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# IMPACT OF BEHAVIORAL BIAS ON THE INVESTMENT DECISION MAKING OF INVESTORS

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**Abstract:** The main aim of the paper is to present a brief on the role of various psychological factors in the investment decision making process. According to behavioral finance, investors make cognitive errors that leads to wrong decisions. This study will help to understand the nature and reasons for certain behavioral biases. Thus helping the investor to avoid problems and invest better. It has put up a light on comprehensive view of various behavioral biases that affects the investment decision making of the investors, identified from literature available. To mitigate the effects of bias, it is important for investors to set up processes for a logical decision making.
**Keywords:** Behavioral bias, decision making, psychology, finance.

## INTRODUCTION

In financial and economic literature, there had been many traditional theories such as Efficient Market Hypothesis (Fama 1970), Capital Asset Pricing Model (Sharpe, Linter, Mossin 1970s) and Modern Portfolio Theory (Markowitz 1952) concerning the market developments and the behavior of individuals in their investment choices. The central assumption of the traditional finance model is that the people are rational and stock markets are efficient. Financial economists assumed that while making financial decisions, investors behaved rationally. Psychologists had found that economic decisions are made in irrational manner, so they challenge this assumption of traditional finance. Cognitive error and extreme emotional bias can cause investor to make bad investment decision, thereby acting in irrational manner.

Behavioral finance differs from, traditional finance in that it focuses on how investors and markets behave in reality rather than in theory. By focusing on actual behavior, behavioral researchers have observed that individual make investment decisions in ways and with outcomes that differ from the approaches and outcomes of traditional finance.

## RESEARCH METHODOLOGY

Investors follow a rational decision-making process while investing. Behavioral biases arise in different stages of the decision-making process (Satish Kumar, Nisha Goyal,2016).The worth of existence of behavioral finance lies in the fact that it makes possible to enrich the understanding of the financial market by including the human elements into it. It shows the investment pattern of the investors specifically those who exhibit under reaction in the short run and overreaction in the long run.(Syed ali Zahera and Rohit Bansal 2018). Investors perceive a half-full glass as holding a different amount of water than a half-empty glass. Rational people know and teach their students that the two glasses contain identical amounts of water. Investors use the term “sentiment” when speaking about optimism and pessimism. They speak of optimism, especially excessive optimism, as “bullish sentiment” and of pessimism, especially excessive pessimism, as “bearish sentiment.”(Meir Statman 2020). Werner DeBondt, William Forbes (2010) Behavioral finance contributes three major insights: (1)Human intuition is fragile.

(2) We have to consider decision processes if we want to know how decisions are made in finance.

(3) People’s personal beliefs are relevant in finance.

## OBJECTIVE OF STUDY

The study was conducted taking into consideration the following objectives:

1. To understand and detect the bias that affects investment decisions.
2. To examine the role of behavioral bias on the investment decision making.

## CONCEPTUAL FRAMEWORK

Behavioral finance is a young sub-field of finance that attempts to understand the human behavior that affects the investment decision making of an individual investor. Behavioral finance is the bridge between finance and psychology.


As shown above, behavioral finance is a combination of cognitive psychological theory and standard finance to provide explanations for why people make irrational investment decisions.

## BEHAVIORAL BIASES AND INVESTMENT DECISIONS

One of the key aspects of behavioral finance is the influence of bias. Bias is defined as an irrational assumption or belief that wraps up the ability to make a decision based on facts. It describes the natural tendencies of the human mind to think, decide and behave in irrational ways that frequently violate sensible logic, sound reason and appropriate judgement. As defined by Shefrin (1985), bias is nothing else but the inclination toward error.

From various literature studies, we have identified the following biases for further research which affects the investment decision of an individual investor:

1) Over Confidence Bias: One of the most crucial skills in finance and investing is knowing where the markets are going. Most market analysts feel their analytical abilities to be above average in this field. Overconfidence bias causes people to perceive investing decisions as being less risky than they are. Overconfidence bias is a false and misleading assessment of our skills, intellect and talent. It is an egoistic belief that we're better than we actually are. It tends to overestimate the knowledge and underestimate the risks.

2) Loss Aversion: First demonstrated by prominent psychologists Amos Tversky and Daniel Kahneman, the concept of loss aversion refers to the human tendency

to strongly prefer decisions that allow us to avoid losses over those that allow us to acquire gains. Many studies on loss aversion commonly suggests that human perception of loss is twice as powerful as that of gain. Loss aversion can significantly impact our own decisions and lead to bad decision making. As individuals, it is evident that we don't want to incur losses. But the fear of incurring losses prevents individuals from taking even well calculated risks, with potential for worthwhile returns.

3) Herding: Herding refers to the tendency of an investor to follow and copy what investors are doing. Investors are largely influenced by the emotion and instinct, rather than by their own independent analysis.Herding is quite an infamous phenomenon in the stock market and is the result of massive sell offs and rallies. These investors do not put much in deep research behind their decisions and only follow the sentiment of the crowd whether positive or negative.

4) Self-Control Bias: Self-control bias derives from a behavioral flaw called hyperbolic discounting. As per hyperbolic discounting, there is an built-in flaw in the way investors perceive gains. Investor with this bias are inclined towards spending more today at the expense of saving less for the future. They have a large appetite for short term gains. In other words, they prefer investments that give them monthly income and have shorter lock in periods.

5) Mental Accounting: It asserts that individual classify funds differently and therefore are prone to irrational decision making in their spending and investment behavior. Investors with this bias choose the assets to invest in speculative and safe portfolios mentally segregating in order to simplify them. Investors disassociate safe portfolios from speculative portfolios so that negative returns from the latter do not affect positive returns from the former.

6) Self Attribution Bias: It refers to the individual tendency to attribute success to personal skills and failures to factors beyond their control (Arvid O.I Hoffman, Thomas Post, 2014). It

occurs when investors credits the successful outcomes to their own abilities and talent, while bad outcomes to the external factors or sheer

luck. It suggests that no one wants to admit to being incompetent and are likely to blame failures on something external to ourselves. This protects our self-esteem.

7) Regret Aversion: This bias occurs when a decision is made to avoid regretting an alternative decision in future. An investor can be said to be suffered from this bias when he/she refuses to make any decision because of the fear that this decision may turn out to be wrong or lead to feeling of regret later.Regret aversion occurs via fear of either commission or omission. In other words, it is the prospect of committing to a failure or omitting an opportunity that we seek to avoid. In financial terms, an investor may be likely to lose the same amount of money either by commission or by omission.

8) Representative bias: It occurs when the similarity of the objects or events confuses investor's thinking regarding the probability of an outcome. Investors often make mistakes believing two similar things are closely related and fail to take other kind of info into account. Because we tend to rely on representatives, we often fail to take other kinds of information into account, which can cause us to make mistakes.

9) Availability bias: This bias describes the tendency of an investor to use information that comes to mind quickly and easily when making decisions about future. Investor may judge the quality of an investment based on information that was recently in news, ignoring all other relevant facts (Tversky and Kahneman, 1974). Because memories that are easily recalled are typically insufficient for determining how probable things are to happen again in the future, the availability bias can lead to poor decision making. As a result, the decision maker is left with low-quality data with which they base their judgment.

10) Anchoring bias: Investors while making choices, interpret newer information from the reference point of an anchor, instead of seeing it objectively. This can twist their judgement, presenting them from uploading the plan/predictions as much as they should.When we become anchored to a specific figure or plan of action, we end up filtering all new information through the framework we initially drew up in our head,

distorting our perception. This makes us reluctant to make significant changes to our plans, even if the situation calls for it.

## CONCLUSION

Behavioral finance is an aspect of financial markets worth learning about. Most investors assume that they are making rational decisions when they are not. A wide range of biases can affect the decision making of an investor - without being aware of it. Behavioral bias can affect the decisions we take on particular investments and the way we construct portfolios. Individual investors can fall prey to the biases but as a part of human nature, professional investors and advisers are also vulnerable.

To make a rational decision free of emotions and beliefs, one needs to get his hands on as much information he can get.The key to success is to outsmart yourself and make better decisions that are free from any type of biasness of emotions.

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