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Research Article

Behavioral Finance: An Extensive Review of Theoretical Frameworks and Their Practical Relevance

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ABSTRACT

In recent years, behavioral finance has developed as a large area of research in the Indian financial landscape. It often opposes the traditional concepts of finance, which consider that participants will make rational decisions and that markets will react efficiently. On the contrary, behavioral finance combines psychological insights into human behavior to scrutinize the irrationality of any investor and how cognitive errors can influence financial decision-making. Various psychological aspects and biases, such as overconfidence, loss aversion, herd mentality, and anchoring, have been identified in prior research as playing a significant role in the execution of investment decisions. These pieces of knowledge are crucial for understanding the discrepancy between the financial theoretical models and the real-market investor behavioral patterns.

The main aim of reviewing this literature is to cover the growth and rise of the behavioral finance area and to look into its theoretical background while at the same time analyzing the present applications of those theories when making investment decisions. The research is qualitative in an exploratory nature and consists of secondary data from various sources, including books, financial journals, academic publications, and trivially, the internet. The results encapsulate the basic principles of the field of behavioral finance, different biases reducing rationality in investment decisions, and the necessity of these prejudices in the formation of market trends. This paper provides an essential knowledge base on investor psychology, with an emphasis on practical applications of behavioral finance such as enhancing investment strategies and market analysis as its contributions.

Introduction

In the last few decades, the attention to money market financing has increased, with investors that make their decisions based on expected performance and the financial state of the assets. Nonetheless, such decisions can sometimes be irrational and influenced by the moods and perceptions of the investors. This is discussed in terms of the theory of behavioral finance.

In the realm of research, behavioral finance in India has risen to prominence due to numerous studies being carried out in recent years that look into the psychological aspects and behavioral traits that impact the decision-making processes of Indian investors. The main point of this research is the fact that investors are not always rational in their investment decisions. They are often found to be reacting to events in ways that are emotional and based on subjective perceptions, rather than strictly following the logical analysis.

Behavioral finance investigates the psychology of investors and presents the fact that several cognitive biases and emotional influences are the ones that largely affect the investors' behavior. The most common of the mentioned are anchoring, overconfidence, regret aversion, herd behavior, framing, and mental accounting. Such biases may lead to diverse irrational decision-making; hence, it is very important

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to critically analyze the relationship between investors' inner psychological processes and market dynamics.

Conceptual Framework of Behavioral Finance

Behavioral finance is a combination of the concepts of behavioral and cognitive psychology and traditional economics and finance, which help to address the question of why people behave irrationally in their financial decisions. The area of Behavioral Finance gives details of what, why, and how of investment and finance factors from a human's perspective. The Basic elements of the Behavioral Finance methodologies are commonly referred to as the "cognitive" branch, i.e., cognitive psychology, which means the thought processes of people or reasoning as well as the bounds to arbitrage. The psychological aspect is having the biases that influence cognition: relative to availability, representativeness and anchoring, overreaction, overstated confidence, and herding followers.

Kumar and Lee (2006), Baker and Wurgler (2007), Garling et al. (2009), and Barnea et al. (2010) narrated that sometimes investors wave the rational scheme, and their choices are shaped by multiple factors that could be demographic, psychological, behavioral, etc.

Definitions

Some definitions of behavioral finance are as below:

Table 1: Definitions of Behavioural Finance

David Hirshleifer(2007)	"Behavioral finance studies the application of psychology to finance and concentrates on individual-level cognitive biases.
M. Sewell, (2007)	Behavioural finance is the study of the impact of psychology on the behaviour of financial practitioners and the financial market.
Hirschey and Nofsinger 2008	Behavioral Finance studies the psychological errors and mistakes that occur in financial decisions
W. Forbes (2009)	Behavioural finance studies the influence of psychology on financial markets.

Source: Compiled from the Literature

Emergence and Development of Behavioral Finance

Traditional economics came into existence at the dawn of the eighteenth century and has been traditionally hybridized with psychology in its initial stages. The idea of traditional economics came into existence in the late 18th century when utility theory, a concept that measures the level of satisfaction or benefit that an individual receives from the consumption of goods or services, was introduced. The first stone of the concept of a rational economic man who is self-centered in his activities to achieve maximum financial satisfaction was laid in 1844 by the scholar Adam Smith. The same theory of classical financial analysis was then utilized to explain the following hypotheses, namely the Efficient Market Hypothesis, Random Walk Hypothesis, and Capital Asset Pricing Model (CAPM). These classical theories were based on the principle of arbitrage, a bet that is risk-free and, over a while, might beat other risk-free investments.

The neoclassical economics movement started around the early 20th century as a reaction against the pulmonary construction of classical economics that it relies on. The utilities and their satisfaction from consuming the product or service outweigh the companies' costs of production as consumers receive the utility from a product or service according to the neoclassical economists who distance themselves from psychology. They argue that consumers try to draw the maximum utility, or in simpler terms, satisfaction, from their personal decisions regarding the business by basing the decisions on the consumer's estimation of a product's utility. In this embodiment of economic rationality, people make decisions that maximize their benefits, and each of them is uninfluenced by others and has all the necessary information about the choices.

When it comes to traditional finance (the standard finance theory), individuals are logical agents who seek to maximize their utility by making rational decisions that are based on data and economic principles. For years, these old finance theories were the main instruments encoding the imperceptive behavior of investors and the eccentricities of the market. Nevertheless, in the long run, these tenets failed to account for the increasingly frequent market irregularities. Investors were thought to be exaggerating the prices of securities way above their fair values, thus creating price unfairness and market instability—a problem that traditional finance was unable to solve.

In this place of classical models, behavioral finance arose to fill the explanatory gap. Meanwhile, by including psychological aspects in financial decision-making, this approach afforded the thought leaders of money a more dominant understanding of investor behavior and the inconsistencies of the market. Behavioral finances were devised as a report to the limitations of broad-based financing, offering solutions by delineating psychological motives as the culprits. It engages persons to remain true to themselves not through logical approaches only but sometimes by intuition, emotion, cognitive flaws, and social interaction.

Behavioral finance came with a new way of interpreting the field where blue-chip types of finance might have failed to give sufficient explanations. It thereafter developed into an important field of study dealing with decision-making under the uncertainties investors face and psychological variables that impact the financial market. Behavioral finance, by taking ideas from the psychology field to the traditional methods of finance and economics, refutes these conventional models, which assume a clear-cut way that a person assesses the risk and payout. Contrary to that, it admits that psychological drivers are indeed the main factors that would influence one's choice of investments, and the result has been a corresponding increase in their effectiveness.

Ward Edwards, Amos Tversky, and Daniel Kahneman are among the key people in the development of behavioral

finance, who all contributed vastly to the discipline by applying cognitive psychological models to decision-making under conditions of risk and uncertainty. Their contributions in the 1970s and 1980s thus led to a significant change in the study of behavioral finance. Tversky and Kahneman's pioneering work described in the paper 'Prospect Theory: Decision Making under Risk' in 1979 introduced a psychological framework for explaining the anomalies that are observed in rational economic behavior, thus marking a moment for behavioral economics.

The expansion of behavioral finance has filled in the gap between traditional financial theories and real-marked market behavior, thus creating more practical and realistic models of understanding financial markets. Behavioral finance assumes that investors are not always entirely rational and that they, therefore, are vulnerable to several cognitive biases, such as overconfidence, loss aversion, and herd behavior. This acknowledgment has behavioral finance as one of the most vital tools for financial managers and investors, providing means to understand the biases and emotions of people and consequently leading to better market outcomes.

Behavioral finance, unlike traditional finance theories that have laid the foundation for understanding markets, is an essential complement to them in that it provides explanations for the irrationalities and anomalies that the classical models cannot account for. The study of psychological factors has been one of the fundamental areas of finance in modern times, which has been able to challenge the default assumptions that were used in the past and has been able to create more effective investment strategies.

Review of Literature

Maheran and Muhammad (2009) aimed to provide a conceptual understanding of behavioral finance by reviewing existing literature on psychological biases and their impact on investor behavior and market prices. Their study adopted a secondary data approach, drawing insights from previously published research. They concluded that investors often demonstrate loss aversion and rely heavily on past performance when making stock purchase decisions. Moreover, investors tend to trade aggressively, fail to diversify portfolios adequately, and are heavily influenced by the actions of their peers in the stock market.

Athur (2014) investigated how behavioral biases influence the investment decisions of individual investors in Kenya. Utilizing a sample of 30 investors selected through snowball sampling, data was collected via structured questionnaires and analyzed using descriptive statistics and regression techniques. The research revealed that behavioral patterns such as representativeness, illusion of control, cognitive dissonance, herd instinct, and hindsight bias significantly influenced investment decisions. In contrast, biases like loss aversion, self-attribution, regret aversion, and over-optimism were found to be statistically insignificant.

Mouna and Anis (2015) sought to explore the influence of investor sentiment and behavioral biases on portfolio returns, with an emphasis on whether investment experience could mitigate such biases. Their study used a structured questionnaire targeting 128 active, small-scale traders on the Tunisian stock market. Findings showed that behavioral biases such as anchoring and familiarity, alongside demographic factors like age and investment experience, had a substantial impact on investment decisions. Additionally, it was found that increased experience could reduce the magnitude of these biases.

Rehan and Umer (2017) focused on examining how cognitive and emotional biases affect investor decision-making in the Pakistan Stock Exchange. Data was collected from 385 market participants via structured questionnaires, and analyzed using descriptive statistics, correlation analysis, and multiple regression. Their results confirmed that biases including anchoring, risk intolerance, over trust, representativeness, and regret aversion significantly affect investors' decisions. However, mental accounting and availability heuristics were found to have no significant influence.

Bhoj (2019) aimed to trace the historical development of behavioral finance, identify common investor biases in India, and evaluate their implications for investment decision-making. Relying entirely on secondary data from websites, books, and published articles, the study emphasized that investors are not always rational and are heavily influenced by emotional, psychological, and social factors. The study concluded that investors often display overconfidence, poor information processing, impulsiveness, and herd behavior.

Jain et al. (2019) sought to prioritize behavioral biases affecting individual equity investors' decision-making by applying the Fuzzy Analytic Hierarchy Process (FAHP). This analytical method allowed for ranking the importance of various biases. The study revealed that herding behavior, loss aversion, and overconfidence were among the most impactful biases. It also highlighted key investment behaviors such as premature profit booking, internet influence, holding loss-making stocks, and irrational portfolio selections.

Madaan and Singh (2019) assessed the prevalence of behavioral biases among investors trading on the National Stock Exchange (NSE) of India. Data was collected from 243 investors using a questionnaire and analyzed through descriptive and inferential statistical methods. The study found that overconfidence and herding behavior significantly influenced investment decisions. It also concluded that individual investors often make emotional and uninformed decisions, with four dominant behavioral patterns shaping their investment strategies.

Sharma and Jain (2019) explored the evolution and development of behavioral finance and synthesized key theories in the field. This exploratory research relied on

secondary sources such as academic papers, journals, and other publications. Their study highlighted behavioral finance as a powerful interdisciplinary domain drawing from psychology and human behavior to better understand market phenomena and investor irrationality.

Shukla et al. (2020) aimed to provide a comprehensive overview of the multiple behavioral biases that affect investment decisions. The study reviewed literature spanning from 1974 to 2019, categorizing studies based on the biases they addressed. The analysis identified seven major categories of biases and offered practical implications for retail investors, finance professionals, and institutions. It also served as an update on the latest research trends in behavioral finance.

Seth and Kumar (2020) examined the impact of various cognitive and emotional biases on investors' decisions using convenience, random, and snowball sampling techniques. Analytical tools such as SPSS and R-Studio were used alongside descriptive and inferential statistical methods. The study found that biases like representativeness, hindsight, and regret aversion significantly affected decision-making, while self-attribution bias did not show a significant impact.

Nkukpornu et al. (2020) analyzed how behavioral biases—specifically overconfidence, regret, belief, and snakebite effects—affect investment decisions. The study used both descriptive and inferential statistical methods, including multiple regression analysis. Results indicated a positive relationship between all four biases and investment decision-making, with the snakebite effect being the most influential. The findings supported key tenets of prospect theory.

Tupe and Lokhane (2021) investigated the effects of emotional and cognitive biases on investment behavior using data from 150 respondents in Aurangabad City. Collected through questionnaires, the data demonstrated that behavioral finance concepts significantly influenced investor preferences for financial instruments and funding sources.

Bhatnagar and Aggarwal (2021) examined common behavioral irregularities in individual investment decisions using survey data collected from 63 respondents. Their study confirmed that confidence bias, familiarity bias, and especially loss aversion strongly influenced investment behavior, with loss aversion emerging as the most dominant factor.

Kartini and Nahda (2021) analyzed how cognitive and emotional psychological factors such as anchoring, representativeness, loss aversion, and optimism guide investor decisions. Utilizing survey data collected from 165 investors in Yogyakarta, hypotheses were tested using a one-sample t-test. The study confirmed that all the examined biases substantially influenced investment decisions, reinforcing the importance of recognizing and managing these tendencies.

Silwal and Bajracharya (2021) explored the relationship between behavioral factors and investment performance using factor analysis and structural equation modeling. Their findings indicated that while some behavioral changes negatively impact performance, others—like reliance on heuristics such as overconfidence and anchoring—can improve investment outcomes depending on market dynamics.

Mushafig et al. (2021) aimed to understand the connection between cognitive abilities, risk aversion, investment intentions, and financial literacy in shaping investment choices. Involving 256 Pakistani investors, the study employed discriminant analysis and used a 20-item questionnaire. It concluded that risk aversion negatively correlated with investment decisions, whereas financial literacy and cognitive functioning had a positive impact.

Mittal (2022) provided an extensive literature review covering five decades of research on behavioral finance, focusing on investment biases. The study developed an analytical model that explained how investor psychology affects decision-making. The paper emphasized that behavioral finance remains under-researched in developing countries and identified key gaps in understanding the role of specific biases.

Darmayanti et al. (2022) conducted a library-based descriptive review grounded in prospect theory. The study emphasized that financial literacy, personality traits, and risk tolerance are crucial factors influencing investment decisions, particularly in the context of risky asset management. It reinforced the notion that irrational investor behavior is a fundamental concept in behavioral finance.

Gawande et al. (2023) reviewed literature to examine how heuristics and cognitive biases affect investment choices. Their study showed that while heuristic techniques are used to manage losses and optimize gains, they often lead to biased and suboptimal decision-making due to cognitive shortcuts and overconfidence.

Kiruthika and Ramya (2023) analyzed the impact of cognitive biases on investment behavior using data from 109 investors collected through stratified sampling. The study found that major influences included confirmation bias, fear of loss, and illusion of control. These biases played a significant role in shaping investor perceptions and financial choices.

Kaur et al. (2023) aimed to assess the influence of psychological biases and cognitive processes on investment decisions. Data from 186 respondents was analyzed using descriptive statistics. Findings revealed that emotional and cognitive biases like status quo bias, loss aversion, media influence, and social cues played a key role in determining investment patterns.

Gupta (2024) investigated behavioral finance from a fresh perspective by examining how psychological biases influence portfolio decisions. Using a questionnaire-based

approach, the study found that cognitive biases significantly affect investor choices. It highlighted that behavioral finance helps investors devise both short-term and long-term strategies to manage these biases effectively.

Chakraborty (2024) sought to identify the determinants of investment decisions using a descriptive and exploratory approach. Based on data from 150 investors collected via online questionnaires, the study found that factors such as income level, tax benefits, liquidity, professional advice, and financial literacy were key influences, with tax benefits and expert guidance being the most impactful.

Research Objectives

1. To review the major theoretical frameworks in behavioural finance.
2. To study various psychological factors that affect investors' decision-making.
3. To study the practical applications of Behavioural finance.

Research Methodology

This research paper employs a descriptive and explanatory method to systematically explore the key concepts of behavioural finance and its practical applications. The methodology employed is based on the thoughtful selection, regulatory and authoritative publications sourced from a variety of authenticated sources. Out of those, peer-reviewed scientific journals, published research papers, financial journals, scholarly articles, and other related literature that aid a deeper understanding of the topic were included. The research's aim of examining behavioural economics concepts, investor behaviour psychology biases, and these concepts' practical applicability in real-world financial decision-making is through a coherent integration of information from these different sources. The use of secondary data allows a researcher not only to have a wide umbrella of sources at one's disposal but also to stand critically on the previous research done and to draw some links between theoretical ideas and market behaviour

Results & Discussions

The notion of behavioral finance was invented in the 1980s due to the failures of the traditional finance theory namely the efficient market hypothesis, which is based on the postulate that financial markets are usually efficient, and prices are true reflections of all information available, however, it turns out that markets are not always rational due to inefficiencies, uncertainties, and biases. Behavioral Finance studies the way investors act in the financial market and how it influences the market. The Efficient Market Hypothesis holds that investors are rational while making their investment decisions, but behavioral finance shows the fact that investors can behave irrationally due to cognitive devices, emotions, and lack of knowledge.

The vital point dark side of behavioral finance is the fact that different investment participants are accomplished, and they think and interpret information differently, which results in varied views on investment opportunity. Moreover, they have been identified as a characteristic of what is known as herd behavior or over-react to market events, which, in turn, brings about market inefficiency. The core objective of behavior-based financing is to not only detect such deficiencies but also give a reason for them by reference to the investors' decision-making processes. The research in the behavioral finance field approaches that the cognitive inaccuracies, along with psychological causes, in this respect could be major target points in the courses of projection and investment planning.

Prospect Theory

At the core of behavioral finance, Tversky and Kahneman (1979) were the first to propose the "Prospect Theory" in 1979. Prospect theory is the theory that states human decision-making in risky situations. It states that decision-making to be genuine is the methodology that gives weight to the gain or loss of an individual. The classical theory of economy propounds that economic agents will make rational decisions based on a utility function. Conversely, prospect theory demonstrates that individuals assign different weights to gains and losses and various ranges of probability. It came up with different psychological states that might be a hindrance to investment performance. Furthermore, they discovered that people are more spooked by potential loss than they are joyful over a similar return to the positive side. In addition, they also discovered that people would react differently to identical cases depending upon the gain or loss. For a start, the investor may suffer from framing effects, which include the representatives, caused by risk and uncertainty.

1. Loss Aversion

A Loss Aversion bias regards investors as people who seek risks in loss situations and refrain from risks in situations of gains. It means people are more prone to the idea of avoiding losses than they are to getting the same number of gains. The argument hypothesizes that obstacles, losses, or drawbacks that result in a more severe impact on the choices will stand out more. Personal consists of a sharper and keener disliking of the losses than advancements in the gains and especially the similar level of gains joy (Kahneman et al., 1990; Tversky and Kahneman, 1981).

2. Regret Aversion

Regret aversion is the tendency of an individual to opt for alternatives that are less regretful. People are scared of taking risks or making decisions that might end up badly, particularly when those results are uncertain. We have an instinct to keep away from acknowledging a mistake and seeing a loss (Kahneman and Tversky, 1982). Moreover, Bell (1982), Ferris et al. (1988), Pompian (2006), and

Coffie (2013) have also supported the idea of regret aversion.

3. Mental Accounting

Mental accounting bias is the inclination of individuals to separate their money into separate accounts based on a variety of subjective criteria, such as the source of the money and the purpose of each account (Thaler, 1985).

4. Self-control

Self-control bias is the inclination of individuals to erase the thought of how they can manage the situations in which they are likely to give in to the temptation or which they can, in fact, exercise self-discipline in the future. This might lead to poor decision-making. It is a cognitive bias wherein individuals are likely to miscalculate their future willpower or self-control, which often results in impulsive behaviors or choices they later regret.

Regret Theory

Professor Statman investigated the behavior of the people who are identified under the name 'fear of regret. Habit is the drive of people to experience feelings of worry and sadness after they make the wrong judgment. The most well-known example is the investors who are seen to continue holding onto the stocks that have lost value to avoid the regret of admitting to a poor investment choice. This is due to the discomfort of having to inform the loss to the clients, accountants, spouses, and other stakeholders as well as the social pressure to keep the good image and hide the failure if it is the case that leads to the holding of bad investments in the first place. Besides this, the investors also can explain the losses on the declining stocks by saying they are due to external factors or market trends.

The Heuristics Decision Process

Heuristics are the kind of procedures one utilizes to make fast and frugal judgments and decisions that usually possibly involve perceiving an individual element of a complicated issue and disregarding others. Under heuristics, the decision-making process of a person is biased in five different ways due to the risk and uncertainty involved. These factors include overconfidence, representativeness, anchoring, herd behavior, and hindsight bias. These are dealt with in detail herein.

1.Overconfidence

Overconfidence is a tendency demonstrated by investors to overstate their abilities and the knowledge they possess, which in turn leads them to excessive trading or risky financial decisions.

2.Anchoring

It refers to that cognitive bias where people rely too intensely on the first piece of information (one bit of data) when making decisions, even if it's arbitrary or irrelevant. In other words, investors don't rely on fundamental factors while making decisions.

3. Representative

People decide on the stereotype side rather than moving to a more comprehensive and objective understanding.

4.Herding

It is an important cognitive bias when investors dive into the crowd and act like most people do to decide.

5.Hindsight

Hindsight bias refers to the inclination of individuals to excessively consider their ability to have predicted correctly that outcome as a basis of the outcome of a past event.

Applications of Behavioral Finance Theories:

Behavioral finance is gaining increasing recognition due to its significant relevance in today's financial markets. The application of behavioral finance in the modern economy can be understood through the following points:

1. Bridging the Gap

Behavioral finance bridges the gap between traditional finance theories and the realities of actual market behavior, offering a more realistic understanding of how markets function.

2. Realistic Decision-Making

Theories in behavioral finance provide insights into the decision-making processes of investors, highlighting how psychological factors influence investment choices.

3. Overcoming Limitations

Behavioral finance addresses the limitations of classical finance theories, such as the Efficient Market Hypothesis, by explaining how and why markets often deviate from the assumptions of perfect rationality and efficiency.

4. Informed Strategy Development

By understanding the psychology behind investor behavior, behavioral finance equips managers with the tools to develop more effective and logically sound investment strategies.

5. Addressing Market Anomalies

Behavioral finance plays a crucial role in identifying and mitigating market anomalies, such as mispricing and uncertainty, that arise due to investor biases and emotional decision-making.

6. Monitoring Market Movements

Behavioral finance provides a framework for closely monitoring market movements driven by investor decisions, offering deeper insights into market dynamics.

Overall, behavioral finance is a vital contribution to the modern economy, enriching our understanding of market behavior and offering practical solutions to address market inefficiencies and uncertainties. It helps investors, financial managers, and policymakers navigate the complexities of financial markets more effectively.

Conclusion

Finance has become more nuanced and insightful due to the introduction of behavioral finance. Previously, traditional finance theories were predominantly used for understanding investor behavior and its effect on financial markets. Nonetheless, these classical theories were the ones that did not take the market anomalies into account

because they were too simplified and outdated. Thus, it happened that conventional models became insufficient to explain the real-world market dynamics, which finally led to the turning point that enabled a more behavioral approach to finance to rise.

Behavioral finance brought a new point of view, filling the gaps that traditional finance could not cover. It now has a significant role, as it deconstructs investor volatility and the complexity of financial investments. This branch of finance combines the principles of the psychology of behavior and thinking with conventional economics and finance, which leads to the identification of the psychological factors influencing financial choices. Unlike traditional models, which indicate that investors always act rationally and make decisions solely based on the risk/return arguments, behavioral finance, through its assumptions of investor psychology, seeks to explain why alternatives and emotional ways of thinking are used by the investors instead of only focusing on the returns.

The main point of behavioral finance is that by taking psychological aspects into account, investors can successfully plan investments that are more in line with human behavior in decision-making. The financial sector is now embracing behavioral finance with its unique ability to comprehend market dynamics and thereby enhance financial decision-making in a difficult and unpredictable present situation.

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