

## **Behavioural Finance and Its Role in Stock Market Decision-Making**

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### **Abstract**

Behavioural finance examines how psychological factors and cognitive biases influence the financial decision-making of investors, challenging the traditional assumption of fully rational behaviour in financial markets. The role of behavioural finance in stock market decision-making, with particular focus on how emotions, heuristics, and biases such as overconfidence, herd behaviour, and loss aversion affect investment choices. Using secondary data and insights from existing empirical studies, the impact of behavioural factors on trading behaviour, risk perception, and portfolio selection. The findings suggest that investor decisions in the stock market are often driven by psychological influences rather than purely by fundamental analysis, leading to market anomalies and irrational price movements. The importance of understanding behavioural finance concepts to improve investment decision-making, enhance market efficiency, and support the development of more informed and disciplined investment strategies.

**Keywords:** Behavioural finance; Stock market; Investor behaviour; Cognitive biases;

### **Introduction**

Traditional financial theories assume that investors are rational and make decisions by carefully analyzing all available information to maximize returns. These theories suggest that stock prices fully reflect all relevant information and that markets are efficient. However, real-world observations of stock market behaviour often contradict these assumptions. Investors frequently make decisions influenced by emotions, psychological biases, and social factors, leading to irrational behaviour and market anomalies. Behavioural finance emerged as a response to the limitations of traditional finance by integrating insights from psychology and sociology into financial decision-making. It seeks to explain why investors deviate from rational behaviour and how such deviations influence stock market movements. Concepts such as overconfidence, loss aversion, herd behaviour, and mental accounting provide a deeper understanding of how investors perceive risk and make investment choices. Stock market decision-making is a complex process involving uncertainty, risk, and incomplete information. Investors are often influenced by market sentiment, past experiences, media reports, and the behaviour of other market participants. Emotional reactions such as fear during market downturns and greed during bull markets can lead to excessive trading, speculative bubbles, or panic selling. These behavioural factors play a significant role in shaping stock prices and market volatility. Understanding behavioural finance is particularly important in modern

financial markets, where rapid information flow and technological advancements amplify emotional and cognitive responses. Retail investors, in particular, are more susceptible to behavioural biases due to limited financial knowledge and experience. Even professional investors are not immune to psychological influences, which can affect portfolio performance and risk management decisions. The role of behavioural finance in stock market decision-making by analyzing how psychological biases influence investor behaviour and investment outcomes. By understanding these behavioural patterns, investors and market participants can develop more disciplined strategies, reduce decision-making errors, and improve overall investment performance in the stock market.

### **Investor Behaviour in the Stock Market**

Investor behaviour in the stock market reflects how individuals and institutions make decisions under conditions of risk and uncertainty. While traditional finance assumes that investors act rationally and process information objectively, actual market behaviour often shows significant deviations from rationality. Behavioural finance provides insights into these deviations by examining the psychological and emotional factors that influence investment decisions.

#### **Rational versus Irrational Investor Behaviour**

Rational investor behaviour is based on logical analysis, where investors evaluate available information, assess risk and return, and make decisions aimed at maximizing expected utility. Rational investors rely on financial fundamentals, diversification, and long-term investment strategies. They adjust their portfolios systematically in response to new information and avoid emotional reactions to short-term market fluctuations.

In contrast, irrational investor behaviour arises when decisions are influenced by cognitive biases, limited information processing, or psychological shortcuts. Investors may overreact to market news, follow the crowd without independent analysis, or hold on to losing stocks in the hope of recovery. Such behaviour can lead to excessive trading, mispricing of securities, and increased market volatility. Irrational behaviour does not imply a lack of intelligence but reflects natural human limitations in processing complex financial information.

### **Role of Emotions in Investment Decisions**

Emotions play a crucial role in shaping investment decisions, particularly in volatile market conditions. Feelings such as fear, greed, hope, and regret significantly influence how investors perceive risk and return. During market booms, greed and overconfidence may drive investors to take excessive risks, often leading to asset bubbles. Conversely, fear and panic during market downturns can result in irrational selling and heavy losses.

Emotional attachment to certain stocks, influenced by past gains or personal beliefs, can also affect decision-making. Investors may resist selling poorly performing assets due to loss aversion, preferring to avoid realizing losses even when better alternatives are available. Emotional responses often override rational analysis, leading to suboptimal investment outcomes.

investor behaviour in the stock market is shaped by a complex interaction of rational analysis and emotional influences. Recognizing the role of emotions and irrational tendencies is

essential for developing disciplined investment strategies and improving decision-making in stock market participation.

### **Psychological Biases Affecting Stock Market Decisions**

Psychological biases play a significant role in shaping investor behaviour and often lead to systematic errors in stock market decision-making. These biases arise from cognitive limitations and emotional responses, causing investors to deviate from rational analysis. Understanding these biases is essential for explaining market anomalies and improving investment decisions.

- **Overconfidence Bias**

Overconfidence bias refers to the tendency of investors to overestimate their knowledge, skills, and ability to predict market movements. Overconfident investors often believe they can outperform the market, leading to excessive trading and underestimation of risk. This bias may result in poor portfolio diversification and higher transaction costs, ultimately reducing investment returns. Overconfidence is commonly observed among active traders who rely heavily on personal judgment rather than objective analysis.

- **Herd Behaviour**

Herd behaviour occurs when investors follow the actions of others rather than making independent decisions based on fundamental analysis. This bias is driven by the desire to conform, fear of missing out, or uncertainty in decision-making. Herd behaviour can amplify market trends, contributing to asset price bubbles during bullish periods and sharp declines during market downturns. Investors engaging in herding often ignore underlying asset values, leading to mispricing in the stock market.

- **Loss Aversion and Prospect Theory**

Loss aversion, a key concept of prospect theory, suggests that investors experience the pain of losses more intensely than the pleasure of equivalent gains. As a result, investors may avoid selling losing stocks to prevent realizing losses, even when rational analysis suggests selling would be beneficial. This behaviour can lead to holding underperforming assets for extended periods and making conservative investment choices that limit potential gains.

- **Anchoring and Mental Accounting**

Anchoring bias occurs when investors rely too heavily on an initial piece of information, such as a past stock price or expected return, when making investment decisions. This can prevent investors from adjusting their views in response to new information. Mental accounting refers to the tendency of individuals to categorize money into separate accounts based on subjective criteria, rather than considering overall portfolio performance. These biases can lead to inconsistent decision-making and inefficient portfolio allocation.

Overall, psychological biases significantly influence stock market decisions by distorting risk perception and judgment. Awareness of these biases can help investors adopt more rational strategies and reduce behavioural errors in investment decision-making.

### **Psychological Biases Affecting Stock Market Decisions**

Psychological biases significantly influence how investors interpret information and make decisions in the stock market. These biases often lead investors away from rational judgment, resulting in systematic errors that affect portfolio performance and overall market efficiency.

- **Overconfidence Bias**

Overconfidence bias refers to investors' tendency to overestimate their knowledge, predictive abilities, and control over investment outcomes. Overconfident investors often trade more frequently, believing they can consistently outperform the market. This behaviour leads to excessive risk-taking, higher transaction costs, and inadequate diversification, which can negatively impact long-term returns.

- **Herd Behaviour**

Herd behaviour occurs when investors imitate the actions of other market participants rather than relying on independent analysis. This behaviour is driven by social influence, uncertainty, and fear of missing out on profitable opportunities. Herding can cause sharp price movements, contribute to speculative bubbles, and intensify market crashes when investors collectively buy or sell securities without regard to underlying fundamentals.

- **Loss Aversion and Prospect Theory**

Loss aversion, a central concept of prospect theory, explains that investors feel the pain of losses more strongly than the satisfaction of equivalent gains. As a result, investors may hold on to losing stocks in the hope of recovering losses and sell winning stocks too early to secure gains. This bias leads to suboptimal portfolio decisions and inefficient risk management.

- **Anchoring and Mental Accounting**

Anchoring bias occurs when investors rely heavily on initial reference points, such as a stock's purchase price or historical high, when making decisions. This can prevent them from adjusting their expectations in light of new information. Mental accounting involves treating money differently depending on its source or intended use, rather than viewing investments as part of a unified portfolio. These biases can distort asset allocation and hinder objective evaluation of investment performance.

psychological biases play a crucial role in shaping stock market decisions. Recognizing and managing these biases can help investors improve judgment, reduce emotional decision-making, and adopt more disciplined investment strategies.

### **Behavioural Finance and Market Anomalies**

Behavioural finance provides valuable insights into market anomalies that cannot be fully explained by traditional financial theories. Market anomalies arise when asset prices deviate from their fundamental values due to psychological biases, emotional reactions, and collective investor behaviour. These anomalies highlight the role of human behaviour in shaping stock market outcomes.

#### *Market Bubbles and Crashes*

Market bubbles occur when asset prices rise significantly above their intrinsic value, driven by excessive optimism, speculation, and herd behaviour. During bubble periods, investors often ignore fundamental information and base decisions on rising prices and positive market

sentiment. Overconfidence and fear of missing out encourage investors to enter the market at inflated prices. When expectations change or negative information emerges, panic selling and loss aversion can trigger market crashes, leading to sharp declines in asset prices.

Behavioural finance explains bubbles and crashes as outcomes of collective psychological biases rather than purely economic factors. Emotional reactions, feedback trading, and imitation amplify price movements, making markets more vulnerable to sudden corrections. These events demonstrate that markets are not always efficient and can be influenced by irrational behaviour.

#### *Excessive Volatility and Mispricing*

Excessive volatility refers to stock price fluctuations that are larger than what can be justified by changes in fundamental information. Behavioural biases such as overreaction to news, anchoring, and representativeness lead investors to exaggerate the impact of information, resulting in unstable price movements. Short-term market sentiment often drives prices away from intrinsic values, causing mispricing of securities.

Mispricing occurs when stocks are overvalued or undervalued due to biased perceptions and emotional decision-making. Limits to arbitrage and constraints faced by rational investors allow mispricing to persist over time. Behavioural finance helps explain why such inefficiencies exist and why prices do not always adjust quickly to reflect true economic value. behavioural finance demonstrates that psychological factors play a central role in creating market anomalies. Understanding these behavioural influences can help investors and policymakers better anticipate market movements and reduce the negative effects of irrational behaviour on financial markets.

#### **Conclusion**

Behavioural finance provides a more realistic explanation of stock market behaviour by acknowledging that investors are influenced by psychological biases and emotional responses rather than acting with complete rationality. The study highlights that investor decisions are shaped by factors such as overconfidence, herd behaviour, loss aversion, anchoring, and mental accounting, all of which affect how information is interpreted and acted upon in the stock market. The analysis further demonstrates that these behavioural biases contribute to market anomalies, including speculative bubbles, market crashes, excessive volatility, and persistent mispricing of securities. Such anomalies cannot be fully explained by traditional financial theories and underline the importance of behavioural finance in understanding real-world market dynamics. Emotional reactions during periods of optimism and fear often magnify price movements and increase market instability. Understanding behavioural finance has practical implications for investors, financial advisors, and policymakers. Investors who recognize and manage their behavioural biases are more likely to make disciplined, long-term investment decisions and avoid costly mistakes. From a regulatory perspective, incorporating behavioural insights can help in designing policies that promote market transparency and investor protection. behavioural finance plays a vital role in improving stock market decision-making by bridging the gap between theory and actual investor behaviour. Integrating behavioural

insights with traditional financial analysis can lead to more informed investment strategies and contribute to greater stability and efficiency in financial markets.

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