhelming information, time pressure, or limited knowledge, investors often fall back on these mental shortcuts Brabazon (2000). For example, they might judge a stock as "safe" simply because it's well-known (representativeness heuristic), or they may rely too heavily on the most recent market news while ignoring long-term trends (availability heuristic). Another common pattern is anchoring, where an investor gets fixated on an initial number—like a stock's past high price—and makes decisions around that reference point, even when market conditions have changed. These heuristics are not used randomly; they are a response to the limits of human attention, memory, and processing power. While they can save time and reduce complexity, they also create room for cognitive distortions that can impact investment choices in significant ways—leading to under-diversification, overconfidence, herding behaviour, or resistance to changing poor strategies. In the context of behavioural finance, heuristics theory provides a strong explanation for why real-world investor behaviour frequently diverges from the predictions of traditional finance models. It reinforces the idea that decisions in financial markets are not just driven by hard data and rational analysis, but also by human tendencies to simplify, assume, and react emotionally in uncertain environments.

Conclusion

This study sheds light on the fact that investors often act in ways that deviate from logical or purely analytical decision-making. In the context of the Indian stock market, it becomes apparent that psychological tendencies and mental biases frequently override rational assessments. Rather than relying on structured analysis or quantitative evaluations, many investors are influenced by emotions, habits, and conventional practices, especially when aiming for higher returns. This behavioural tendency reflects a broader pattern where short-term thinking dominates long-term planning, often resulting in impulsive or suboptimal investment choices. The findings suggest that for investors to make more effective decisions, there is a need to shift towards a future-oriented mind-set—one that values patience, long-term growth, and calculated risk-taking. By recognizing the psychological factors that unconsciously guide their decisions, individuals can better navigate market uncertainties and improve their financial outcomes. Awareness of these behavioural patterns is particularly crucial in volatile markets, where emotional reactions can lead to poor investment timing or unnecessary risk exposure.

Furthermore, this study brings to the forefront the limitations of relying solely on traditional financial theories. While conventional models like the Efficient Market Hypothesis or Expected Utility Theory assume that investors are rational and markets are self-correcting, real-world behaviour tells a different story. In reality, human emotions, cognitive shortcuts, and social influences play a significant role in shaping market dynamics. This mismatch between theory and practice emphasizes the growing importance of integrating behavioural finance into mainstream financial thinking. Rather than discarding traditional theories altogether, a more balanced and realistic approach would involve blending the strengths of both traditional and behavioural perspectives. Traditional finance offers structure and logic, while behavioural finance contributes psychological realism. When combined, they can provide a more comprehensive framework for understanding how investment decisions are made and how market anomalies occur.

In conclusion, this research reaffirms that incorporating human behaviour into financial analysis is not only relevant but essential. Acknowledging the behavioural side of investing helps create more adaptive, resilient, and informed strategies—ones that align better with how people actually think and act in financial environments. This integration marks a progressive shift toward a more inclusive and realistic approach to understanding investor behaviour in today's complex financial markets.

REFERENCES

1. Barberis and Thaler. (2002). Working paper, National Bureau of Economic Research. 1050 Massachusetts Avenue Cambridge, MA 02138 September 2002.
2. Barberis, N., & Thaler, R. (2003). A survey of behavioural finance. Handbook of the Economics of Finance, 1, 1053-1128.
3. Barberis, N., & Thaler, R. (2005). A survey of behavioural finance. Princeton university press program (NCEP).
4. Brabazon, T. (2000). Behavioural Finance: A new sunrise or a false dawn. 28th August.
5. Fabozzi, F., & Grant, J. (2001). Modern Portfolio theory, capital market theory, and asset pricing models. Journal of Finance, 6(2), 11-41.
6. Fishburn, P. C. (1988). Expected utility: An anniversary and a new era. Journal of Risk and Uncertainty, 1(3), 267-283.
7. Kahneman, D., & Tversky, A. (1979). On the interpretation of intuitive probability: A reply to Jonathan Cohen, Cognition, 7(4), 409–411.
8. Markowitz, H. (1952). Portfolio selection. Journal of Finance, 7(1), 77- 91.
9. Nofsinger, J. R. (2017). The psychology of investing. 6th ed., Routledge, New York.
10. Nofsinger, J. R. (2017). The psychology of investing. 6th ed., Routledge, New York.
11. Prosad, J. M., Kapoor, S., & Sengupta, J. (2015). Theory of behavioural finance. Copur, Z. (Ed.). (2015). Handbook of research on behavioural finance and investment strategies: Decision making in the financial industry. IGI Global.
12. Ross, S. A. (1976). The Arbitrage Theory of Capital Asset Pricing'. Journal of Economic Theory, 13, 341-360.
13. Selten, R. (1990). Bounded rationality. Journal of Institutional and Theoretical Economics (JITE)/Zeitschrift für die gesamte Staatswissenschaft, 146(4), 649 658.
14. Sharpe, W. F. (1964). Capital asset prices: A theory of market equilibrium under conditions of risk. The Journal of Finance, 19(3), 425-442.
15. Shefrin, H., & Statman, M. (1994). Behavioural capital asset pricing theory. Journal of Financial and Quantitative Analysis, 29(3), 323-349.
16. Thaler, R. H. (1993). Advances in behavioural finance (Vol. 1). R. H. Thaler (Ed.). New York: Russell Sage Foundation.

17. Tversky, A., & Kahneman, D. (1974). Judgment under uncertainty: Heuristics and biases: Biases in judgments reveal some heuristics of thinking under uncertainty. Science, 185(4157), 1124-1131.

18. Tversky, A., & Kahneman, D. (1985). The framing of decisions and the psychology of choice. In Behavioural Decision Making, 25-41. Springer, Boston, MA.