Behavioral Bias in Investment Decision Making: A Behavioral Finance Perspective

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ABSTRACT

This study discusses the role of behavioral bias in individual investment decision making from a behavioral finance perspective. Traditional finance theory assumes that investors behave rationally when making investment decisions. However, in reality, investors are often influenced by psychological and emotional factors that lead to irrational behavior. Various behavioral biases such as overconfidence bias, herd behavior, loss aversion, anchoring bias, and confirmation bias can affect how investors process information and make investment decisions. This study uses a literature review approach by analyzing previous studies related to behavioral finance and investor behavior. The findings show that behavioral biases significantly influence investor decisions. Understanding behavioral bias is important for helping investors make wiser and more rational investment decisions. This study contributes to the behavioral finance literature by providing a conceptual understanding of the psychological factors underlying investor behavior.

Keywords: *Behavioral Bias, Investment Decision Making, Behavioral Finance, Investor Behavior, Cognitive Bias.*

1. INTRODUCTION

Investment decision making is an important activity for investors in achieving financial goals (Beatrice et al., 2021). Traditional financial theories assume that investors behave rationally and make decisions based on complete information (Fama, 1970). However, in reality, investors are often influenced by psychological and emotional factors that lead to irrational behavior (Beatrice et al., 2021). Behavioral finance emerged as an alternative perspective to explain how psychological factors influence investor behavior (Pompian, 2011). This approach explains that investors are often affected by behavioral biases in interpreting information and responding to market conditions. Behavioral bias refers to systematic deviations from rational judgment that can influence investment decisions. Several behavioral biases commonly influence investors, such as overconfidence bias, herd behavior, loss aversion, anchoring bias, and confirmation bias. These biases can affect how investors assess risk, process information, and make investment decisions (Pompian, 2011). Previous studies have shown that behavioral bias plays an important role in investor decision making. Therefore, understanding behavioral bias is important to help investors make more rational and effective investment decisions. This study uses a literature review approach to analyze previous studies related to behavioral bias and investment decision making.

2. RESEARCH METHOD

This study uses a literature review approach by analyzing various previous studies related to behavioral bias and investment decision making. The data used in this study were obtained from journals, articles, books, and previous research discussing behavioral finance and investor behavior. The analysis was conducted by identifying several major behavioral biases commonly found in investment decision making, such as overconfidence bias, herd behavior, loss aversion, anchoring bias, and confirmation bias. The findings from previous studies were then analyzed and integrated to provide a conceptual understanding of how behavioral biases influence investor decision making . This study aims to provide a broader understanding of the psychological factors underlying investor behavior in the investment decision making process.

3. RESULT AND DISCUSSION

Behavioral bias plays an important role in influencing investor decision making. Investors are often influenced by psychological and emotional factors that cause them to make irrational decisions in financial markets (Ahmed et al., 2022). Several behavioral biases commonly found in investment activities include overconfidence bias, herd behavior, los aversion, anchoring bias, and confirmation bias.

Table 1. Previous Articles

Author(s)	Brief Description	Behavioral Bias Perspective	Investment Decision Perspective	Implication
Kahneman & Tversky (1979)	Prospect Theory explaining decision making under risk and uncertainty.	Investors tend to avoid losses more strongly than they pursue gains (loss aversion).	Investors may hold losing stocks too long and sell profitable stocks too early.	Explains irrational investor behavior in financial markets.
Barber & Odean (2001)	Study on investor trading behavior and overconfidence.	Overconfidence causes investors to overestimate their investment abilities.	Investors tend to trade excessively and underestimate risks.	Excessive trading may reduce investment returns.
Banerjee (1992)	Study on herd behavior in financial markets.	Investors tend to follow the actions of others without independent analysis.	Investment decisions are influenced by market trends and crowd behavior.	Herd behavior can create market bubbles and panic selling.
Tversky & Kahneman (1974)	Study on heuristics and cognitive bias in decision making.	Anchoring bias influences how investors interpret information.	Investors rely too heavily on initial information or past prices.	Investors may misjudge investment value and market conditions.
Nickerson (1998)	Study on confirmation bias in human decision making.	Investors seek information that supports existing beliefs.	Investors ignore contradictory information in investment analysis.	Confirmation bias can lead to poor and biased investment decisions.

3.1. Overconfidence Bias

Overconfidence bias occurs when investors overestimate their knowledge, abilities, and accuracy in predicting market movements (Pompian, 2011). Investors with high confidence tend to trade excessively and underestimate investment risks (Ahmad & Shah, 2022). This behavior can lead to poor investment decisions and financial losses because investors believe that their judgments are always correct.

3.2. Herd Behavior

Herd behavior refers to the tendency of investors to follow the actions of other investors without conducting sufficient analysis (Devenow & Welch, 1996). Investors often buy or sell assets simply because many others are doing the same thing (Javed et al., 2017). This behavior is commonly found during periods of market uncertainty and can contribute to market bubbles and panic selling.

3.3. Loss Aversion

Loss aversion explains that investors tend to feel losses more strongly than gains of the same value (Pompian, 2011). As a result, investors often avoid realizing losses and hold declining investments for too long. This behavior can prevent investors from making rational investment decisions and managing their portfolios effectively.

3.4. Anchoring Bias

Anchoring bias occurs when investors rely too heavily on initial information when making decisions (Pompian, 2011). Investors often use previous stock prices or initial information as reference points even when market conditions have changed. This bias can influence how investors evaluate investment opportunities and risks (Murhadi, 2025).

3.5. Confirmation Bias

Confirmation bias refers to the tendency of investors to seek information that supports their existing beliefs while ignoring contradictory information (Pompian, 2011). Investors may focus only on positive news related to their investments and disregard negative information. This behavior can lead to biased judgments and poor investment decisions.

4. CONCLUSION

Behavioral bias has become an important topic in understanding investor decision making within the field of behavioral finance. Traditional financial theories generally assume that investors behave rationally and always make decisions based on complete information and logical analysis. However, in reality, investors are often influenced by psychological and emotional factors that lead to irrational investment behavior. As a result, investment decisions are not always objective and may be influenced by cognitive limitations and emotional reactions.

This study identifies several behavioral biases that commonly influence investor behavior, including overconfidence bias, herd behavior, loss aversion, anchoring bias, and confirmation bias. Overconfidence bias causes investors to overestimate their abilities in predicting market conditions, while herd behavior encourages investors to follow the actions of others without conducting sufficient analysis. Loss aversion explains that investors tend to fear losses more strongly than they value gains, causing them to make less rational decisions. In addition, anchoring bias and confirmation bias also influence how investors process and interpret investment information.

Through a literature review approach, this study demonstrates that behavioral bias significantly affects how investors evaluate risk, respond to market information, and make investment decisions (Banerjee, 1992; Barber & Odean, 2001; Kahneman & Tversky, 1979; Nickerson, 1998; Tversky & Kahneman, 1974). Behavioral finance provides a broader perspective in explaining investor behavior compared to traditional finance theories because it considers psychological and emotional aspects in the decision making process.

Overall, understanding behavioral bias is important for investors in order to improve awareness of the psychological factors influencing their decisions. By understanding these biases, investors are expected to make more rational, objective, and effective investment decisions. This study also contributes to the development of behavioral finance literature by providing a conceptual understanding of the relationship between behavioral bias and investment decision making. Future studies are expected to further explore behavioral bias in different investment environments and among various types of investors.

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