

United International Journal of Multidisciplinary Research

ISSN: 3048-6726(UIJMR)Impact Factor: 6.934 (SJIF)

An International Peer-Reviewed and Refereed Multidisciplinary Journal

www.ujmr.in Vol-3, SpecialIssue-2,2026

A Study on Role of Behavioural Finance in Investment Decisions

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Abstract

Traditional finance theories assume that investors are rational and make decisions based on complete information and logical analysis. However, real-world investment behavior often deviates from rationality due to psychological, emotional, and cognitive factors. Behavioural finance emerged as a field that integrates psychology with finance to explain such anomalies in investment decision-making. This research paper examines the role of behavioural finance in influencing individual investment decisions, focusing on key behavioural biases such as overconfidence, herd behaviour, loss aversion, anchoring, and mental accounting. The study highlights how these biases affect risk perception, portfolio selection, and market outcomes. The paper concludes that understanding behavioural finance is essential for investors, financial advisors, and policymakers to improve decision-making and market efficiency.

Keywords: Behavioural Finance, Investment Decisions, Investor Psychology, Cognitive Biases, Risk Perception

1. Introduction

Investment decision-making is a critical aspect of financial management that directly impacts individual wealth creation and economic growth. Traditional finance theories, such as the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT), assume that investors act rationally and markets efficiently reflect all available information. However, empirical evidence shows frequent market anomalies such as bubbles, crashes, and irrational trading behavior.

Behavioural finance challenges the assumption of investor rationality by incorporating psychological principles into financial decision-making. It explains why investors often make systematic errors due to emotions, heuristics, and cognitive limitations. In recent years, behavioural finance has gained prominence in

248 National Conference On “*Contemporary Issues In Global Business Management Practices*” 25 & 26 February, 2026 by University Arts & Science College (Autonomous), Kakatiya University.

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understanding investment behavior, especially in emerging markets like India, where retail investor participation is increasing.

2. Objectives of the Study

The main objectives of this study are:

1. To understand the concept of behavioural finance and its relevance to investment decisions
2. To identify key behavioural biases influencing investors
3. To analyze how psychological factors affect risk perception and investment choices
4. To examine the implications of behavioural finance for investors and financial markets

3. Research Methodology

This study is **descriptive and conceptual in nature**, based on secondary data collected from:

- Academic journals
- Books on behavioural finance
- Research papers and reports
- Online financial publications

The study synthesizes existing literature to analyze behavioural patterns affecting investment decisions.

4. Concept of Behavioural Finance

Behavioural finance is a branch of finance that studies the influence of psychological factors on investor behavior and financial markets. It seeks to explain why investors often act irrationally and how such behavior leads to deviations from theoretical financial models.

Unlike traditional finance, behavioural finance recognizes that investors are not always logical, have limited self-control, and are influenced by emotions such as fear and greed.

5. Behavioural Biases Affecting Investment Decisions

5.1 Overconfidence Bias

Overconfidence refers to investors' tendency to overestimate their knowledge, skills, and ability to predict market movements. Overconfident investors trade excessively, underestimate risks, and often earn lower returns.

5.2 Herd Behaviour

Herd behaviour occurs when investors follow the actions of others rather than relying on their own analysis. This behavior is common during stock market booms and crashes and often leads to asset price bubbles and sudden market corrections.

5.3 Loss Aversion

Loss aversion suggests that investors feel the pain of losses more intensely than the pleasure of equivalent gains. As a result, investors may hold losing investments too long and sell winning investments too early.

5.4 Anchoring Bias

Anchoring occurs when investors rely heavily on an initial piece of information (such as purchase price) while making decisions. This bias prevents investors from adjusting their expectations based on new information.

5.5 Mental Accounting

Mental accounting refers to the tendency of investors to categorize money into separate accounts based on subjective criteria. This can lead to inefficient portfolio allocation and inconsistent risk-taking behavior.

6. Behavioural Finance and Risk Perception

Behavioural biases significantly influence how investors perceive and respond to risk. Emotional reactions often dominate rational analysis, leading investors to avoid risk during market downturns and take excessive risk during market booms. Fear, regret, and overconfidence play crucial roles in shaping investment strategies.

7. Impact of Behavioural Finance on Financial Markets

Behavioural finance explains several market phenomena, including:

- Market bubbles and crashes
- Excessive volatility
- Mispricing of securities
- Momentum and reversal effects

Investor psychology can cause prices to deviate from intrinsic values, challenging the assumption of market efficiency.

8. Implications of Behavioural Finance

For Investors

- Helps recognize and control emotional biases
- Improves long-term investment decisions
- Encourages disciplined investing

For Financial Advisors

- Enables personalized investment strategies

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- Improves client communication and trust

For Policymakers

- Supports investor education programs
- Enhances market stability through behavioral insights

9. Limitations of the Study

- Based on secondary data
- Lacks empirical validation
- Findings may vary across different demographic groups

10. Conclusion

Behavioural finance plays a vital role in understanding real-world investment behavior. Psychological biases and emotions significantly influence investor decisions, often leading to irrational outcomes. By recognizing and managing these biases, investors can make more informed and rational investment decisions. Behavioural finance provides valuable insights that complement traditional financial theories and contribute to better market understanding and efficiency.

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