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### Original Research

# Behavioral Finance and Investment Decisions

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### Abstract

This article explores how behavioral finance reshapes our understanding of investment decisions by emphasizing the impact of psychological biases, heuristics, and emotions. Contrasting traditional finance's rational-agent model, behavioral finance explains persistent market anomalies and patterns in investor behavior. Drawing on contemporary research, this article reviews foundational theories, common cognitive biases, practical investment impacts, recent developments, and suggestions for mitigating irrational tendencies. Tables and conceptual diagrams are included to highlight behavioral effects and their implications.

Keywords: Behavioral finance | Investment biases | Prospect theory | Investor psychology | Decision-making strategies

## INTRODUCTION

Modern investment theory once rested on the notion of rational, utility-maximizing investors. However, repeated asset bubbles, crashes, and inconsistencies in investor behavior led to the emergence of behavioral finance—a field combining psychology, cognitive science, and economics. By analyzing the cognitive and emotional factors that drive financial decisions, behavioral finance broadens our comprehension of risk-taking, portfolio construction, and market dynamics<sup>[1][2]</sup>. Understanding these insights is essential for both individual and institutional investors to avoid costly errors and enhance long-term returns.

### Foundations of Behavioral Finance

#### From Rational Markets to Biased Investors

Traditional finance is anchored in the Efficient Market Hypothesis (EMH) and expected utility theory, assuming that all available information is fully reflected in market prices and that investors act rationally<sup>[3]</sup>. Behavioral finance challenges these pillars by documenting the prevalence of irrational behavior, citing frequent overreactions, underreactions, and other anomalies.

### Prospect Theory

Developed by Kahneman and Tversky (1979), prospect theory is foundational to behavioral finance. It demonstrates that individuals perceive gains and losses asymmetrically—losses inflict more psychological pain than equivalent gains bring pleasure. This "loss aversion" often results in risk-averse behavior following gains and risk-seeking behavior during losses<sup>[4][5]</sup>.

### Key Behavioral Biases Influencing Investment

Table: Common Behavioral Biases and Their Impact

Bias	Description	Investment Impact
Loss Aversion	Losses are felt more intensely than gains	Holding losing assets too long, early exit from gains
Overconfidence	Overestimation of one's knowledge or prediction abilities	Excessive trading, poor diversification
Herd Behavior	Following crowd trends, often contrary to fundamentals	Bubbles, crashes, momentum investing
Mental Accounting	Assigning different values to money based on origin/use	Inefficient portfolio allocation
Anchoring	Relying on irrelevant reference points (e.g., purchase price)	Sticking to losing positions, mispricing
Confirmation Bias	Favoring information that supports existing beliefs	Ignoring contrary evidence, reinforcing misjudgments

### Empirical Evidence and Case Studies

Recent studies consistently demonstrate that cognitive biases drive both retail and institutional investors to make suboptimal choices, often independent of financial literacy<sup>[6][7][8]</sup>. For example:

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- **Overconfidence** leads to more frequent trading, resulting in lower net returns on average.
- **Herding** creates market bubbles such as the tech boom of 2000 or the cryptocurrency surge of 2021.
- **Loss aversion** explains inertia in selling stocks at a loss, even when fundamentals suggest doing so.

A systematic review by Ferdian (2024) highlights significant differences in how long-term and short-term investors are affected by biases—and notes that even well-informed institutional players are not immune<sup>[8]</sup>.

### Behavioral Finance in Action: Investment Decision Impact

#### Bubbles and Market Anomalies

Market bubbles and crashes often stem from positive feedback loops in herd mentality. Behavioral finance explains phenomena like the dotcom bubble, real estate bubble, and meme-stock rallies<sup>[2][4]</sup>.

#### Trading Frequency and Returns

Research indicates that overconfident investors tend to trade more frequently, incurring higher transaction costs and often receiving lower returns than less active investors<sup>[9][5]</sup>.

#### Asset Allocation and Mental Accounting

Investors commonly segregate their portfolios into mental “buckets” (e.g., retirement vs. discretionary funds), impeding overall risk management and diversification<sup>[10]</sup>.

### Example: Visualizing Bias Effect on Investment Returns

Investor Type	Annualized Trading Frequency	Average Return (%)	Main Bias
Overconfident	24 trades/year	4.7	Overconfidence
Balanced	8 trades/year	6.8	N/A (control)
Herd Follower	20 trades/year	5.2	Herd behavior, loss aversion

*Note: Illustrative data based on synthesis of empirical sources.*<sup>[6][8][9]</sup>

### Recent Developments and Quantitative Insights

#### Behavioral Indices

- The VIX index (measuring volatility) and sentiment surveys (e.g., American Association of Individual Investors Bull/Bear Index) provide insights into investor mood swings, further illustrating how these emotions can drive markets out of step with fundamentals<sup>[11]</sup>.

#### Financial Literacy as a Moderator

Recent research underscores that while education reduces some biases, it does not fully negate their influence—suggesting deep-rooted psychological factors<sup>[7]</sup>.

#### Theoretical Implications

Behavioral finance broadens classical models by highlighting:

- **Limits to Arbitrage:** Irrational investors can influence prices over significant time periods, resisting immediate correction by rational actors.
- **Market Inefficiency:** Persistent anomalies challenge the EMH and support the view that markets are often not perfectly rational or efficient<sup>[2][4]</sup>.

### Strategies to Mitigate Behavioral Biases

1. **Awareness and Education:** Regular training, reflection, and feedback can help investors recognize their biases.
2. **Rule-Based Investing:** Adopting preset asset allocation rules and automatic rebalancing reduces impulsive behavior.
3. **Third-Party Advice:** Consulting objective advisors often curbs emotional overreaction and groupthink.
4. **Diversification:** A disciplined approach to diversification can offset the effects of herding and loss aversion.

## CONCLUSION

Behavioral finance exposes the psychological roots behind many investment mistakes, from excessive trading and asset bubbles to persistent risk aversion and herd following. By integrating psychological principles, investors and advisors can refine their strategies, avoid costly misjudgments, and strengthen market stability. While education and rules can help, the persistent influence of human emotion ensures that behavioral finance will remain central to understanding financial markets for years to come.

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