

Chapter 5

Behavioural Finance: Understanding Investor Psychology and Market Trends

Dr Ritu Nehra

Associate Professor, Commerce

Desh Bandhu Gupta Govt College Panipat

ritunehra76@gmail.com

Abstract

Behavioural finance is a bridge connecting the traditional pillars of finance to human psychology and irrational behaviours affecting the financial markets. Classical finance assumes rationality and market efficiency; behavioural finance argues cognitive biases, emotional factors, and social influences affecting investor decisions. In this chapter, we look at evolution within the scope of behavioural finance as psychological biases, emotional influences and implications towards investment decisions and market anomalies. Tools and techniques like neurofinance and analytics driven by AI will be discussed for understanding investor psychology and its convergence in current financial practices, including portfolio management and ESG investing. Behavioural finance comprises a body of knowledge on bias and irrational behavior, thus improving decision-making in the context of mitigating market inefficiencies and providing information for policy making to have a healthier financial system.

Keywords

Behavioural Finance; Investor Psychology; Cognitive Biases; Market Anomalies; Emotional Decision-Making; Heuristics in Investing

1. Introduction

Behavioural finance is a branch of finance that merges psychology analysis with traditional finance theory to explicate irrationality in financial markets. In contrast to the Efficient Market Hypothesis (EMH), which presupposes that investors are rational and markets are efficient, behavioural finance posits that emotions, cognitive mechanisms, and social factors affect investors' behaviors and decisions, which in turn deviate from rationality (Kahneman & Tversky, 1992). This field seeks to understand how these biases affect the behavior of an individual or a group in financial markets, issues which classical models of finance do not capture well enough, for instance, why traders trade excessively, why bubbles form, and why stock prices exhibit anomalies.

Concerning the phenomena that fall under behavioral finance, one can name psychological factors such as overconfidence, loss aversion, and herd behavior, as well as the events at the market level, that is, specific bubbles and crashes (Barberis et al., 1998). Behavioral finance also interacts with new directions like neurofinance and finance with artificial intelligence, allowing researchers to examine the financial decision-making system on both conative and affective levels (Bennett et al., 2023).

Behavioral finance may be traced to a theory by Herbert Simon (1955) that asserted that some rationality was bounded by information processing constraints. This idea seemed to depart considerably from the theoretical provisions of the classical theory economic models that assumed that people were always fully rational.

The key advancement was achieved by Kahneman and Tversky's Prospect Theory (1979) which showed how losses are processed differently from gains. This theory has provided the basis for other future researches into decision making under conditions of uncertainty. This was followed by De Bondt and Thaler (1985) who built on the foundational theories through looking at how markets reacted to news which provided evidence to show that psychological factors could impact market trends.

Further development of the behavioral finance theory continued in the 1990s as other scholars such as Shiller (1981) and Barberis et al. (1998) focused on the psychological factors that cause market fluctuations and sentiments in the context of market prices. For example, Shiller's work on speculative bubbles showed how the herd behavior induced by the psychology of the markets could result in overbought stocks. In a more recent study, the use of technology and data analysis has helped in identifying how sentiments on social media, cultural bias, and individual bias impact the markets (Ángeles López-Cabarcos et al., 2020, Padmavathy, 2024).

There are several reasons why investor psychology needs to be considered firstly. First, it aids in defining certain observed market phenomena that standard finance theories fail to elucidate, including the momentum effect (Jegadeesh & Titman, 1993), as well as the disposition effect (Shefrin & Statman, 1985). They show that attitudes towards risk and self-asset, including fear and overconfidence can negatively affect investment portfolio decisions.

Second, behavioral finance offers practical implications regarding policy-making for practitioners. Portfolio managers and personal advisors can leverage these findings and implement them to minimize the implications of biases, either through data-diversification or via implementation of AI-based tools (Suresh, 2024). For instance, the endowment effect, in which investors place a higher value on objects belonging to them, can inform the process of portfolio rebalancing (Kahneman et al., 1991).

Lastly, more information on investor psychology can be applied to policy-making and regulation of the market. Speculative bubbles and market crashes can be prevented by implementing regulators that analyze areas of irrational behavior. According to Shiller (2003), it was possible to use a behavioral approach to policy in order to enhance market efficiency and investors.

2. Literature Review

Behavioural finance has travelled a long way since then, filling the gaps between the market anomalies and psychological approach to investing. This chapter offers a

narrative review firstly and then offers a detailed table of findings of prior research.

Behavioural finance can be defined as a field of study that analyzes the impact and implications of the critics of the Efficient Market Hypothesis and the rational behaviour assumption. In the prestructure approach, early work by Simon (1955) put forward bounded rationality and set the stage for analysing cognitive biases and heuristics. Kahneman & Tversky subsequently continued these ideas in the framework of Prospect theory in 1992, which included the topics of loss aversion, and framing. The most influential cognitive biases include mental accounting, which Thaler (1985) brought into the debate along with other related distortions.

Subsequently, researchers of the latest generation incorporated ideas of behavioural finance to various settings. For instance, Suresh (2024) studied mutual fund investors' behaviour and its impacts on financial literacy and behavioural biases, whereas Padmavathy (2024) focused on psychological factors affecting stock market anomalies. Some new areas like decentralized finance (DeFi) have integrated elements of behavioural finance, discussed by Bennett et al. (2023).

Table 1: Key Behavioural Finance Studies

Year	Authors	Focus/Findings	Research Gap
1955	Simon, H. A.	Introduced bounded rationality, highlighting limitations of human decision-making.	Lack of application in financial markets.
1981	Shiller, R. J.	Examined market volatility and speculative bubbles.	Limited exploration of psychological drivers behind bubbles.

1983	Keim, D. B.	Identified size-related anomalies and stock return seasonality.	Lack of behavioral explanations for anomalies.
1985	De Bondt, W. F., & Thaler, R. H.	Demonstrated stock market overreaction to news.	Limited cross-cultural analysis.
1992	Kahneman, D., & Tversky, A.	Extended Prospect Theory with cumulative representations of uncertainty.	Application to complex financial instruments was missing.
1993	Jegadeesh, N., & Titman, S.	Analyzed momentum effects in stock returns, challenging EMH.	Did not explore psychological underpinnings of momentum.
1998	Barberis, N., Shleifer, A., & Vishny, R.	Modeled investor sentiment and its impact on market pricing.	Limited empirical validation in diverse markets.
2000	Barber, B. M., & Odean, T.	Highlighted overconfidence bias leading to excessive trading.	Focused primarily on individual investors in developed markets.
2007	Bollen, N. P.	Explored mutual fund attributes affecting investor behavior.	Lack of integration with behavioral theories.
2010	Chui, A. C., Titman, S., & Wei, K. J.	Investigated cultural influences on momentum effects.	Limited exploration of emerging economies.
2020	Ángeles López-Cabarcos et al.	Reviewed the role of investor sentiment in behavioral finance.	Limited integration with technological advancements.
2023	Bennett, D., Mekelburg, E., & Williams, T. H.	Applied behavioral finance principles to decentralized finance asset pricing.	Early-stage exploration with limited real-world applicability.
2024	Suresh, G.	Studied the impact of financial literacy and behavioral biases on investment decisions.	Limited to specific demographic groups.
2024	Padmavathy, M.	Analyzed psychological factors driving stock market anomalies.	Narrow focus on psychological biases; lacked integration with market dynamics.

3. Theoretical Foundations

The theory of behavioural finance was developed in the attempt to overcome the

shortcomings of classical finance theories including the efficiency market hypothesis. This section discusses the theoretical framework of behavioral finance, its

divergence from classical finance, cognitive psychology, and the behavioral finance versus the EMH.

Classical finance is founded on rational expectations and efficient market hypothesis. The Efficient Market Hypothesis (EMH), propagated by Fama (1970) states that existing asset prices incorporate all possible information and thus there exists no prospect for constant out-performance of the market. Behavioral finance on the other hand reacts to these assumptions by embracing psychological and cognitive characteristics that affect investors (Zahera, & Bansal, 2018).

Classical finance believes that investors make decisions to maximize utility based on rationality, but in contrast, behavioral finance understands that people make decisions that do not always align with strict rationality due to emotions, biases or heuristics (Baker & Nofsinger, 2010). For example, investors can overtrade due to overconfidence or they avoid taking losses more than they seek gains (Howard, 2012).

Here it is imperative to mention that unlike classical finance, behavioral finance does not dismiss classical finance but presents a more advanced model to account for irregularities such as bubbles, crashes, and so forth, alongside constant market inefficiencies (Konstantinidis et al., 2012).

In behavioural finance, cognitive psychology remains core because it helps explain how humans rationalise their choices. People follow heuristics when taking investment decisions, and most are bound to have systematic biases. In this relation, Prospect Theory proposed by Kahneman and Tversky in 1979 is basic in illustrating how individuals evaluate possibilities of losses and gains.

Frydman & Camerer (2016) also focus on how neuroscience can explain the financial decisions and emphasize on the feelings such as the fear, greed is derived from the neuro images that have an impact on risk and valuation. For example, investors may respond emotionally towards negative events where the market overcorrects as shown by Howard (2012).

In addition, factors such as anchoring, confirmation bias and herding can prejudice decision making regarding investment. According to Boda and Sunitha (2018), the key point of enhancing financial decision-making is the understanding of such biases at both individual and institutional levels.

The EMH postulates that the stock markets are rational, and the prices incorporate all the available information. However, we have seen signs of it before, the dot-com bubble and the 2008 global financial crisis. According to Ball (2009), these crises underscore the importance of other models that can capture the unpredictable behavior of investors.

Behavioral finance contradicts the EMH by claiming that markets are not always efficient because of cognitive biases and emotions. For instance, Konstantinidis et al. (2012) observed that people mimic the actions of others to reach the herd instinct and create the bubbles in the market; Lo (2005) presented the AMH model. The AMH also confirms that market efficiency is not constant but dynamic because investors over time lose their efficiency due to new environments.

Kartašova et al. (2014) also pointed out that while EMH remains grounded in theory it seems to lack flexibility in its assumptions as opposed to what is visible in the real

world as seen through behavioural finance. For instance, Zahera and Bansal (2018) surveyed several papers that show why and how the rationalities such as overconfidence and aversion to loss lead to inefficient transactions not accounted for by EMH.

4. Psychological Biases and Heuristics

Psychological factors such as biases and heuristics directly impact the decisions that investors make as well as their effects on the market. For example, overconfidence causes investors to overestimate their knowledge and the ability in decisions making leading to the excessive trading and poor performance. Overconfidence makes people take more risks, herd with others, and under-diversify, even when they lose a lot of money, according to Barber and Odean (2000). Other cognitive biases that distort market value include reference point bias whereby investors stick too much on the first points of reference. Investors could focus on previous prices of the stock or future expected earnings, and neglect to balance their expectation when new information is obtained (Howard, 2012; Frydman & Camerer, 2016).

According to Kahneman and Tversky's model called Prospect Theory (1979), loss aversion illustrates why losses rank more significantly than similar gains with investors. This behaviour leads to the what is termed the disposition effect in which one holds a losing position in the hope that the value will rise but sells a winning position quickly only to save the gains (Shefrin & Statman, 1985). This behavior illustrates that the emotional aspects may triumph over rationality in financial choice-making. Herd behavior, another pervasive

bias, occurs when investors follow the actions of the majority, often driven by social conformity and the fear of missing out. This phenomenon has been linked to speculative bubbles, such as the dot-com and housing market booms, amplifying market volatility (Konstantinidis et al., 2012; Baker & Nofsinger, 2010).

Mental accounting is a phenomenon whereby money is treated based on some self-generated criteria such as its origin or the purpose it will be used for. For example, people possess high risk tolerance with regard to monetary gains but low risk tolerance with regard to future savings (Thaler, 1985). Such behavior causes irrational management of portfolio, thus disturbing overall financial performance (Howard, 2012). Another factor causing such decision-making is confirmation bias through which people look for evidence in support of existing decisions while disregarding evidence that could work against those decisions. This bias makes investors overly confident in the strategies and fail to adjust to a new environment (Boda and Sunitha, 2018; Zahera and Bansal, 2018). Cognitive biases are inherent in human decision-making processes; therefore, recognizing these biases is crucial in designing a strategy that will eliminate or reduce the impact of bias that influences investors to make irrational decisions.

5. Emotional Influences on Investment Decisions

Emotional influences play a pivotal role in shaping investment decisions and market dynamics, particularly through the powerful forces of fear and greed. It usually appears during periods of market decline

and causes investors to panic sell undermining stability through volatile prices. This response is due to loss aversion, one of the principles of behavioral finance, which states that investors are more sensitive to losses than to gains (Kahneman & Tversky, 2013). Whereas greed entices investors to take greater risks during periods of market buoyancy thereby causing asset inflation. Self-interest leads investors to ignore factors that could affect a specific investment to gain higher returns, thus bringing about massive failures when these essentially speculative bubbles burst (Bennett et al., 2023).

Risk-taking ability is another way through which stress affects investors' behavior to a large extent. Investors behaviors under pressure are risk-adverse and are more inclined towards going for safer low risk investments rather than taking high risk investment opportunities with higher returns. Such change in behavior is observed especially during increased volatility or in a financial crisis (Frydman & Camerer, 2016). Yet another factor that influences investors' decisions is an emotional state, as long as this aspect impairs rational thinking. For instance, stressed patients may not manage their portfolios efficiently or may quickly sell securities to avoid feeling threatened, even

if such action will be costly (Padmavathy, 2024). These emotional responses strike a blow at the fundamental concept of rationality of securities investments and thus assert the need to consider the emotional angle in the decision-making process.

Thus, behavioral patterns during the financial crisis reveal the phenomenon of strong dominance of emotional factors in stock exchanges. The investors also experience behavioral bias during periods of crisis, for example, herding behavior where the investors act as the larger group does, as opposed to exercising their discretion on an informed decision. This herd behavior is mainly due to fear and greed of losing and not knowing, resulting to selling of securities during bear runs or on the other extreme, over buying during the bull runs (Baker & Nofsinger, 2010). The behaviors manifested through such practices hinder efficient functioning in the markets, eradicating conventional mainstream theories such as the Efficient Market Hypothesis (Akintoye, 2008). Analyzing emotions that precipitate these kinds of behavioral patterns is vital tailoring risks and enhancing investment tumultuous and anxiety-inspiring market conditions (Zahera & Bansal, 2018).

6. Behavioral Anomalies in Financial Markets

The irrationality occurs due to the collective behavior of humans, which interferes with the efficiency of the financial markets. Some key examples include market bubbles and crashes, which are fueled by factors such as greed and fear. During bull markets, optimism emerges to drive up the prices of assets thus reaching

implausible heights which at some point is identified to be unrealistic. Like other examples of patterns and anomalies, such as seasonal and calendar effects, like January effect, which indicates that high returns occur in January due to tax-loss selling in the December (Keim, 1983). Statman (1999) has provided an example of

Sentiment and psychological readiness after weekends by pointing toward the Monday blues, where returns are low on Mondays. Explanatory theories tied to behaviour of returns, including overreaction to information and bandwagon effects, emphasise transient mispricing of securities (Jegadeesh & Titman, 1993).

Another prediction of the prospect theory is that people are loss averse; this is used to explain changes in the market by the fact that losses weigh more than equivalent gains in influencing the decision-making process of the investors (Kahneman & Tversky, 2013).

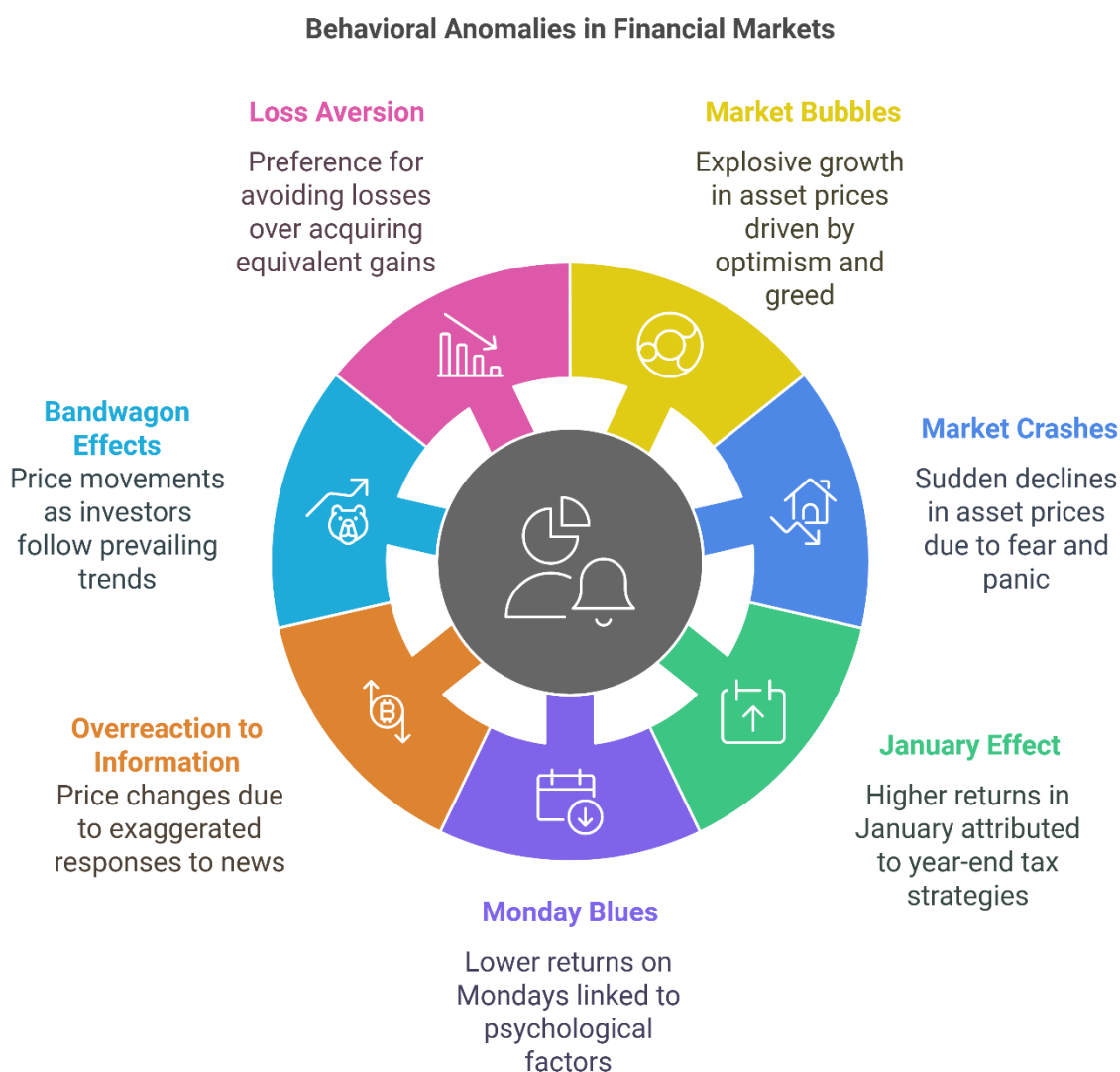


Figure 1 Conceptual Diagram by Author

Studies of investor psychology involve the use of different tools and methods.

7. Tools and Techniques to Understand Investor Psychology

Compared to questionnaires, behavioral finance surveys involve the use of questionnaires, which gives statistics on provided answers to identify trends and difficulties (Baker & Nofsinger, 2010). Advanced technology such as big data and AI have proven crucial in financial analysis since large data can be processed and analyzed to determine the next best action or the public sentiment towards a given investment opportunity. These technologies help to amplify the observation of these patterns in real-time, and refine the prediction of the market rates (Bennett, Mekelburg, & Williams, 2023). Neurofinance has therefore contributed to the knowledge of how people arrive at their financial decisions through consideration of neuronal data. Methods like the functional magnetic resonance imaging (fMRI) map how cognitive functions and emotions impact investment behaviors; and by understanding the unconscious decision-making processes that underpin investments (Frydman & Camerer, 2016).

8. Implications for Market Participants

Behavioral finance has implications on practice for different participants. Bias can be managed by individuals through the formulation of certain rules and sticking to compound investment aims, avoiding the inclination to make reactive decisions based on short-term fluctuation (Zahera & Bansal, 2018). Its implications for financial advisors enable them to help clients to make wiser decisions by controlling their feelings that cause rebellion (Suresh, 2024). Decision-makers can use information about behavioral biases such as herd behavior to formulate rules that assist in the establishment of order in the field of

finance. Awareness-based policies that expose general practitioners (GPs) to market conditions are helpful in curbing irrationality in the wake of the 2008 crisis, according to Padmavathy (2024). Mitigating these implications serves to strengthen the ability of the financial system to withstand shocks as well as benefiting from improved capacity to make sound decisions.

9. Integration with Modern Finance Practices

Behavioral finance has become accepted as an integral part of current portfolio management, investment consultation, and sustainability investment. Behavioral finance provides a framework for portfolio construction, which other strategies like Behavioral Portfolio Theory (Howard, 2014; Antony, 2020) also embrace. The biases like overconfidence and loss aversion can be eliminated by integrating them using the robo-advisors powered by the AI technology as they enhance the investment processes to be less emotional and time-consuming (Bhatia, Chandani, & Chhateja, 2020). All these digital innovations respond to behavioral imperfection and bring access to wealth management (Darskuviene & Lissauskiene, 2021; Bhatia et al., 2022). Moreover, behavioral aspects are used in decision-making within the ESG investing, factors such as herd effects and mental accounting. Such findings ensure that investor behaviors fit the positive results by reconciling the available knowledge on behavioral finance between reasonability and ethicality (Bhatnagar & Rajaram, 2025). By applying behavioral principles with modern upbeat finance tools, it brings

out a more sustainable, comprehensive, and responsible finance.

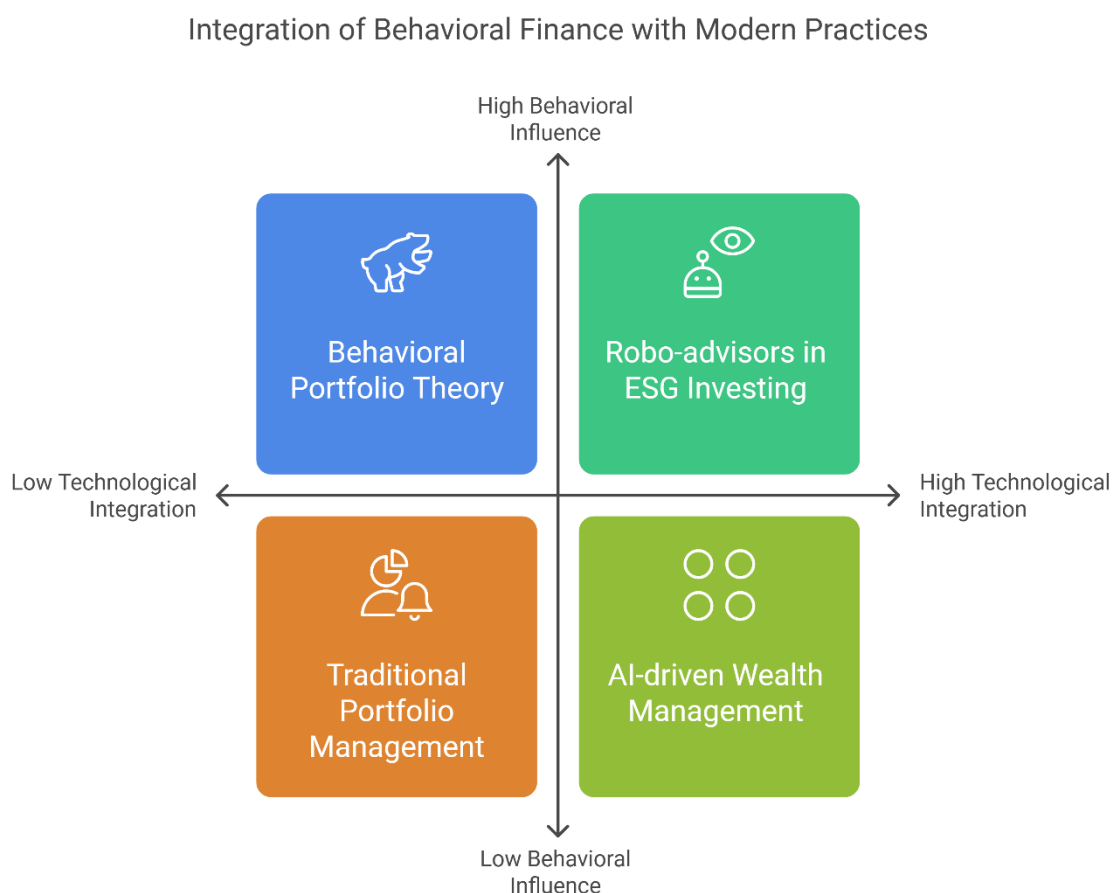


Figure 2 Conceptual Diagram by Author

10. Applications of Behavioural Science and challenges

Behavioral science has revolutionized finance by improving investment strategies and portfolio management. By accounting for common biases like overconfidence and loss aversion, investors can make more rational decisions that align with long-term goals. Similarly, understanding how individuals perceive risk enables financial advisors to offer solutions tailored to clients' comfort levels, reducing impulsive or irrational actions.

Another key application is the use of behavioral nudges, such as automatic enrollment in retirement plans, which encourage positive financial habits without requiring active decision-making. Insights from behavioral science also help in predicting market trends by analyzing collective behaviors like herding or panic selling, which are often driven by emotions rather than logic. Furthermore, behavioral profiling enables personalized financial advice, catering to the psychological preferences of individual investors. Finally, the development of FinTech solutions,

informed by behavioral science, leverages gamification and user-friendly interfaces to encourage saving and investing habits.

Despite its potential, applying behavioral science in finance faces significant challenges. Human behavior is complex and influenced by various cognitive, emotional, and social factors that are difficult to measure and predict accurately. Additionally, cultural and contextual variations mean that behavioral tendencies differ across regions and situations, limiting the universality of these applications.

Ethical concerns also arise, as behavioral interventions, such as nudges, may be perceived as manipulative if not implemented transparently. Collecting accurate behavioral data often involves privacy issues, as it requires in-depth insights into individual actions and preferences. Moreover, both individuals and institutions may resist adopting behavioral approaches due to unfamiliarity or skepticism. Integrating behavioral insights into traditional financial models and frameworks further adds to the complexity, requiring significant adjustments and industry-wide acceptance. Addressing these challenges is essential to fully harness the potential of behavioral science in transforming finance.

11. Future Trends and Research Directions

The future of behavioral finance is determined by technological innovations, cross-cultural research, and ethical implications. Technological developments such as AI, machine learning and neurofinance are changing the landscape by providing new information about investor

decision-making and facilitating predictive analytics (Bhatia et al., 2022). Cross-cultural research will be vital to customize bias mitigation strategies to suit different cultures in the global financial market (Agudelo Aguirre & Agudelo Aguirre, 2024). However, issues regarding privacy and the unethical use of human biases call for stronger regulations on both individual level, organizational level and even societal level (Bennett et al., 2023). Again, these future developments underscore that two needs: responsible application and innovative extension are critical for advancing both academic and practical behavioral finance.

12. Conclusion

Behavioral finance has evolved as an important field, questioning standard financial assumptions and providing a better knowledge of investor behavior and market dynamics. It explains anomalies like bubbles, breaks down, and other market inefficiencies by combining psychological and emotional elements. With the use of technologies like artificial intelligence (AI) and neurofinance, behavioral finance principles can be applied to help investors, advisors, and policymakers recognize and reduce biases, enhance decision-making, and promote market stability. As finance progresses, the continuing integration of behavioral insights with current methods will be critical for navigating complicated, unexpected market settings and improving financial system resilience.

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