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THE PSYCHOLOGY OF INVESTMENT: EXPLORING THE PARADIGM SHIFT FROM TRADITIONAL FINANCE TO BEHAVIOURAL FINANCE IN FINANCIAL MARKET

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Abstract

Financial management is considered the cornerstone of any economic system. It encompasses various theories and assumptions aimed at elucidating the means of investment decisions. However, the inadequacy of traditional finance theories in explaining numerous repeatable market anomalies prompted a departure from conventional assumptions, marking the advent of behavioural finance. The study aims to elucidate the transition from traditional finance theories to behavioural finance by exploring the conceptual developments and contributions in both fields. The present study uses existing literature from Google Scholar based on prominent keywords related to traditional finance, behavioural finance, and investment decisions. The findings of the study try to shed light on the significant behavioural biases influencing investors' investment decisions in the financial markets. The study concludes that behavioural finance theories contradict the rigid assumptions of traditional finance theories, arguing that real-world investors take investment decisions in the presence of psychological biases that significantly impact individual returns and the financial market as a whole.

Keywords: Behavioural Biases, Behavioural Finance, Investment Behaviour, Investment Psychology, Traditional Finance, Financial Market

JEL classification: G1, G4, G41

Introduction

In the realm of finance, the 1950s and 1960s are often regarded as the most innovative decades, marking a shift from finance as a descriptive discipline to a more scientific approach that integrated new concepts. During this time, researchers across the globe focused on harnessing the power of mathematical, probabilistic, and optimization models, which resulted in the development of key theories such as portfolio optimization, the capital asset pricing model (CAPM), and the efficient market hypothesis (EMH). However, contradictions in the applicability of these theories have begun to emerge within twenty years of their introduction. Researchers across the globe were prompted to re-evaluate the traditional finance theories based on the emerging market anomalies. This cognitive shift from age-old traditional finance theories to a new area of finance marked the beginning of behavioural finance (Andrikopoulos, 2005). Behavioural finance as a discipline was introduced through the critical evaluation of traditional finance theories. The principal objective of behavioural finance is to explain the reasons for investors' irrational behaviour in the financial market while making investment decisions. The present study showcases the inapplicability of classical and neo-classical theories in a real-world scenario based on existing literature of both traditional and behavioural finance theories. The following sections of the study cover research objectives, research methodology, an overview of traditional finance theories, and the transition from traditional finance to behavioural finance in the light of various behavioural biases.

Review of literature

The traditional finance theories explain the investment behaviour of investors under the umbrella of certain assumptions such as rational behaviour of the investors, efficiency of the market, risk aversion characteristics of investors, etc (Ritter, 2003). However, dissimilarity among investors' market returns and the existence of various market anomalies have questioned the assumptions and applicability of traditional finance theories (Hammond, 2015). Smith (2008) argued that market available information in the form of security prices is processed by investors, where they are prone to be affected by various psychological biases. Zahera & Bansal (2018) highlighted the role of investor emotions in explaining stock market volatility and returns. Singh (2019) emphasized the theories of behavioural finance, which offer a framework for understanding the stock market dynamics when rationality is absent. It also highlights various factors influencing the diverse behaviour of investors. Pompian (2006) categorizes behavioural finance into two subfields: behavioural finance micro, which focuses on the behavioral biases of individual investors, and behavioural finance macro, which investigates anomalies within efficient markets. Zahera & Bansal (2018) highlighted the importance of understanding the principles of behavioural finance and its associated biases, which can help investors better recognize the irrational aspect of stock market investing. Based on the findings from existing literature, the advancements in both traditional and behavioural finance can be witnessed globally; but a complete understanding on the shift from traditional finance theories to behavioral finance remains fragmented. Traditional finance theories assume the concept of market efficiency and perceive investors' rationality in the investment decision making. However, the occurrences of market anomalies caused by investors' irrational investment decision highlighted the limitations of traditional finance theories. Although, behavioural finance has evolved from the critical discussion of traditional finance by combining psychological insights into financial-decision making, existing studies often highlighted some market specific events or selected behavioral biases rather than comprehensively accessing the underlying transition between the two paradigms. Moreover, a limited research works has been documented identifying the presence of behavioral biases among investors and how they systematically shift their investment behavior from rational to irrational decisions. A conceptual exploration of this transition from traditional finance era to behavioral finance is essential to bridge the theoretical divide between rational and behavioural perspectives, offering a more holistic understanding of investor psychology in real-world markets. The present study seeks to address this gap by examining the evolution from traditional to behavioural finance, highlighting how psychological factors reshape investment decisions and market outcomes

Objectives

The present study aims to achieve the following objectives:

(i) To explore the paradigm shift from traditional finance to behavioural finance
(ii) To identify the relevant psychological biases influencing investment decisions in the financial market

Significance of the study

The theories of behavioural finance and their related biases have significant relevance in both industry and academia, strengthening the understanding of the financial market both by individual and institutional investors. From the industrial perspective, the insights from the field of behavioural finance allow market participants such as asset managers, financial advisors, and institutional investors to better understand and mitigate the behavioural biases that affect investment decisions. Behavioural biases such as overconfidence, anchoring,

herding behaviour, disposition effect, etc., can lead to market inefficiencies, mispricing of assets, and suboptimal investment decisions. By applying behavioural finance concepts, industry professionals can enhance decision-making processes, optimize portfolio management strategies, and develop effective risk management frameworks that account for human irrationality. In academia, the theories of behavioural finance challenge the classical assumptions of rational decision-making and market efficiency, prompting a re-evaluation of financial models and theories. It leads to the development of new research methodologies that integrate psychological factors with economic models, offering a richer understanding of market dynamics and investor behaviour. This interdisciplinary approach has widened the scope of financial research, encouraging researchers to explore the psychological underpinnings of economic decision-making and their impact on financial market outcomes.

Research Methodology

The study is descriptive and qualitative and aims to explore the available relevant literature to investigate the transition from traditional finance theories to behavioural finance theories. Pieces of literature in the form of books, review papers, and journal articles on the selected study area are located, identified, and surveyed through the Google Scholar database which is considered to be a large pool of peer reviewed data (Donthu et al., 2021). Literature was identified by using keywords that include: "Traditional Finance Theories", "Criticism of Traditional Finance Theories", "Behavioural Finance Theories", "Shift From Traditional Finance to Behavioural finance", "Investment and Behavioural Finance", "Psychological/Cognitive/Emotional/ Behavioural Biases and investment decision". The study used a variety of search terms by using Boolean operators (OR, AND, etc.). The research papers exhibited by the database in response to the search terms mentioned above were accessed based on availability. Data collected from Google Scholar with these search strings were prone to erroneous information which were further refined with certain criteria. An appropriate data set was extracted after implementing certain inclusion and exclusion criteria which included pondering the “title”, “keywords”, and “abstracts”. Further, filtration had been done based on the “subject area”, “type of documents”, “source type”, “language screening”, and “content screening”(Goodell et al., 2021). The accessed literature from different areas of behavioural finance and investment psychology is then investigated, analysed, and synthesized.

An overview of traditional finance

The foundation of traditional finance is believed to have been laid in 1844 by J.S. Mill, who introduced the concept of "homo economicus" where the concept of rationality serves as the foundation for many neoclassical economic theories (Hausman, 2007). In 1944, Von Neumann and Morgenstern introduced the “Theory of Games and Economic Behaviour”, which developed the concept of “expected utility theory”. This theory demonstrated that when an individual is offered various options, the optimal choice is always that option which accelerates the expected utility (Fishburn, 1989). Building on expected utility theory, Harry Markowitz laid the groundwork for “Modern Portfolio Theory” (MPT) in 1952. This model aids individuals in the creation of an optimal portfolio by selecting a mix of risky and risk-free assets to have maximum returns and minimum risk (Elton and Gruber, 1997). Expanding on “modern portfolio theory”, William Sharpe, Jack Treynor, John Lintner, and Jan Mossin developed the “Capital Asset Pricing Model” (CAPM), which transformed the algebraic framework of MPT into a testable model predicting the relationship between risk and expected return (Rossi, 2016). However, in the late 1970s, the CAPM theory faced criticism when research across the globe began identifying additional variables such as size, price ratios, and momentum effect that could explain the average returns beyond beta alone (Fama and French, 2004). To address these anomalies, Eugene Fama introduced the “Efficient Market Hypothesis”

(EMH) in 1965, proposing that stock prices react rapidly to new information. EMH classifies markets into three types: weak, semi-strong, and strong efficiency, assuming that information is immediately reflected in investment decisions.

A paradigm shift from traditional finance to Behavioural finance theories in the financial market

The Efficient Market Hypothesis (EMH), introduced by Eugene Fama in 1965, is a cornerstone theory of traditional finance. The theory defines financial markets as "efficient," meaning stock prices react too quickly to all the available information, making it nearly impossible to predict future movements based on past data. This led to the "random walk" theory, suggesting that changes in the stock prices are unpredictable and techniques like technical and fundamental analysis are considered ineffective. However, critical analyses of the theory have indicated that the connection between random stock movements, investor rationality, and market efficiency lacks statistical significance. Many economists have debated the real-world applicability of EMH, arguing that market prices do not always perfectly reflect all available information. If they did, arbitrageurs would not be compensated for their efforts (Singh, Babshetti and Shivaprasad, 2021). The critical analysis of the traditional finance theories gained attention when behavioural finance theorists argued that even if market prices reflect all significant information, investors' decision-making process is influenced by psychological biases (Smith, 2008). Hammond (2015) criticized EMH by highlighting the volatility caused by the stock market "bubbles," undermining the assumption of investor rationality. Shiller (2003) attributed excessive volatility to mass psychology rather than fundamental factors. This has led researchers to reconsider traditional finance assumptions and explore the influence of investors' psychological factors in the creation of stock market bubbles (Kapoor and Prosad, 2017). Behavioural biases play a crucial role in shaping key financial market outcomes such as volatility, herding, and asset mispricing. Investors influenced by cognitive and emotional biases often deviate from rational decision-making, leading to market inefficiencies. For instance, *overconfidence* and *representativeness biases* drive excessive trading and speculative behaviour, contributing to heightened *market volatility* (Barber & Odean, 2001). Similarly, *herding behaviour*, often rooted in *social proof and loss aversion*, intensifies during periods of market stress, causing investors to mimic collective trends rather than rely on independent judgment (Bikhchandani & Sharma, 2000). Moreover, persistent biases such as *overreaction* and *anchoring* lead to *asset mispricing*, where securities deviate from their fundamental values, resulting in bubbles or prolonged corrections (Thaler, 1985). These behavioural tendencies reveal that psychological factors are integral to understanding anomalies and inefficiencies within modern financial markets. Investment choices are frequently made in complex scenarios, prompting investors to simplify their decisions, sometimes at the cost of decision quality. Kartini and Nadha, (2021) emphasized the role of psychological factors other than logical and rational factors in leading deviations from the concept of rationality. Further, Zindel et al. (2014) identified the constraints in processing available information by investors, resulting in them opting for certain heuristics. While Yalcin (2010) examined the existence of market anomalies, Shleifer (2000) focused on the patterns of deviations from rationality. These instances encourage researchers to think beyond the assumptions of traditional finance theories and explore the presence of human psychology in shaping investment decisions.

An overview of behavioural finance

Behavioural finance: history and development

During the neoclassical era, the existence of the psychological aspect disappeared from economic and financial theories. However, by the mid-20th century, several market anomalies

were observed, followed by the critical analysis of neo-classical theories (Singh, 2019). As a consequence, researchers across the globe reintroduced the concept of psychology by deviating from the concept of pure rationality to understand individual behaviour. In the mid-18th century, the origin of behavioural finance was traced in the Adam Smith's "Theory of Moral Sentiments" (1759), where the principles of human nature were explored (Wang, 2019). However, during the mid-20th century, the idea of rationality underwent critical analysis, giving rise to the concept of "Bounded Rationality," which acknowledges the impracticality of achieving complete rationality in decision-making. In 1957, Leon Festinger introduced the "Theory of Cognitive Dissonance", which explains that holding contradictory beliefs creates a state of discomfort, or dissonance, leading individuals to avoid information that exacerbates this tension (Hinojosa et al., 2017). In 1974, Daniel Kahneman uncovered the role of heuristics in human decision-making, showing that decisions made under complex and uncertain conditions are often influenced by cognitive shortcuts. This reliance on heuristics introduces biases, including representativeness, availability, and anchoring biases. Kahneman's research, alongside Amos Tversky, culminated in the development of "Prospect Theory" (1979), a descriptive model of decision-making that highlights how individuals perceive gains and losses asymmetrically (Kahneman and Tversky, 1979; Thaler, 2000; Pompian, 2006). The framing and processing of information by investors have been the point of argument between traditional and behavioural finance theories. Behavioural theorists argue that information is often presented ambiguously, where investors may struggle to process it effectively, giving disproportionate weight to initial impressions, which leads to anchoring bias (Kartini and Nadha, 2021). R. Thaler (1985) introduced Mental Accounting, a concept explaining how individuals categorize their wealth into distinct "mental accounts" based on superficial characteristics, each with varying levels of significance. Bondt & Thaler (1985) also investigated market overreaction, analysing monthly stock market returns and finding that investors tend to overreact to contrasting events and information, deviating from the Bayesian rule. Traditional finance theories assumed that investors behave rationally at the occurrence of any financial information while taking investment decisions. However, conceptual and empirical evidence of behavioural finance research works argued that the presence of psychological biases among financial market participants hinders the rational process of extracting accurate information. Stålnacke (2019) conducted a study on financial market participants to examine their behaviour of using financial information available in the market. The study found that unsophisticated investors tend to us filtered financial information while taking higher portfolio risk. On the other hand, sophisticated investors use unfiltered financial information more frequently and tend to make better financial decisions by earning higher risk adjusted returns. Similarly Mohammed Elwani (2016) found that investment experience factor negatively impact information seeking behaviour of the investors. On the other hand, risk tolerance attitude of the investors confirmed that investors' risk appetite increases the information seeking behaviour. The study also confirmed a positive relation between regret aversion and information seeking behaviour. Naveed et al. (2021) conducted a study where he tried to examine the role of information acquisition in moderating the role of behavioural biases and investment decisions. The study found that overconfidence bias and self-attribution bias were negatively related to rational decision making of the investors. The moderation effect ofg information acquisition behaviour in the association of behavioural biases and investment decisions confirmed that an increase in acquisition of better and relevant information will significantly reduce the loss of irrationality caused by overconfidence bias. However, the hypothesis which expresses that information acquisition moderates the relationship of self-attribution bias with investor decision was not supported. Gentile et al. (2015) conducted a study to analyse the perception of investors towards the presentation of financial information focussing on the "framing effect" in the realm of psychological biases. The findings of the

study suggested that the 'optimal' disclosure might not exist and the 'one-size-fits-all' approach couldn't be effective in ensuring a suitable level of investors' protection. Risk perception is context-dependent and mainly determined by the way financial information is disclosed. The study highlighted that simplifying financial disclosure was not sufficient to ensure correct risk perception and unbiased investment choices. A study conducted on the role of cognitive biases on investment decision documented that herding bias negatively impact investment decision, while disposition effect and mental accounting bias positively impact investment decisions. Further, the moderating role of financial literacy in the association of behavioural biases and investment decisions confirmed that rationality in investment decision making increases with increased level of financial literacy (Khan, 2020). A study conducted on analysing the impact of various factors on investment decision found that behavioural biases on experienced investors results different than on inexperienced investors. Demographic variables like profession, education, gender and culture play a significant role on investment decision. The study further claimed that the presence of investors' emotions at the time of making investment decision plays a significant role behind stock market volatility and stock market return. The decision to invest in any investment avenues is taken by individuals or a group of managers, and this can be influenced by some behavioural influences which results into suboptimal decisions (Zahera & Bansal, 2018). These findings collectively demonstrate the inadequacy of traditional finance theories in explaining financial market anomalies. In an increasingly globalized economy, behavioural factors are recognized as critical supplements to standard finance theories in understanding the dynamics of financial markets.

Conceptual framework of Behavioural finance

Behavioural finance considers psychological insights into the processes of judgment and decision-making, diverging from the rationality framework emphasized by traditional finance theories. Singh (2019) identifies behavioural finance as an interdisciplinary domain that merges psychology and economics to explore why investors sometimes make irrational investment choices. Pompian (2006) categorizes the field into two distinct branches: Behavioural Finance Micro, which examines individual investor Behaviour, and Behavioural Finance Macro, which focuses on broader market phenomena.

Behavioural Finance Micro (BFMI): BFMI focuses on analyzing the Behaviours and biases exhibited by individual investors that deviate from the rational decision-making framework outlined in classical economic theory.

Behavioural Finance Macro (BFMA): BFMA investigates and interprets anomalies within the Efficient Market Hypothesis, offering explanations through Behavioural models.

The concept of behavioural finance seeks to understand the irrational behaviour exhibited by market participants, which causes stock mispricing in the financial markets. This field rests on two foundational pillars: Limits to Arbitrage and Psychology (Pompian, 2006; Ricciardi, 2008; Singh, 2019). In finance and economics, arbitrage means the opportunity to make a profit from the differences in prices for the same asset across different markets (Singh, 2019). Eugene Fama once argued that the irrational behaviour in financial markets is offset by the rational actions of arbitrageurs. However, the practical implication of this process is subject to various risks. At the time of short selling an overpriced security with the object of making a profit at low prices, the lack of suitable substitutes can lead the prices to remain high, which can cause a loss to the arbitrageurs. Another significant risk can occur from the unpredictable actions of noise traders, which can disrupt the rational objectives of arbitrageurs. Another pillar of behavioural finance is the psychological aspect of market participants. Behavioural finance theories explained the causes of investors' irrationality in the light of psychological factors

(Kartini and Nadha, 2021). Individual differences in how information is perceived, interpreted, and applied exacerbate this issue (Hammond, 2015). Illusions of control, knowledge, and experience, combined with investors' inability to utilize their knowledge efficiently, often result in flawed judgments and irrational investment decisions (Andrikopoulos, 2005). Researchers have highlighted that emotions significantly influence investment decisions, contributing to stock market volatility and fluctuations in returns. This irrationality can be explained by biases rooted in personal beliefs and preferences, which behavioural finance defines as systematic judgment errors. Researchers categorize these biases as heuristics (rules of thumb), beliefs, judgments, or preferences (Singh, 2019). Pompian (2006) further distinguishes between cognitive and emotional biases. Cognitive biases stem from flawed reasoning and can often be mitigated through better information and guidance. In contrast, emotional biases are driven by intuition rather than deliberate calculation, making them more resistant to correction. From an extensive review of existing literature on behavioural finance, the prominent behavioural biases are discussed as follows:

Overconfidence Bias: Investors with overconfidence bias tend to overestimate their knowledge, overlook possible hazards, and exaggerate their capacity to affect results (Kartini & Nadha, 2021). Due to their great analytical skills, investors frequently become overconfident, believing that their information is superior and can be used in the best possible way (Naveed et al., 2021; Pompian, 2006; Ranjit Singh, 2019; Ritter, 2003; Zahera & Bansal, 2018).

Representativeness Bias: Investors' tendency to connect recent results to prior experiences, frequently establishing causation without enough evidence, is known as representativeness bias (Ritter, 2003). This bias causes suboptimal decision-making by placing too much focus on recent events while ignoring long-term trends (Ranjit Singh, 2019; Zahera & Bansal, 2018).

Herding Bias: Investors with a herding tendency frequently follow the crowd while making investment decisions without questioning their judgment (Zahera & Bansal, 2018). Instead of depending on independent analysis, these people are more likely to follow the decisions made by the bulk of market players (Ahmed et al., 2022; Kartini & Nadha, 2021)

Anchoring Bias: When investors prioritize arbitrary or psychologically significant reference points, they are engaging in anchoring bias and making essentially irrational financial judgments (Kartini & Nadha, 2021; Pompian, 2006; Ranjit Singh, 2019; Zahera & Bansal, 2018)

Cognitive Dissonance Bias: The mental stress people feel when presented with information that contradicts their preconceived notions is known as cognitive dissonance bias. Investors frequently disregard new information that contradicts their existing opinions to ease this discomfort (Pompian, 2006; Olsen, 2008).

Regret Aversion Bias: Regret aversion bias occurs when people focus too much on the possible regret that could result from their choices (Bhatt & Chauhan, 2014). This bias results from a strong reluctance to own up to one's faults, which drives decisions that aim to prevent regret (Pompian, 2006; Zahera & Bansal, 2018).

Mental Accounting Bias: Investors' propensity to handle various amounts of money differently depending on how they mentally classify them is known as mental accounting bias (Bhatt & Chauhan, 2014; Khan, 2020; Pompian, 2006; Ritter, 2003b; Zahera & Bansal, 2018).

Hindsight Bias: Hindsight bias causes investors to make poor decisions because they think they could have forecast the investment's outcome before it happened (Bhatt & Chauhan, 2014).

Additionally, they could misunderstand previous rulings and assert that they "knew it all along," even though the results were unclear at the time (Zahera & Bansal, 2018).

Availability Bias: Availability bias occurs when investors base their choices on the information which are available, frequently ignoring more complicated or difficult-to-access data (Pompian, 2006; Bhatt and Chauhan, 2014).

Conservatism Bias: Conservatism bias is the tendency of investors to largely depend on historical data and partially react when presented with fresh information (Bhatt & Chauhan, 2014; Pompian, 2006; Ritter, 2003; Zahera & Bansal, 2018).

Disposition Effect: The disposition effect is caused by investors' risk aversion, which causes them to hold onto loss-making investments in the hopes of a future comeback while selling profitable stocks too soon (Khan, 2020; Ahmed et al., 2022).

Loss Aversion Bias: Loss aversion bias, which has its roots in prospect theory, is an investor's propensity to fear loss more than comparable profits (Kahneman & Tversky, 1979). Because of this bias, they frequently make choices that are more concerned with preventing losses than with increasing possible gains (Kartini and Nadha, 2021).

Optimism Bias: Optimism bias has emerged from overconfidence bias, where investors are hopeful that their future performance will consistently outperform their expectations (Kartini and Nadha, 2021).

Confirmation Bias: Investors with confirmation bias ignore the facts that contradict their existing knowledge while taking into account information that confirms it. Their assumptions are strengthened by confirmation bias, which causes them to base decisions on inaccurate or biased information (Pompian, 2006; Bashir et al., 2013).

Framing Effect: The framing effect explains how different people react differently to the same information depending on how it is framed or presented (Kartini and Nadha, 2021).

House Money Effect: Investors tend to take higher risks after achieving a prior gain. The feeling of “free money” from a prior successful investment prompts investors to take more risks in the subsequent investments (Hsu & Chow, 2013; Zahera & Bansal, 2018).

Endowment Effect: Investors with the endowment effect tend to overvalue their possessed assets; investors overvalue those assets because they own them (Zahera & Bansal, 2018).

Self-Attribution Bias: It is the propensity of investors to consider their own abilities as the root cause of a successful investment (Naveed et al., 2021). On the other hand, failures from an investment are attributed to external factors. With this bias, investors take credit for their successful investments and blame others for any kind of loss or failure (Pompian, 2006; Zahera & Bansal, 2018).

Recency Bias: Investors with recency bias have the propensity to focus more on recent information rather than considering the past. It leads to a skewed decision making as investment decisions are taken based on the latest developments and events while ignoring the significant information that belongs to the past (Pompian, 2006; Zahera & Bansal, 2018).

Home Bias: Investors having a sense of cultural familiarity often consider making investments in the stock of a company that belongs to their own country, which is known to have home bias. The presence of this bias is underpinned by the comfort feeling of investing in their own country’s company whose operations and management align with their cultural norms (Ranjit Singh, 2019).

Findings

Theories under traditional finance attempt to explain the mechanisms of investment based on several key assumptions, such as investors' rationality, available market information, risk aversion characteristics, etc. However, these theories failed to explain the occurrence of market anomalies as well as the causes of irrational investment decisions. This gap marked the beginning of a new wing of finance, known as behavioural finance, which bridges the gap between two extreme points of rationality in investment decisions. Behavioural finance combines psychology with financial investment decisions and explains that investors are not completely rational; they are influenced by various psychological biases that influence their investment decisions. Such influence is not only limited to individual returns, but it has its wide impact on the financial market on a macro level. The origin of behavioural finance came as a response to the critical analysis of traditional finance theories. When the theories and assumptions of traditional finance fail to explain the unexpected variations in market returns, behavioural finance tries to explain them with the support of human psychology in combination with finance and economic theories. The concept of pure rationality was being wiped out by behavioural finance theories way back in 1759 with Adam Smith's "Theory of Moral Sentiments". Following which research across the globe on investors' investment decisions in the financial market has discovered a significant relationship between psychological biases and investment decisions. Further, many studies on identifying the category of psychological biases have confirmed the presence of cognitive biases among investors, which originate from flawed reasoning. These kinds of biases can be rectified with rational thinking and correct information. On the other hand, a set of biases is found under the emotional category of investors, where investment decisions are made based on intuition, rather than rational reasoning and logical thinking.

Conclusion

By the early twentieth century, the psychological dimension of human financial behaviour was largely overshadowed by classical and neoclassical economics. However, the existence of market volatility made it difficult to accept the notion that a stock's price accurately reflects the market information, as suggested by most finance theorists. This discrepancy raises two possibilities: either the foundational principles of finance regarding stock valuation are fundamentally flawed, or investors are not entirely rational. The critical analysis of the market points directly to the presence of irrational investment decisions, showing that not all market participants act rationally, and such irrational behaviour leads to volatility in stock prices. This realization has led researchers to turn to investor psychology to better understand the causes of these irrational behaviours. To answer this behavioural discrepancy, a new wing of finance, known as behavioural finance, has emerged, which studies the psychological factors influencing financial decision-making, challenges the assumption of perfect rationality posited by traditional finance theories. It explains that real investors are often guided by psychological biases, which in turn lead to suboptimal decisions. When these decisions occur on a large scale, they can result in market anomalies. Since these anomalies can have damaging effects on both individuals and the economy at a macro level, it is crucial to address them. The prevention of such anomalies requires increased awareness among practitioners of their own psychological and behavioural limitations. As such, a deeper understanding and exploration of this field are vital in the contemporary financial landscape.

Future implications

Future research in behavioural finance can move beyond identifying biases to developing quantitative frameworks and predictive models that integrate psychological variables with real-

time market data. With the advancement of artificial intelligence, machine learning, and neuro-finance, there is growing potential to empirically map how emotions and cognitive distortions influence trading patterns, volatility clustering, and market contagion during crises. Moreover, examining behavioural biases within digital investment platforms, algorithmic trading, and cryptocurrency markets can provide new insights into investor psychology in technology-driven environments. On the policy front, integrating behavioural insights into financial literacy programs, investor protection policies, and corporate governance practices could enhance market stability and informed decision-making. Such future-oriented investigations would not only extend the theoretical boundaries of behavioural finance but also translate its findings into practical interventions that foster more resilient and transparent financial systems.

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