The Influence of Emotional Factors on Investor Decision-Making: A Behavioral Finance Perspective

By

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Abstract

Investors now have access to a wider range of securities and financial instruments than ever before because to the development of global financial markets. As a result, the field of behavioral finance has illuminated the traits and mental processes that shape investors' motivations and choices when making financial commitments. Changes in national and global economic and political processes, the availability and accessibility of information, and many other elements all have an impact on the global financial markets. However, the reaction and impression of investors is the most crucial component. One's state of mind can be profoundly affected by the decision-making process, which may be seen as an ongoing cycle by an individual investor. Behavioral finance is based on studies of human and social recognition and emotional tolerance and is utilized to make financial decisions. This article's focus is on research that track investors' behavior over many years. In explaining the mental and emotional factors that affect investment decisions, this article shows the investor's own mentality. The results of the investigation are shown graphically.

Keywords: Decision making, Psychology, Behavioral Finance, investor’s behavior, psychological and emotional factor.

Introduction

Investing psychology, data gathering, hypothesis testing, and historical research are all part of the cutting-edge subject of behavioral finance known as "investment behavior." The term "investment behavior" describes this action fully. The rationality of investors and the efficiency of markets have been central tenets of much of the academic study in finance. The key premise was that markets are aligned with projected utility maximization and that investors' actions are always rational. However, several studies over the past few decades have shown that conventional financial theories cannot account for investors' irrationality when making financial decisions. As a result of being subject to a number of different cognitive biases, investors in the actual world often act irrationally. Behavioral finance rejects the assumptions of classical finance, which assumes investors are rational, and demonstrates that investors are illogical in their investment choices.

The recent worldwide financial crisis highlights the need of assessing the elements impacting individual investors' investment decision making processes.

The study of human behavior is crucial to understanding stock market anomalies and choosing the best investing strategies, according to the behavioral finance hypothesis. The flip side of this is that investors are more likely to continue investing after they learn how to use their own behavioral biases to their advantage (in the form of higher returns).

Objectives of the Study

The primary purpose of this article is to examine studies of individual investors' methods. In an attempt to shed light on the mental and emotional effects of investing, this essay examines the intentions of psychological and emotional components on market movements. This paper has been organized as follows. In Section 2, we discuss the research efforts made to understand investors' monetary habits throughout time. The research methods used in this study are detailed in Section 3. In Section 4 we describe our analysis and main results. Section 5 provides a conclusion and summary of the study's findings through the use of graphics.

Literature of Review

[1] Investors are not significantly influenced by two types of behavioral biases (mental accounting and availability). According to behavioral finance theorists, the results show that human psychology plays a major role in investment choices.

[2] It was formerly believed that stock markets were "perfect markets," in which any and all public information would be instantly reflected in share prices and insiders could not obtain an unfair advantage. However, recent theoretical developments imply that these factors are not always what drive investors' decisions. Their decisions are often unexpected. Furthermore, several studies have shown that investors' decisions are influenced by a wide range of psychological factors. The purpose of this research is to catalog the many mental factors that have a role in the investment decisions of Indian stock market participants. For this study, researchers polled a total of 380 retail investors, splitting them in half between novice and seasoned investors. Using discriminant analysis and the chi-square test, we examine and evaluate four prevalent cognitive biases: loss aversion, regret aversion, herding, and anchoring. It was shown that herding bias occurred similarly often in both sets of people. Moreover, individuals with more investing experience showed higher levels of loss aversion bias, regret aversion bias, and anchoring bias compared to those with less experience.how much weight investors give to the recommendations of behavioral finance theorists.

[3] The purpose of this research is to provide light on how human psychology (specifically cognitive biases) affects economic decision-making. The method of systematic review was used to choose 29 publications published between 2010 and 2020 for critical evaluation. It has been proven that overconfidence (18 articles), anchoring bias (11 papers), the herding effect (10) and loss aversion (9 articles) have the biggest impact on economic choice. Half of the papers relied on qualitative or mixed-methodologies techniques, while the other half employed quantitative, survey-based (questionnaire) methods. People's spending decisions were discovered to be heavily influenced by behavioral and psychological aspects. However, the biggest challenges to a thorough analysis of the study are the time and effort needed to search for the necessary terms in the titles of the articles. The unpredictable nature of the COVID-19 pandemic should be used in future research to evaluate the most commonly occurring cognitive biases.

[4] The six established content topics of investor behavior are as follows: individual and social characteristics; market information; company and product particular variables; demographics; and demographics. Using the theoretical framework of theories, concepts, contexts, and methods, the authors emphasize the priorities for future study. The results have theoretical and practical implications for businesses, banks, and other organizations.

[5] In contrast to the traditional emphasis on risk and return, the discipline of behavioral finance introduces the concept that psychological elements can impact investment decisions. The purpose of this research is to analyze how human error influences economic investment decisions made under conditions of uncertainty. Decisions on investments are complex and include many moving parts; they should never be made in a vacuum or with a single piece of data. The findings of this study may be used to examine the role of behavioral finance in the investing decision-making process. Potential explanations of behavioral finance phenomena are studied, including heuristics, expectancies, personality characteristics, emotions, moods, and contextual influences. Overconfidence, representativeness, anchoring, regret aversion, hindsight, the herding effect, and home bias are just few of the investor psychological features that can lead to poor decisions. The results of this empirical study showed that heuristic behaviors had a higher influence on investors' choices than either forecasts of the future or personal characteristics. This study adds to the growing body of evidence that investors and financial institutions benefit when they take psychological factors into account.

[6] The emerging field of behavioral finance contrasts with the traditional academic finance emphasis on theories like Modern Portfolio Theory (MPT) and the Efficient Market Hypothesis (EMH) by looking at how cognitive factors and emotional issues influence the decision-making process of individuals, groups, and organizations. Overconfidence, cognitive dissonance, regret theory, and prospect theory are discussed, among other foundational ideas of behavioral finance. Important investment strategies are provided to help consumers avoid falling victim to these cognitive biases and emotional traps while purchasing stocks or mutual funds.

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[8] Various elements, such as national and international economic processes, institutional and political limits, the availability of relevant information, and so on, all have an impact on global financial markets. People's responses and interpretations, however, are crucial. Investing is a never-ending series of choices, no matter the type of financial instrument used. This article provides a theoretical and historical examination of studies of the investing habits of ordinary people. Focusing on a select group of investors' rationality, this essay examines the psychological consequences of investing activities while revealing the goals of recognition and emotional variables on market movements. The paper makes use of analytical synthesis, descriptive analysis, and comparative analysis. The outcomes are shown via graphical representation.

[9] The human brain can make complex judgments with relative ease, yet it may also make mistakes and be susceptible to biases. Because of these prejudices, they end up making poor choices, which costs them money. Because of the significant role that emotions play in the decision-making process, human beings are prone to make poor financial choices. For this reason, it's crucial to investigate the impact of investors' different emotional biases. Therefore, the goal of this study is to examine the impact of investors' emotional biases on their investing choices in India. This publication has evaluated as many relevant research papers as possible

and cited their findings. As a guidance for decision-makers to consider while making invested-related decisions, this study has attempted to explain some of the emotional biases, such as overconfidence, loss-aversion, home bias, and the endowment effect. This article not only aids investors in recognizing their own bias and taking steps to mitigate its impact on their investing decisions, but it also adds to the dwindling body of knowledge in the field of behavioral finance.

[10] Behavioral finance is an organizational framework that complements traditional finance while also substituting for it in some key areas. It depicts the behaviors of investors and managers in making decisions and shows how their interactions affect financial and capital markets. Because making judgments in difficult scenarios is an art form, investors often act irrationally while making investments. Consequently, picking one option out of several similar ones is a special skill. Although the field of behavioral finance does not promise that all investors will experience the same illusion, it does provide insight into how to avoid falling prey to these traps in the future.

[11] Rational investors who weigh risk against reward and maximize their own utility have long been assumed to dominate the stock market. Although individuals often behave rationally when making financial choices, studies in behavioral finance have demonstrated that emotions may play a role. Numerous studies in the ASEAN, the Middle East, and the West have shown evidence that psychological characteristics influence stock market choices. Since there are geographical and demographic differences between Malaysia and other countries, this research aims to help close them by examining the impact of psychological characteristics on investors' decisions in the Malaysian stock market. We survey 200 Klang Valley and Pahang residents who have an interest in the Malaysian stock market and are between the ages of 18 and 60. The results demonstrate that investors are significantly influenced by overconfidence, conservatism, and availability bias, but are not significantly influenced by herd behavior. It's also been discovered that the psychological elements differ depending on a person's gender. This study's findings are generally in line with those of other research. With any luck, this research will educate investors on the role that their own emotions play in their stock market selections, leading to more logical investment choices and more market efficiency.

[12] Behavioral finance studies have shown that investors act irrationally while making financial decisions. Investors' judgments are influenced by a number of behavioral biases, which arise because investor conduct typically deviates from logic and reason. This paper's goal is to rank the behavioral biases that affect equities investors' choices in the Indian state of Punjab. Investors and other participants in the capital market might benefit greatly from the findings of this study by gaining a deeper understanding of the many behavioral biases they face.

[13] The importance of investing as a means to build wealth is growing. An individual's analytical abilities, intellect, emotional self-control, and common sense are all crucial to their investing success. It also necessitates that investors make judgments based on logic rather than emotion or impression. The research aims to determine if higher levels of education, emotional stability, and cognitive ability all contribute to better investing results and choices. There is a literature review that helps frame the research problem.

[14] Its core focus is on the study of the flawed or imperfect human behavior that drives individual investment decisions and their subsequent effect on the market, and it uses psychologically based ideas to show stock market oddities. This study seeks to critically examine conventional financial theories, the ways in which behavioural finance has added to

these theories by integrating behavioral features, and the ways in which the psychological influence of individuals on their decision-making behaviour has been shown.

[15] The field of behavioral finance is interdisciplinary, drawing from the fields of psychology, sociology, and traditional finance.

The prevalence and influence of behavioral biases in investor behavior and human judgment are now widely acknowledged, making behavioral finance a well-established field of study. To better grasp the importance of behavioral finance in investors' financial decision making, we shall explore a number of relevant research in this paper.

[16] Investors are assumed to act rationally, maximizing their own utility, under the efficient markets hypothesis (EMH). However, cognitive psychology claims that humans are susceptible to a variety of illusions while making judgments. These include those brought on by heuristic decision-making processes and those brought on by the use of "mental frames." These heuristics may lead to a variety of cognitive illusions, such as the representativeness fallacy, the overconfidence bias, the anchoring bias, the gambler's fallacy, the regret bias, and the loss bias.

Market prices, according to proponents of behavioral finance, deviate from fundamental values owing to heuristic-driven bias and framing effects. This area of study attempts to create a more "complete" model by combining concepts from financial economics, psychology, and sociology to account for the unique ways in which individuals interact in financial markets.

Individual investors stand to benefit the most from understanding the conclusions of this study, which seeks to increase awareness of the many human biases and the substantial costs they impose on portfolios.

[17] Investment decision makers do not always follow the guidelines laid out in investment decision making classes taught at universities. Long-held views, such as that investors are always reasonable, despite the evidence to the contrary. Thus, students enrolled in basic investing courses fail to recognize the significance of investor behavior in determining investment results. This gap may be bridged and investment outcomes improved by teaching decision-makers the principles of behavioural finance alongside those of data-driven decision making. Instead of being revolutionary, this shift would be evolutionary. Using data from past stock market returns, a simulation model shows how investors underperform the market when they make illogical decisions.

[18] This paper's goal is to present a summary of the findings from research on behavioral finance that has been published in the recent decade (2006-2015).

An Historical Perspective On Investor's Financial Behavior

Based on the belief that price changes in financial markets are heavily influenced by the psychological state of individual investors, Selden published Psychology of the Stock Markets in 191. Raiffa and Raiffa offered evidence that human behavior deviates from the normative principles of economics in 1968. The availability heuristic was first proposed by Tversky and Kahneman in 1973. It is a form of heuristic reasoning in which the frequency of classes or the likelihood of occurrences is judged based on availability, or how quickly and easily relevant examples are brought to mind.

Methodology

This study is mostly descriptive in nature, and its primary objective is to shed light on the ways in which investors' behavioral biases could cause them to veer astray from logical thought during the process of investment decision making. In order to investigate the influence that it has on investors' mindsets, we use methods such as analysis and synthesis, description, and comparison.

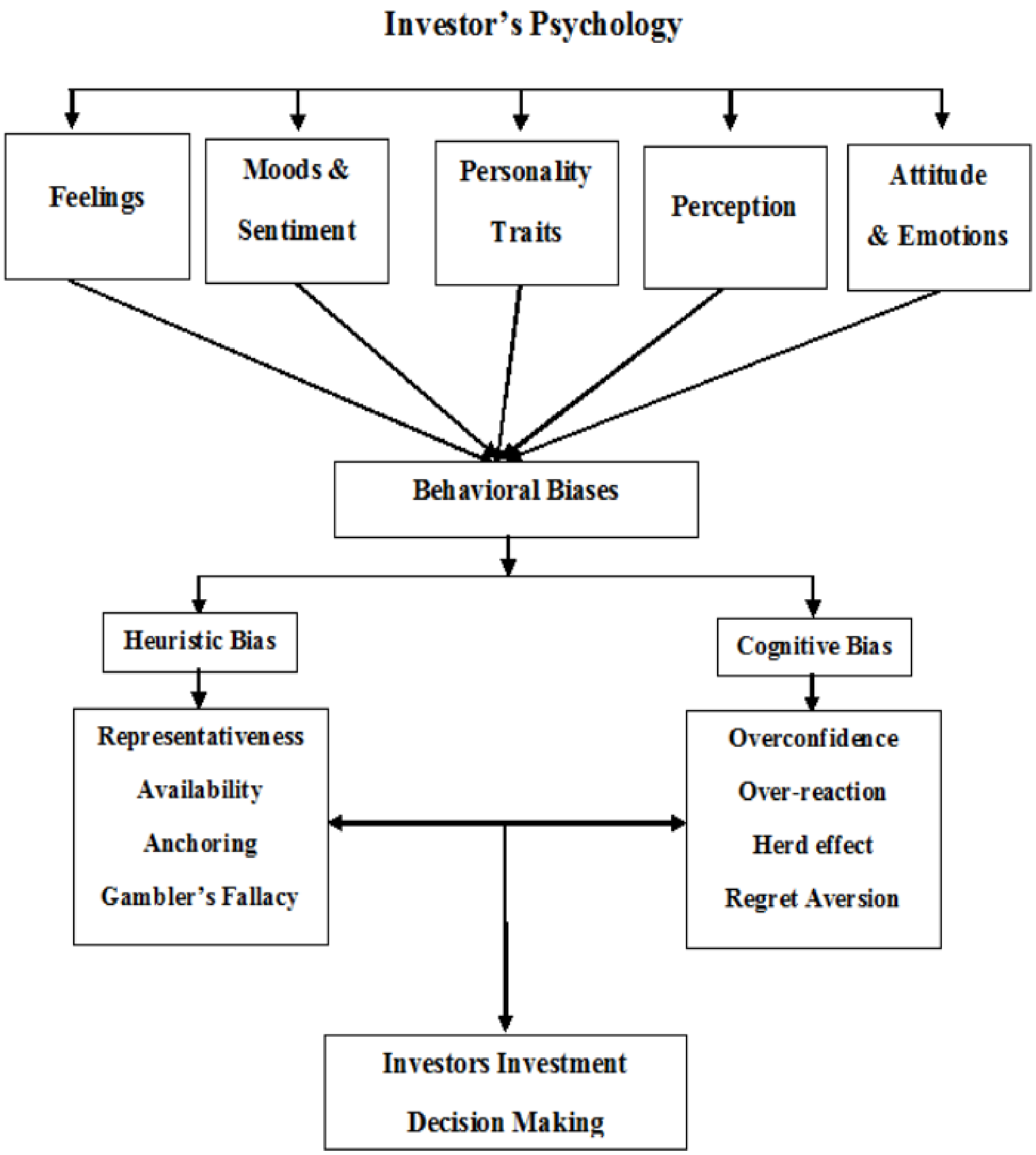

Figure1: *Psychological approach to Investment Decision making*

The fundamental goal of the academic field of psychology is to arrive at an understanding of the ways in which the mind influences and is determined by behavior.

Finding out whether or if psychological biases play a substantial part in the decision-making process and the relationship between behavior and its effects is the primary goal of this study. It is hard to grasp the psychology of investors in the context of investment decisions without taking into consideration the feelings and attitudes of the investors, in addition to their moods and sentiments, personality traits, and perceptions with regard to the process of investment making. This is because it is impossible to predict how investors would feel or act in a given situation.

Behavioral psychology include fallacies known as heuristics, which include representativeness, availability, and anchoring, among others. The field of behavioral psychology also include cognitive biases including overconfidence, overreaction, and herd behavior, amongst other examples. The fundamental goal of the academic field of psychology is to arrive at an understanding of the ways in which the mind influences and is determined by behavior.

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Behavioral psychology include fallacies known as heuristics, which include representativeness, availability, and anchoring, among others. The field of behavioral psychology also include cognitive biases, which might include over-confidence, over-reaction, and the herd effect, amongst others. The study of psychological biases, as opposed to the traditional methods to finance, could, to some degree, reveal causes for market anomalies as well as potential cures to these abnormalities. This is in contrast to the traditional techniques, which focus on how markets work. The empirical findings of the behavioral finance theory provide confidence to the theory's capacity to describe behavioral psychology in depth. Additionally, the findings of the theory shed light on anomalies in the stock market as well as the process of selecting an investment strategy.

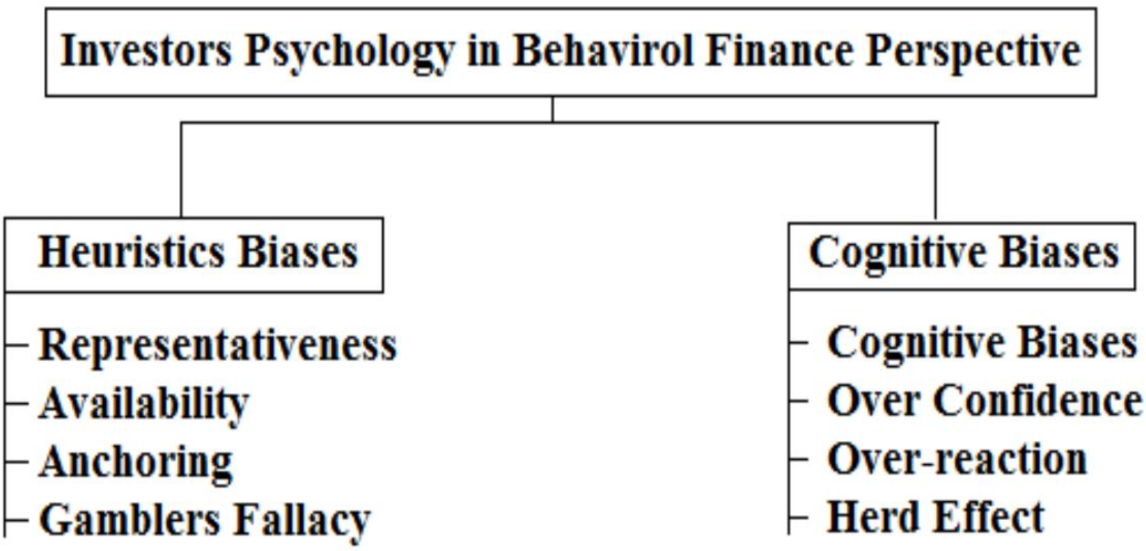

Figure 2: *Investors Psychology in Behavioral Finance Perspective*

When it comes to making decisions about investments, psychological biases demonstrate an illogical quality.

According to the findings of the research, the four primary types of psychological biases are cognitive bias, overconfidence, self-attribution bias, and herd affect. These prejudices are particularly obvious among investors, which suggests that psychological biases cannot be addressed or eradicated via learning and experience accumulation alone.

Conslusions

This research is a synthesis of previous work that analyzes investors' financial behavior across time. For a deeper insight into the psyche of the average investor and how it affects their investment choices, researchers are looking at the mental repercussions of investing. The bulk of empirical study has supported, experimented with, and come to the same conclusion that it is difficult to dismiss the thoughts and attitudes of investors while attempting to foresee the movements of the market. Better knowledge of individual behavior in the stock market might help retail investors capitalize on psychological biases. Retail investors may avoid costly mistakes in their portfolios by gaining a thorough grasp of the thought processes that go into making investing decisions.

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