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(Review Article)

# Impact of behavioral finance on financial decision making

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## Abstract

This paper highlights the disproportionate effect of behavioral finance on investor's investing decisions. While making any financial decisions, one easily gets influenced by psychological and emotional factors. Past individual experiences, tendency or opportunity for herd behavior, personal judgment, overconfidence in one's abilities, aversion to feelings of regret, reliance on advice from experts, and last but not least, something known as the disposition effect—by which investors tend to hold on to losing investments and professionally sell profitable ones too early. The impact of these factors on the investment decision-making process varies; on the one hand, they may enhance the quality of the decision-making process by aligning investments with risk tolerance and financial goals. However, on the other hand, behavioral factors can be a cause of inefficiency if investment decisions are based more on emotions than objective analysis.

In our recent research, we questioned 187 investors, using a questionnaire from whom we acquired crucial information regarding the impact of behavioral finance on financial decisions. The primary objective of the questioning was to determine the effect of behavioral finance on financial decision-making. The secondary objective was to suggest some methods for making one aware of the repercussions of impulsive or emotional decision-making and making prudent investments.

**Keywords:** Investing; Securities; Behavior; Decisions

## 1. Introduction

Investment in securities is an integral part of today's financial environment. With comprehensive information at their command, the discerning investor will still subject it to strenuous analysis. It is also where human psychology comes in, with all its attendant vagaries that tend to destroy good judgment. Overconfidence- an overestimation of one's knowledge and powers that most often leads to imprudent risks. A similar factor is the anchoring effect—that investors tend to be emotionally bound to an original purchase price and cannot think rationally when market conditions change. Gambler's fallacy—the belief that past outcomes tend to influence the probabilities of future events—and a reliance on mental shortcuts and heuristics further compound decision biases.

Other biases that result in investment mistakes include availability bias, where more recent or vivid events have a disproportionate influence on decisions, and experiential investing, which is based on personal experience rather than on hard data. Then there is impetuosity, where the investment decision is founded on an emotional base with less regard for rational analysis. These behavioral tendencies often result in huge financial losses, consequently leading to a sense of regret among investors.

Investors must learn to adjust strategies, manage risks, and improve safety against future uncertainties. Such experiences often serve as turning points for investor growth, emphasizing the importance of continuous learning and

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adaptation to navigate the complexities of financial markets effectively. By adopting these practices, investors can better position their investment portfolios for success.

## 2. Literature review

Presented below are some of the most prevalent investing patterns that investors may exhibit as a result of emotional influences

### 2.1. Empirical investing

Empirical investing refers to past experiences and historical data to decide on the line of action. This type of investment incontestably incorporates the behavioral traits of investors, which likely has the greatest impact as effects can range from significant losses to windfall gains. My study indicates that about 25-30% of investors continue to invest capital based on past successes by reinvesting in the same security that returned profits. Despite providing an investable framework that may seem familiar and rational, this approach also comes with associated problems including its inherent vulnerability to behavioral biases and possible mismatch between historical performance and future market conditions.

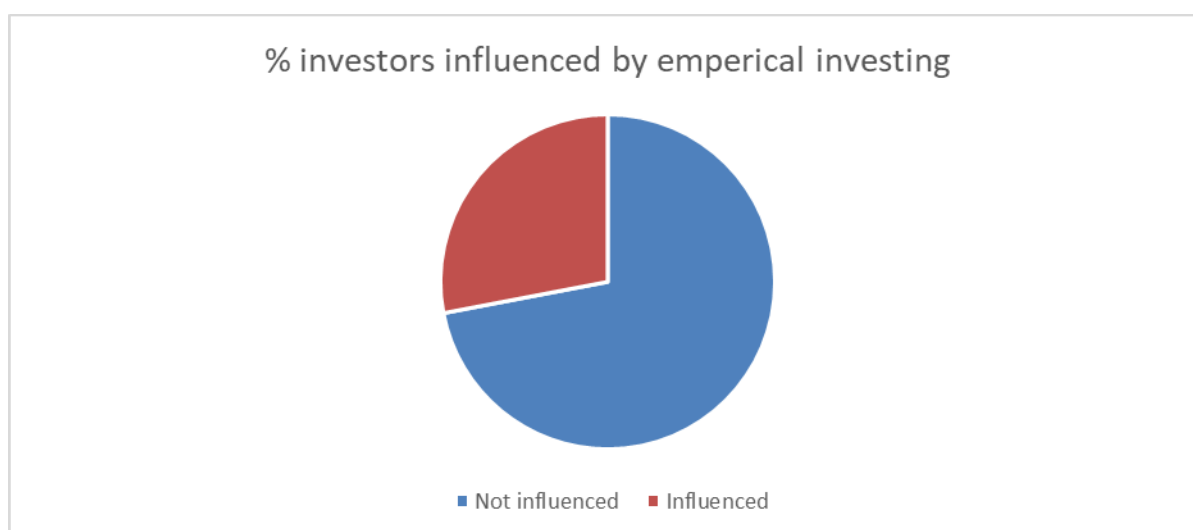


**Figure 1** % investors influenced by empirical investing

### 2.2. Subjective investing

It is investing based on judgment and intuition rather than rigorous quantitative analysis. There is a lot of individual insight, experience, and instinct in the approach that investors take, which may meld with such subjective personal beliefs and opinions about market trends and individual securities. The investment style helps provide flexibility and can help to turn up unique opportunities that wouldn't have been captured by purely quantitative methods. However, subjective investing is not without its pitfalls. Easily prey to cognitive biases, overconfidence, anchoring, and confirmation bias can blur clear decision-making into unexpected outcomes. The impact of emotions—either through the fear of missing out or the desire to make a quick buck—can be strong enough to cloud judgment and increase risk exposure. As per the author's study, 40% of all investors indulge in subjective investing in the equity market. This may occasionally reap very high returns but also subjects investors to very high risks. The lack of a rigorous systematic process and serious analytical discipline in such investment could mean inconsistent performance with too little risk control, opening up the possibility of unexpected losses. In simple words, subjective investing brings flexibility in itself and has the potential for finding gems, but an investor needs protection from inherent biases and emotional factors, which can influence his investment outcome on a negative note over time.

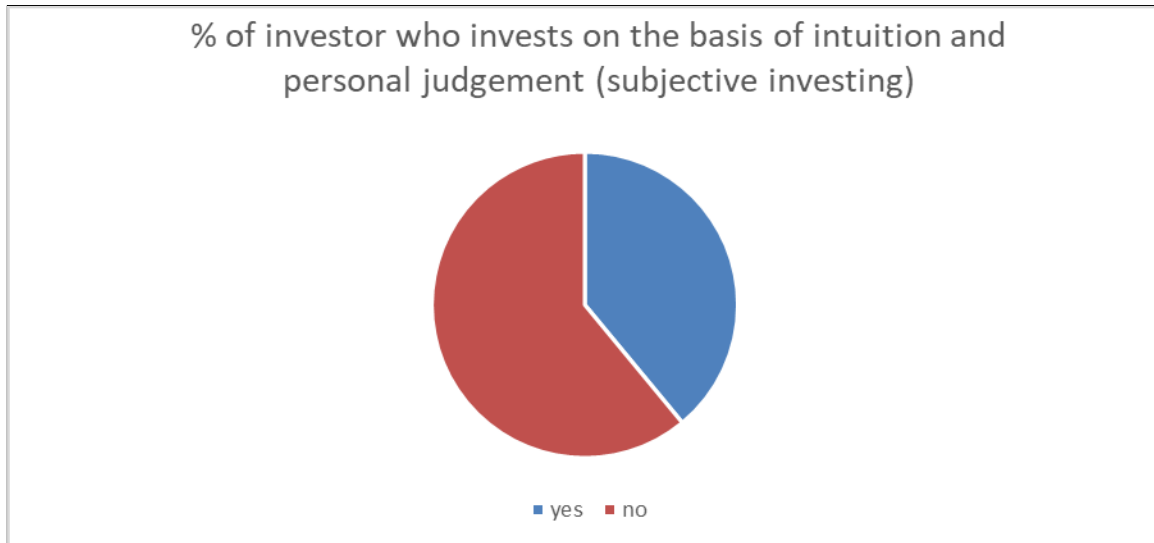


**Figure 2** % of investor who inverts on the basis of intuition and personal judgement

### 2.3. Availability bias

The phenomenon of availability bias significantly influences investors' decision-making processes. It manifests as a reliance on readily accessible information rather than seeking out comprehensive data or conducting thorough analyses. This cognitive bias leads individuals to perceive the immediate and easily obtainable information as sufficient and pertinent for making informed decisions.

In the context of investment, this bias can have profound implications. A striking 49% of investors, as noted in my study, regard readily available information as trustworthy. This reliance underscores a critical flaw in the decision-making framework within which many investors operate. The tendency to prioritize convenience over critical scrutiny can result in the neglect of vital data and broader market trends that deserve closer examination.

Moreover, this inclination towards readily available information contributes to a reinforcing cycle where key insights are overlooked, further distorting market perceptions and potentially leading to suboptimal investment outcomes. The implications of availability bias extend beyond individual decisions, affecting market dynamics as collective behavior may be driven by the same skewed perceptions.

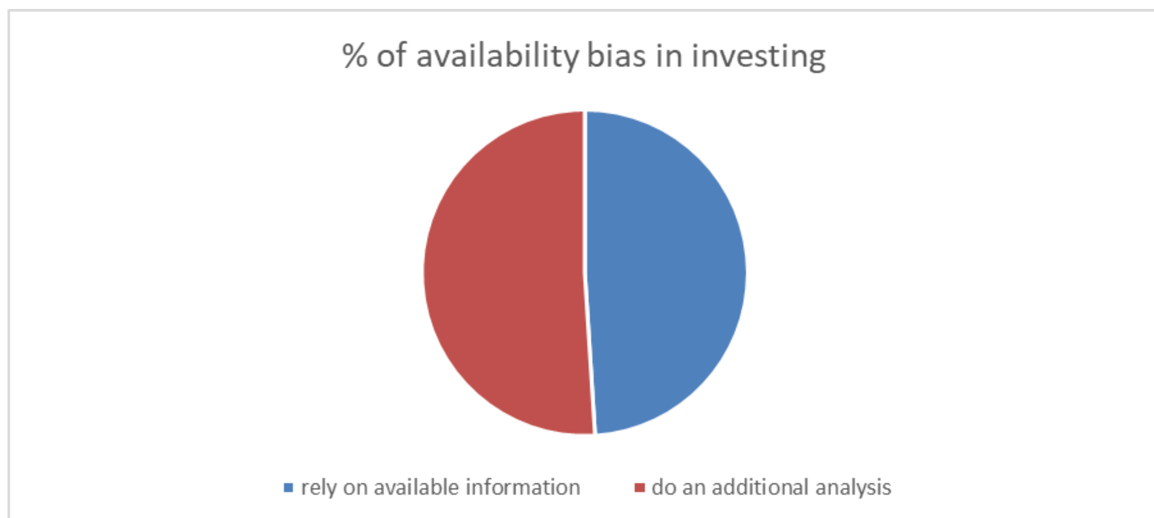


**Figure 3** % of availability bias in investing

### 2.4. Regret aversion approach

The Regret aversion approach to investor behavior describes that having already invested in a security, people are averse to realizing losses. This makes it so that they sell the security when its price starts rising out of fear that it might decline again and probably miss more gain if they had waited a little longer. The other way around is that investors can also hold on to stocks that decline in value, hoping for recovery, as usually due to the desire not to sell below the initial buying price, they have to overcome their regret.

This approach brings out the deepest psychological impact of regret on investment decisions, where actions are often based upon anticipatory emotions rather than a strictly rational review of the possible outcomes that an investment may produce. Such behavior causes lost opportunities to make profits and further exposure to loss, especially in those cases when investors do not have reliable foresight into the future course of market movements and their implications for investment performance. As per my studies, almost 30-32% of the investors have faced loss due to a lack of rational investment planning.

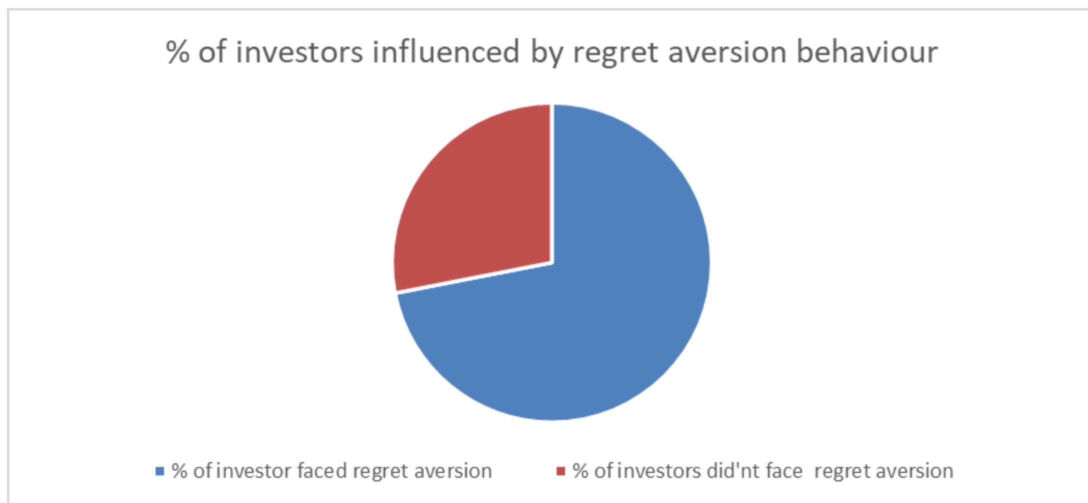


**Figure 4** % of investors influenced by regret aversion behaviour

### 2.5. Illusory superority

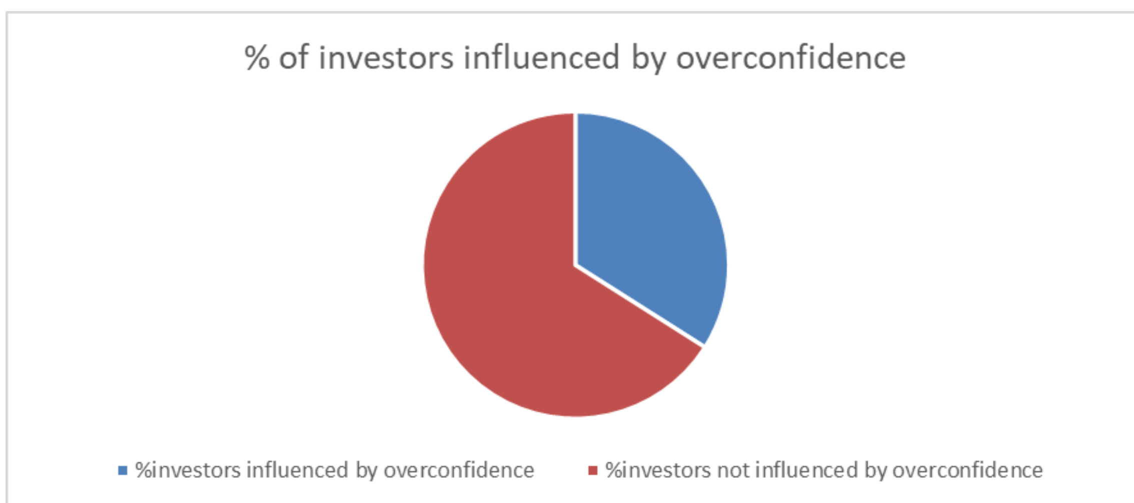


**Figure 5** % of investors influenced by overconfidence

It is described as a situation whereby individuals invest their funds based on perceived abilities, qualities, or judgment. In investing in securities, this behavior can prove to be quite harmful since it could alter well-established investment trends with the potential for huge losses. Such investors would, therefore, be driven by mere opinion, rather than an objective analysis of market situations and any associated risks. They are bound to be easily carried away by sudden changes in market situations or economic circumstances that had not been anticipated earlier.

According to my study, 34% of investors in this modern age have suffered financial losses due to overconfidence in their ability of judgments. This percentage itself explains how big of an impact cognitive bias can create on investment decisions and how unchecked subjective beliefs result in adverse financial consequences. Hence, recognizing and realizing the implications of illusory superiority in investment decision-making is very important if investors want to negotiate the complexities of the financial markets more awareness-filled and with greater caution.

### 2.6. Herd mentality

Herd mentality in investing can be defined as a phenomenon where investors make investment decisions primarily based on the actions and suggestions of others, as opposed to independent analysis. This behavior normally leads to the buying or selling of securities simply because an investor believes others' tips are prudent; hence, it does not take into consideration other important factors, thereby diverting investors from making investment decisions based on principle or individual research. According to my survey, in the modern world, 33% of the total investors generally invest based on others' recommendations while almost 50% of the investors covered in this study do not invest in securities recommended by someone without conducting further research

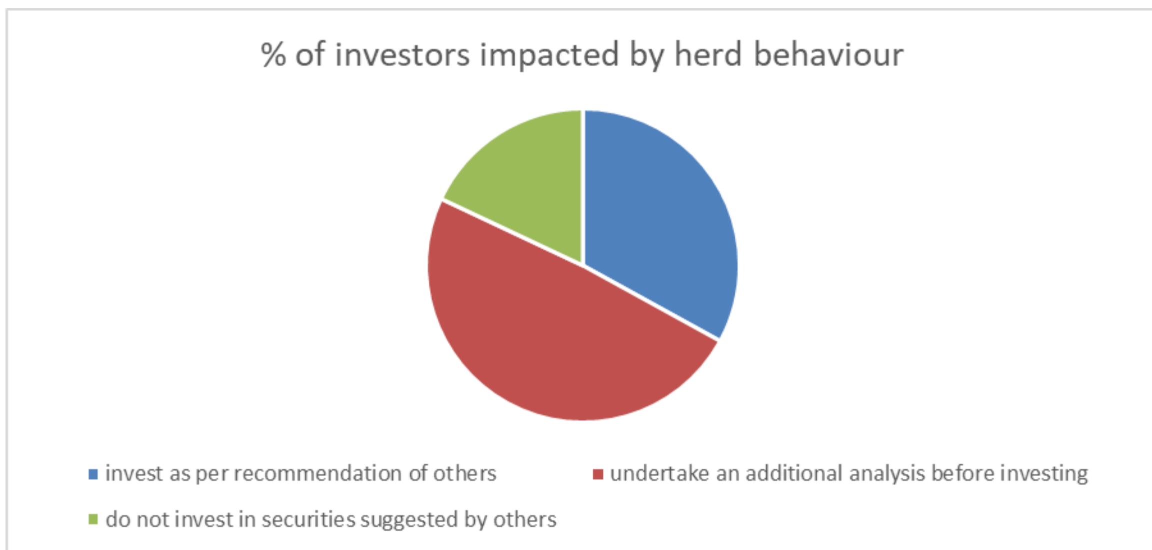


**Figure 6** % of investors impacted by herd behaviour

### 2.7. Gamblers fallacy

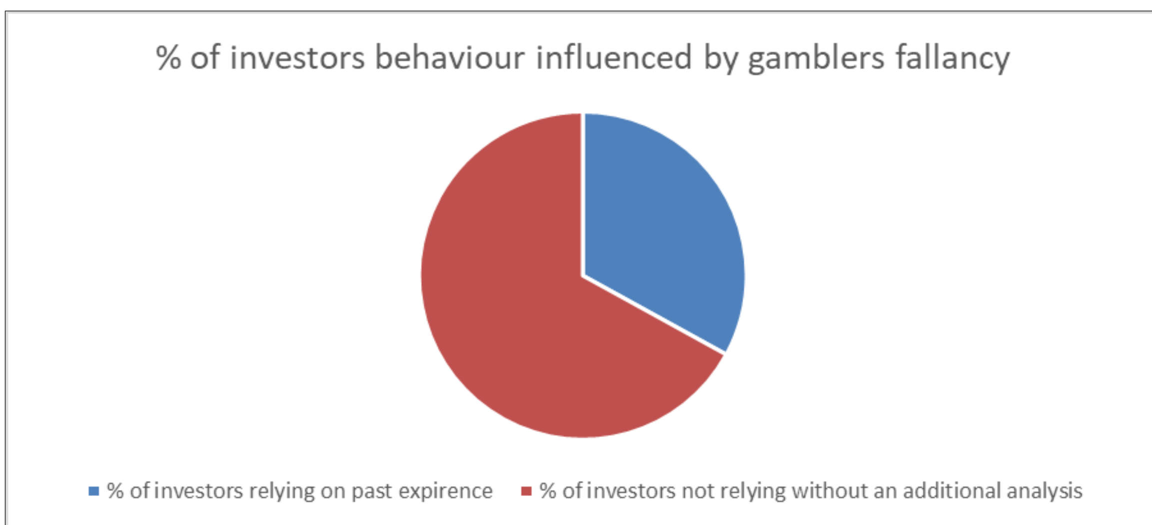


**Figure 7** % of investors influenced by gamblers fallancy

The gambler's fallacy is when we make financial decisions assuming that the way markets behaved in the past can predictably influence their future. For example, an investor might believe a stock that has been declining for several days is "due" for a turnaround because the price will have to increase again at some point, just as with betting in gambling; sometimes it comes out heads this time and eventually tails on your next bet. This fallacious line of thought ignores the natural randomness and non-correlation among market movements.

Investors, by working under the gambler's fallacy make decisions that are not influenced by proper analysis or data and can often result in huge financial losses. Being aware of and sidestepping this cognitive bias is one of the keys to rational investing. According to my studies, nearly 27% of investors make decisions under the influence of such misconceptions.

Above are some of the most common behavioral factors that can hamper the investment decision of the potential investor or investor. To overcome these pitfalls here are some of the common practices that can help one to make a prudent investment decision.

#### *2.7.1. Diversified investment*

Investors need to spread their investment across various portfolios rather than relying on the past performance of a single security. Depending solely on the historical performance of one security may increase risk significantly and lead to losses if market forecasts are wrong. By undertaking an analysis of different investment opportunities and diversifying their portfolio among several securities, they can effectively manage risk. This diversified strategy also minimizes potential losses by spreading exposure across diverse sectors, asset classes, and market environments; it also contributes towards increased chances of obtaining attractive returns.

#### *2.7.2. Restrict inherent biases and emotional factors*

There is a need to reduce the impacts of internal biases and emotions so that investments can be managed effectively. This means that decisions should not be controlled by emotions or biases but based on objective analysis. It is also vital to exercise discipline by sticking to a predetermined investment strategy and avoiding adverse decisions driven by fear or greed. Another useful thing that individuals can do to make informed choices involves seeking professional advice from financial advisers who offer non-partisan insights and strategies. To remain well-informed and proactive, investors should always learn about market trends as well as investment plans. If these approaches are implemented, one will minimize the effects of emotional factors and biases, making outcomes less guided by sentiments.

#### *2.7.3. Additional analysis*

A careful self-examination should be done before investing in securities. Your financial position has to be scrutinized and it includes net worth, contingencies fund, and liabilities. Establishing short-term and long-term differentiation for your investment objectives is important; each should have its time horizon. The potential investor must try to get the information from official sites and reliable channels, stay current with market trends, and carry out an extensive investigation on potential investments. Write a detailed investment plan, frequently review your portfolio, and make changes accordingly. Do not rely fully on the available information, sometimes the data can be manipulated or twisted to fool the investor but the rational investor is the one who undertakes an additional analysis of the securities and mitigates the risk associated with the investment.

#### *2.7.4. Prior goal specification*

Predefined goals enable one to look at the predefined characteristics that potential stocks may possess. Not only do these predefined plans govern your investment decision once in place, but they also significantly impact how you're going to deal with emotions. Setting the definition of what your goals are—growth, income, or preservation—facilitates boundaries around the means for reaching those goals. This structured approach reduces impulsive decisions made by the fleeting ups and downs of the market or any other short-term changes. Clear goals also help in measuring progress and give a relative position about whether your investments are running parallel to your long-term financial goals. Bringing it to the bottom line, this disciplined approach can radically improve the chances of achieving satisfactory consistent returns over time.

#### *2.7.5. Regular auditing and reallocating*

Rebalancing and regular auditing are two important steps to keeping a tight investment portfolio. Systematic audits should be instituted by an investor to ensure everything stays aligned with his financial objectives and risk tolerance. Otherwise, the suboptimal performance of investments will let one have increased risks. Investments that fail to meet the expectations need to be forensically looked into with professional advice when necessary. If one finds, after closer

scrutiny, that the particular investment is not doing very well, it would be best to quit while ahead of the event, relative to the impact, and divest the capital into other securities that have the most potential. All this leads to a reduction in risk and increased desirable expected returns.

## 3. Conclusion

This study shows how our feelings and actions have repercussions on our investment choices. Even with loads of data and logical economic models, investors often fall for mental traps like being too sure of themselves sticking to first impressions thinking streaks will continue relying on easy-to-remember info, and trying to avoid regret. If we don't watch out for these traps, they can cause us to make bad choices and lose money. To lower these risks, investors and money advisors need to spot these behavior patterns. Some helpful tricks include checking and tweaking investment portfolios often, spreading money across different types of investments asking experts for help, and sticking to well-planned strategies. These can help investors make smarter choices. Keeping up with market changes and being ready to adapt is also key to keeping finances healthy and steering clear of worst-case money troubles. As per the study, it reveals that 40% of the investors in the modern era want to gain knowledge about investing, 27% of the investors need it partially and almost 33% have the proper knowledge to invest. By gaining the proper knowledge of investing and by keeping the behavioral factors in mind one can easily keep the investment safe and can earn a good amount of return.

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