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A Study On Comprehensive Review Of Emotional Bias Impact On Investment Decisions Of Investors

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Abstract

Emotional bias is the term used to describe how people express their feelings about acting in a particular way. It affects how people behave, and conduct in turn affects the choices made by individual investors. The impact of emotional biases on the equities investment decisions of individual investors is the main topic of this study. Everyone believed for a long time that traditional finance theory was correct since it said that investors utilize economic models or various estimates to make educated decisions. According to the investment theories, investors are logical beings that make decisions based on limiting risks and optimizing returns. Loss aversion, overconfidence, endowment, self-control, regret aversion, and status quo biases are markers of emotional biases. Research indicates that the biases against loss aversion, overconfidence, self-control, and remorse had a strong positive influence on decisions regarding investing in stock none of the less, prejudice stemming from endowments and the status quo did not significantly influence the stock investment choices of individual investors. When making financial decisions, decision-makers may be influenced by certain biases. This research adds to the existing knowledge on behavioral finance and assists investors in identifying and reducing bias in their investment decisions.This study examines the impact of Emotional biases on investment decisions and the types of investors involved.

Key Words: Loss Aversion, emotional bias, human behavior, Overconfidence, Self-Control bias

Introduction

According to traditional theories of finance investors rational and take the decisions based on risk and return but it contradicted by the behavioral finance the investors are irrational and take the decisions based the biases. Behavioral authors identified the two types of biases

a) Cognitive bias
b) Emotional bias

In this Paper we are going to learn about emotional bias. Emotional bias means "Biases that arise spontaneously when a person acts, depending on their emotions when making choices or investing money." The main aim of the paper is to explore the impact of emotional bias on the investment decisions of the individual investors.Investing is the process of distributing available funds among several potential opportunities, which could either result in a profit or a loss for the investor. The objective of making an investment is to earn a good return from an investor's perspective. Investments can be made in a variety of methods, including the stock market, real estate, banks, post offices, insurance companies, and more. An investor's most important responsibility is to select the right investment channel that will allow them to achieve their goal. It takes a long time to analyze and determine "where to invest". Before selecting an investment, carefully weighing all of your options is essential. Emotional biases are critical for individual investors and financial experts. Strategies including as education, mindfulness, and disciplined decision-making can help to reduce the impact of emotional biases on investing decisions. Furthermore, more knowledgeable and logical investing strategies may result from the incorporation of these behavioral insights into financial planning and consulting services.

Review of literature

1. “Psychology and Financial Decision Making “ late Herbert

Simon, PhD in Political Science, Professor of Psychology at Carnegie-Mellon University in (1978) Nobel laureate in economics has given the very important concept of bounded rationality.

2. Shefrin (2000) shown that the study of behavioral finance is the area in which psychological factors influence the decision-making process of financial practitioners.
3. Two psychologists Kahneman and Tversky (1979), also conducted researches on cognition investors, and found that investor's cognitive biases, feelings and attitudes increases by the time and form beliefs and preferences those considered errors in decision-making.
4. Baker &Nofsinger, (2002); Barber &Odean, (2001); Kahneman&Riepe, (1998); Shefrin, (2002). Individual investors are vulnerable to a number of biases that keep them from making wise financial choices.
5. Linter (1998) has defined behavioural finance as study of how human interprets and act on information to make informed investment decisions.
6. The irrationality of decision-making has been linked to behavioral biases (Shefrin). The field of behavioural finance, according to Graham et al. (2002), is centred on the psychological elements that influence conventional investment practises.
7. According to (LempertandPhelps2014) The emotional reaction may arise accidentally from the available options, so impacting the option's perceived worth in an indirect manner. One option in a group, for instance, may be negatively assessed if it causes a fearful emotion in the person evaluating the options. This would result in a negative subjective value being assigned to the option, and its relevance would be disregarded. Emotions can also have a direct impact on decisions. The emotional response can be included in the computation as a separate option rather of having an impact on the choice option's subjective worth.

Objectives of the study:

1. Conduct thorough assessments of studies on emotional biases in financial decisions.
2. To recognize emotional biases and other emotions influencing investors' financial choices.

Emotional bias influencing investment decisions

Loss Aversion: The psychological condition known as "loss aversion" describes people's propensity to fear losses more than they appreciate comparable gains. Investors may be more inclined to accept risks to avoid losses, resulting in poor decisions. Fear of losing money can make people risk-averse, which keep them from taking calculated chances that can pay off. It could also be a factor in a portfolio that is unbalanced due to apprehension about selling failing investments. "loss aversion" explains why people experience psychological anguish twice as strong as joy when winning. It can be more painful to lose money or any other precious item than to gain it again. Loss aversion is the inclination of an individual to favor avoiding losses above achieving comparable gains.

Over-Confidence bias: Overconfidence bias is characterized by an individual's inclination to overestimate their abilities and expertise. Overconfident investors may assume they can precisely foresee market changes or consistently pick profitable stocks.Investors that are too confident might trade too much and neglect to properly manage their risks. This bias can cause poor portfolio performance and higher transaction costs. The propensity to overestimate our skills and knowledge in a particular field is known as overconfidence bias. People's perceptions of danger and achievement are typically inaccurate because they frequently have false beliefs about their abilities, traits, or conduct.

Herding Behaviour: When people follow the majorities or a popular trend's activities without considering their own analysis or information, this is known as herding behavior. Investors susceptible to herd mentality could choose to follow the herd rather than doing their own research before making a decision. This can lead to market booms and crashes, as well as asset mispricing.

Regret Aversion bias: The fear of making a mistaken choice is known as regret aversion. In order to reduce the possibility of regretting a bad investment decision, investors may choose to steer clear of some chances. Investing conservatively and choosing safer but less profitable assets can result from regret aversion. This could lead to lost chances for portfolio expansion. When a choice is made with the intention of not regretting it later, this is known as regret aversion. Sometimes, people make choices to prevent feeling helpless and uncomfortable, which is regret.

Self-control bias: Self-control bias is a behavioral economics notion that relates to people's proclivity to prioritize immediate satisfaction above long-term rewards, even when they are aware that the long-term gains are more advantageous. This bias indicates a lack of self-control or the inability to postpone instant gratification in favour of more profits down the road. In addition to creating imbalances in asset allocation, self-control bias can make investors forget fundamental financial concepts like dollar cost averaging, compound interest, and other disciplined practices that, when followed, can contribute to the accumulation of substantial long-term wealth of the investors.

Methodology of the study:

The study is descriptive in nature, and the secondary sources used to gather the data included research papers, journals, articles, periodicals, and other sources.

Findings

People are the most sentimental animals on the planet. Education has the power to stimulate logical thought, but emotions, feelings, and moods all have an impact on investing judgments when it comes to making decisions about investments. There are two sides to any emotional state: a positive side and a bad side. How an investor uses, these feelings will determine whether he succeeds or fails in the market. Studies have indicated that emotional biases affect the investor’s investment decisions. In addition to these biases, moods and emotions, risk, and uncertainty also influence decision-making in different ways. Based on the many research articles we may know about majority of theemotional biases influence the investment decision making of the individual investors like

a) Mood swings
b) Spontaneous decisions
c) No clarity about the investment
d) Emotions negatively or positively

As per the behavioral finance investment decisions are irrational and decision might be change based on spontaneous situations and Prevailing news in the market. This study will be help to the investors to know about the biases and how much it will be going to influence the investment decisions of the individual investor.

Conclusion

Emotional bias influences rationality, which in turn influences the financial decisions of individual investors.Ultimately, emotional biases are difficult to overcome and rectify. Therefore, investors need to take responsibility for their own actions, ensure that information is processed appropriately, regulate their emotions, moods, and behavior when making judgments about investments, and use strategies to avoid or adjust to biases. Due to emotional biases, individual investment decisions may be unpredictable and impacted by a variety of circumstances.The emotional biases exhibited by investors suggest that irrational investing decisions may arise from human biases, emotions, moods, feelings, overconfidence, beliefs, and qualities, ultimately leading to market inefficiencies. Lastly, the study suggests that investors manage their emotional biases, moods, feelings, beliefs, and personal characteristics and create an appropriate plan to prevent, disregard, or adjust to such conduct. Furthermore, investors must correctly examine the relevant information, accept professional advice and recommendations, and control their own emotions and biases when making investment decisions.

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