



## Behavioral Biases and Their Effect on Investment Decisions: A Systematic Review

Aanchal Sharma<sup>1</sup>, Dr. Bhavna Prajapati<sup>2</sup>

<sup>1</sup>Research Scholar, School of Commerce Management and Research, ITM University Raipur, 493661, India.

<sup>2</sup>Associate Professor, School of Commerce Management and Research, ITM University, Raipur, 493661, India.

**Emails:** [anchals.2022@itmuniversity.org](mailto:anchals.2022@itmuniversity.org)<sup>1</sup>, [bhavnap@itmuniversity.org](mailto:bhavnap@itmuniversity.org)<sup>2</sup>

### Abstract

*This paper aims to investigate and outline various biases influencing investment decision-making by reviewing a wide array of research in the field of behavioral finance. It examines the distinct behavioral patterns exhibited by individual investors, drawing insights from studies published from the foundational work in 1974 to the latest contributions up to 2024. The identified biases are categorized into seven distinct types, providing a structured understanding of how they manifest in investment behaviors. This study also incorporates contemporary research to offer a snapshot of recent developments in the field. The findings are particularly relevant for individual investors, financial advisors, students, and institutions, providing practical insights for informed decision-making. A key feature of this research is its focus not only on fundamental behavioral finance principles but also on emerging concepts, fostering interest in exploring strategies to mitigate the impact of biases in investment choices.*

**Keywords:** Behavioral finance; Decision-making; Emerging concepts; Investment biases; Individual investors

### 1. Introduction

In the dynamic realm of finance, understanding the psychological factors that influence investment decisions has become increasingly crucial. Behavioral finance delves into the cognitive biases and emotional influences that shape the choices made by investors, often leading to irrational behaviors and market inefficiencies. This paper seeks to systematically explore various investment biases, drawing on a comprehensive review of research spanning from foundational studies in 1974 to the latest insights available up to 2024. The focus is primarily on individual investors, as they often exhibit distinct behavioral patterns that can significantly affect their decision-making processes. By categorizing the identified biases into seven key types, this study aims to enhance our understanding of how these factors interact with investment strategies. Furthermore, the integration of contemporary research highlights recent developments in behavioral finance, providing a well-rounded perspective on the topic.

### 2. Review of Literature

Behavioral finance has evolved significantly since its inception, providing a comprehensive framework for understanding how psychological factors influence investor behavior and market dynamics. In 1979, Kahneman and Tversky laid the groundwork with their seminal paper "Prospect Theory: An Analysis of Decision Under Risk," introducing critical insights into how individuals assess potential gains and losses. Their research showed that people are generally loss-averse, leading to decision-making that deviates from traditional rational models. Thaler (1980) further contributed to the field by emphasizing the impact of behavioral biases on investor decisions, noting that these biases often result in suboptimal outcomes. In his influential paper, "The End of Behavioral Finance" (1999), Thaler identified areas where conventional finance theories fall short, such as anomalies related to dividends, market predictability, equity premium, trading volume, and market volatility. His work highlighted the necessity of incorporating psychological insights into financial



models. Ricciardi and Simon (2000) defined behavioral finance as a lens through which the psychological processes and emotional factors affecting investors can be studied. Their perspective underscored the importance of understanding the mental frameworks that guide financial decision-making. Shiller (2003) critiqued the efficient market hypothesis, proposing that behavioral finance provides a more robust explanation for market phenomena. He argued that the intersection of finance and social sciences has deepened our understanding of financial markets, particularly in the context of investor irrationality and market bubbles. In recent years, behavioral finance has grown to encompass a wider array of cognitive and emotional factors that impact financial decision-making. Research has delved into specific biases such as overconfidence, herd behavior, and loss aversion, with numerous studies confirming their prevalence among investors. Additionally, the role of demographic factors, such as age and gender, has been explored to understand how these biases manifest differently across various investor groups. The integration of technology into investing has also emerged as a critical area of study. The rise of fintech and algorithmic trading has changed how investors access information and make decisions, warranting investigation into how these advancements impact behavioral biases. Scholars are examining the implications of digital platforms on investor psychology, including the effects of social media and online trading communities on herd behavior and overconfidence. As of 2024, the field continues to evolve, with ongoing research addressing the complexities of investor behavior in developing markets and the implications of cultural differences on financial decision-making. There is a growing emphasis on longitudinal studies that track behavioral changes over time, particularly during periods of market volatility. The interdisciplinary approach of behavioral finance, integrating insights from psychology, sociology, and economics, remains crucial for enhancing our understanding of the nuanced factors that influence investor behavior and financial markets. In summary, the literature on behavioral finance has demonstrated its relevance in

explaining anomalies that traditional financial theories cannot account for. The continued exploration of psychological biases, technological impacts, and cultural factors promises to further enrich the field, offering valuable insights for both academics and practitioners in finance. [1-5]

### **2.1 Overconfidence**

Overconfidence is a common bias in which investors overrate their knowledge and ability to predict market movements. Research indicates that overconfident investors tend to engage in excessive trading, convinced they can beat the market, which frequently results in suboptimal investment performance (Barber & Odean, 2001). This bias can distort risk perception, leading to underestimation of potential losses and increased portfolio volatility. Recent studies have further established the impact of overconfidence on investment decisions, emphasizing its role in market dynamics. Research indicates that overconfident investors not only trade more frequently but also tend to underestimate risks associated with their investments. A 2024 study found that technological advancements, such as AI-driven trading tools, may exacerbate overconfidence by providing investors with a false sense of security in their predictive capabilities.

### **2.2 Herding**

Herding behavior arises when individuals follow the actions of a larger group, which can often result in irrational market movements. Research indicates that investors may abandon their own analysis and follow the crowd, especially during volatile market conditions (Bikhchandani et al., 1992). This phenomenon can exacerbate market bubbles and crashes, as collective movements can overshadow fundamental values. Herding behavior has garnered increased attention with the growth of social media and online trading communities. Recent research demonstrates that herding behavior is intensified by social platforms, where collective sentiment can drive market trends. A 2024 study highlighted how information cascades on these platforms can lead to rapid price movements, resulting in both bubbles and crashes, further illustrating the need for investor education on independent analysis inhibit effective risk management. [6-8]



### 2.3 Disposition Effect

The disposition effect describes the tendency of investors to prematurely sell profitable investments while holding on to losing ones for too long. Shefrin and Statman (1985) identified this bias as a result of emotional attachment and regret aversion, leading to suboptimal decision-making. This behavior can adversely affect portfolio performance and inhibit effective risk management. The disposition effect continues to be a critical area of investigation, with recent studies exploring its psychological underpinnings. Research published in 2024 revealed that investors' emotional responses to gains and losses are influenced by personality traits, such as risk tolerance and impulsivity. This nuanced understanding suggests that personalized investment strategies could help mitigate the disposition effect.

### 2.4 Anchoring

Anchoring happens when individuals place excessive emphasis on the first piece of information they receive, which then disproportionately influences their decision-making process. Tversky and Kahneman (1974) demonstrated that investors might anchor their expectations based on historical prices or specific financial metrics, which can limit their ability to adapt to new information. This bias can hinder effective investment analysis and lead to misguided strategies. Anchoring remains a prominent bias in investor decision-making. A 2024 study explored how modern information sources, such as real-time market data and financial news, impact the anchoring effect. Findings suggest that constant exposure to fluctuating prices can either reinforce or weaken anchoring, depending on how investors process information. This insight is particularly relevant for understanding investor behavior in fast-paced market environments.

### 2.5 Loss Aversion

Loss aversion, a concept introduced by Kahneman and Tversky (1979), suggests that people tend to feel the pain of losses more acutely than the pleasure from gains of the same magnitude. This bias can result in overly conservative investment strategies, where investors prioritize avoiding losses over pursuing gains. Consequently, loss aversion can lead to missed opportunities and an inclination to hold

onto losing investments. Research in 2024 has expanded on the concept of loss aversion, revealing its variability across different demographic groups. A recent study found that cultural background significantly influences loss aversion levels, affecting how individuals from various cultures perceive risk and make investment decisions. This suggests that tailored approaches may be necessary to address loss aversion in diverse investor populations. [9-10]

### 2.6 Mental Accounting

Mental accounting describes the cognitive process through which individuals compartmentalize money based on its origin or its intended purpose, leading them to treat it differently depending on these factors. Thaler (1985) argued that this bias can lead to irrational financial behaviors, such as treating gains from investments as "play money" while being overly cautious with savings. This misallocation of resources can undermine overall financial health. Recent research has shed light on mental accounting in the context of digital finance. A 2024 study highlighted how mobile banking apps and investment platforms encourage specific mental accounting practices, impacting how individuals allocate funds and make investment decisions. Understanding these digital influences is crucial for developing effective financial management tools that promote better decision-making.

### 2.7 Representativeness

The representativeness bias occurs when individuals make judgments based on perceived patterns or stereotypes rather than actual probabilities. Tversky and Kahneman (1971) found that investors might wrongly assess the likelihood of an event based on recent trends, leading to flawed expectations about future performance. This bias can skew decision-making, particularly in volatile markets. The representativeness bias has been examined in light of behavioral finance's integration with machine learning and predictive analytics. A 2024 study indicated that reliance on past patterns can lead investors to misinterpret data generated by algorithms, resulting in poor investment choices. This research emphasizes the need for investors to critically assess algorithmic recommendations rather



than passively following suggested trends.

### 3. Research Gap

A thorough review of the existing literature on behavioral finance and behavioral biases reveals several critical research gaps that future studies should address:

1. Most studies center on developed countries, leaving a significant gap in understanding behavioral biases among investors in developing nations.
2. Existing research primarily analyzes individual investors in developed markets, neglecting the behavior of institutional investors and various demographics in emerging markets.
3. Many studies rely on subsamples of investor groups, which can lead to incomplete insights about behavioral trends. Broader datasets are needed for a comprehensive analysis.

### Conclusion

The review of literature on behavioral finance reveals that this field provides a psychology-based framework to understand stock market anomalies, including significant fluctuations in market prices. By integrating insights from psychology, sociology, and other disciplines, behavioral finance challenges the traditional assumptions of rationality in standard finance theories, highlighting how psychological biases shape real investor behavior.

Our examination of existing studies confirms the presence of seven key behavioral biases among investors, with overconfidence and herd behavior being the most frequently documented. Additionally, research indicates a correlation between these biases and demographic factors such as age and gender. While substantial progress has been made in understanding these biases within the financial markets of developed countries, there remains significant potential for further exploration in developing countries. This gap presents an opportunity for future research to investigate how cultural and economic contexts influence investor behavior and the manifestation of behavioral biases in these emerging markets.

### Reference

[1]. Barberis, N., & Thaler, R. (2003). A survey

of behavioral finance. *Handbook of the Economics of Finance*, 1, 1053-1128. [https://doi.org/10.1016/S15740102\(03\)01027-6](https://doi.org/10.1016/S15740102(03)01027-6)

- [2]. Kahneman, D., & Riepe, M. W. (1998). Aspects of investor psychology: Beliefs, preferences, and biases investment advisors should know about. *The Journal of Portfolio Management*, 24(4), 52-65. <https://doi.org/10.3905/jpm.1998.409643>
- [3]. Tversky, A., & Kahneman, D. (1974). Judgment under uncertainty: Heuristics and biases. *Science*, 185(4157), 1124-1131. <https://doi.org/10.1126/science.185.4157.1124>
- [4]. Ricciardi, V., & Simon, H. K. (2000). What is behavioral finance? *Business, Education & Technology Journal*, 2(2), 1-9.
- [5]. Shiller, R. J. (2003). From efficient markets theory to behavioral finance. *Journal of Economic Perspectives*, 17(1), 83-104. <https://doi.org/10.1257/089533003321164967>
- [6]. Shefrin, H., & Statman, M. (1985). The disposition to sell winners too early and ride losers too long: Theory and evidence. *The Journal of Finance*, 40(3), 777-790. <https://doi.org/10.1111/j.1540-6261.1985.tb05002.x>
- [7]. Odean, T. (1998). Are investors reluctant to realize their losses? *The Journal of Finance*, 53(5), 1775-1798. <https://doi.org/10.1111/0022-1082.00072>
- [8]. Baker, H. K., & Nofsinger, J. R. (2010). *Behavioral finance: Investors, corporations, and markets*. John Wiley & Sons.
- [9]. De Bondt, W. F., & Thaler, R. H. (1985). Does the stock market overreact? *The Journal of Finance*, 40(3), 793-805. <https://doi.org/10.1111/j.1540-6261.1985.tb05004.x>
- [10]. Statman, M. (2008). Countries and culture in behavioral finance. *CFA Institute Conference Proceedings Quarterly*, 25(3), 38-44. <https://doi.org/10.2469/cp.v25.n3.4>