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Behavioural Finance and the Psychology of Investment: How Cognitive Biases Influence Retail Investor Decisions

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ABSTRACT: This study explores how behavioural finance explains the influence of cognitive biases on retail investor decision-making. Traditional finance assumes rational behaviour, yet evidence shows that investors are often guided by emotions and psychological tendencies. Key biases such as overconfidence, loss aversion, herd behaviour, confirmation bias, and mental accounting significantly affect trading patterns, portfolio diversification, and long-term wealth creation. The research, based on secondary data, highlights how these biases lead to excessive trading, poor risk management, and underperformance. Findings emphasise the importance of financial literacy and awareness to mitigate irrational behaviour and promote more sustainable investment outcomes.

KEYWORDS: Behavioural Finance, Cognitive Biases, Retail Investors

I. INTRODUCTION

Traditional financial theories, such as the Efficient Market Hypothesis, assume that investors make rational decisions based on all available information. In reality, retail investors often behave irrationally, influenced by psychological factors, emotions, and cognitive shortcuts (Gabhane et al., 2023). This divergence has given rise to the field of behavioural finance, which explains how biases shape investment decisions and market outcomes.

The role of retail investors in financial markets has grown significantly in recent years. In India, retail investors contributed around 52% of equity trading volumes in 2023, compared to 42% in 2019, reflecting a surge in participation through digital trading platforms (Joseph, 2024). Similarly, in the United States, retail investors accounted for nearly 23% of equity trading activity in 2022, a sharp rise from just 10–15% a decade earlier. The COVID-19 pandemic accelerated this trend globally, as millions of individuals entered stock markets, motivated by low-cost trading apps and higher risk appetite (Bihari et al., 2025).

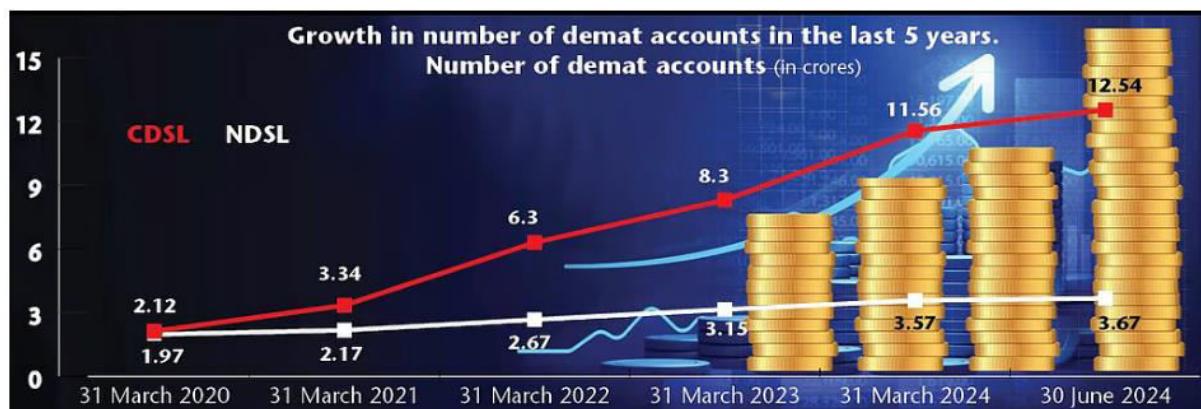


Figure: Growth in Demat Account

Source: (Joseph, 2024)

Despite this growth, research shows that retail investors consistently underperform institutional investors. The poor performance has been associated with behavioural biases like overconfidence, herd behaviour, and loss aversion (Padmavathy, 2024). It is important to understand these biases as a way of explaining why retail investors make less than optimal decisions and why such choices affect their long-term financial performance.

II. RATIONALE AND OBJECTIVE

Rationale

Retail investors are significantly more active in modern-day markets, but the choices made by these investors are highly influenced by factors that are psychological in nature, rather than based on an objective assessment. As trading becomes more universally available via online platforms, investors are more susceptible to these biases that result in erratic decisions, excessive buying and selling, and poor results (Yasmin and Ferdaous, 2023). This paper can thus shed light on why most retail investors do not obtain optimal returns by analysing the impact of cognitive biases on retail investor behaviour. Awareness of these dynamics is essential to raising the level of financial literacy, investment strategy, and policies that enable more informed and rational decision-making.

Objectives

The purpose of this paper is examining the interconnection between behavioural finance and the decision-making process of retail investors, with emphasis on cognitive biases. The most important goals are:

1. To determine the retail investors most prevalent cognitive biases, including overconfidence, herd behaviour, and loss aversion.
2. To assess how significant such biases are on portfolio choices, the frequency of trading and the consequences of investment performance.
3. To make actionable suggestions to retail-level investors or financial advisors, and policymakers about the changes needed so that these biases do not cause so much pain to the investors.

III. METHODOLOGY

This study is founded on secondary data collection whereby it uses the type of information that has been already published in books, journals, articles and industry reports. The secondary data would be suitable in this study since behavioural finance and investor psychology are broad topics and the amount of reliable data on those already exists. The study can be carried out through secondary research by using the existing research literature and statistical data to outline the tendencies in the behaviour of retail investors without conducting primary research.

The data will be obtained through academic research, published surveys, financial market studies and the knowledge documented case studies. This guarantees that the information taken in account has already been proven and tested in varying situations. Secondary data can be used to cover the widest range since they encompass findings in different regions and over the periods of time.

This study shall employ the qualitative and descriptive approach, examining the way the investment decisions and financial effects are affected by cognitive biases. Quantitative evidence reported in earlier studies will be used to support the discussion where relevant. By combining theoretical concepts with documented findings, the methodology ensures a comprehensive understanding of the role of behavioural factors in shaping retail investor decisions.

IV. LITERATURE REVIEW

Theme 1: Evolution of Behavioural Finance and Departure from Rational Models

Traditional finance theories, such as the Efficient Market Hypothesis (EMH) and Rational Choice Theory, are built on the assumption that investors act logically and consistently in their pursuit of wealth maximisation (Suresh, 2024). According to these models, markets are efficient, prices fully reflect all available information, and investors make choices purely on the basis of rational evaluation of risks and returns. While these frameworks have provided valuable insights into market functioning, they often ignore the emotional, psychological, and social dimensions of human behaviour (Ogunlusi and Obademi, 2021).

Over time, the limitations of these rational models became increasingly visible. Market anomalies such as bubbles, crashes, and herd-driven rallies revealed that investors do not always behave in a manner consistent with rationality. For instance, the global financial crisis of 2008 erased nearly \$8 trillion in U.S. household wealth, much of it due to panic selling and herd-driven withdrawals (Brooks, 2009).

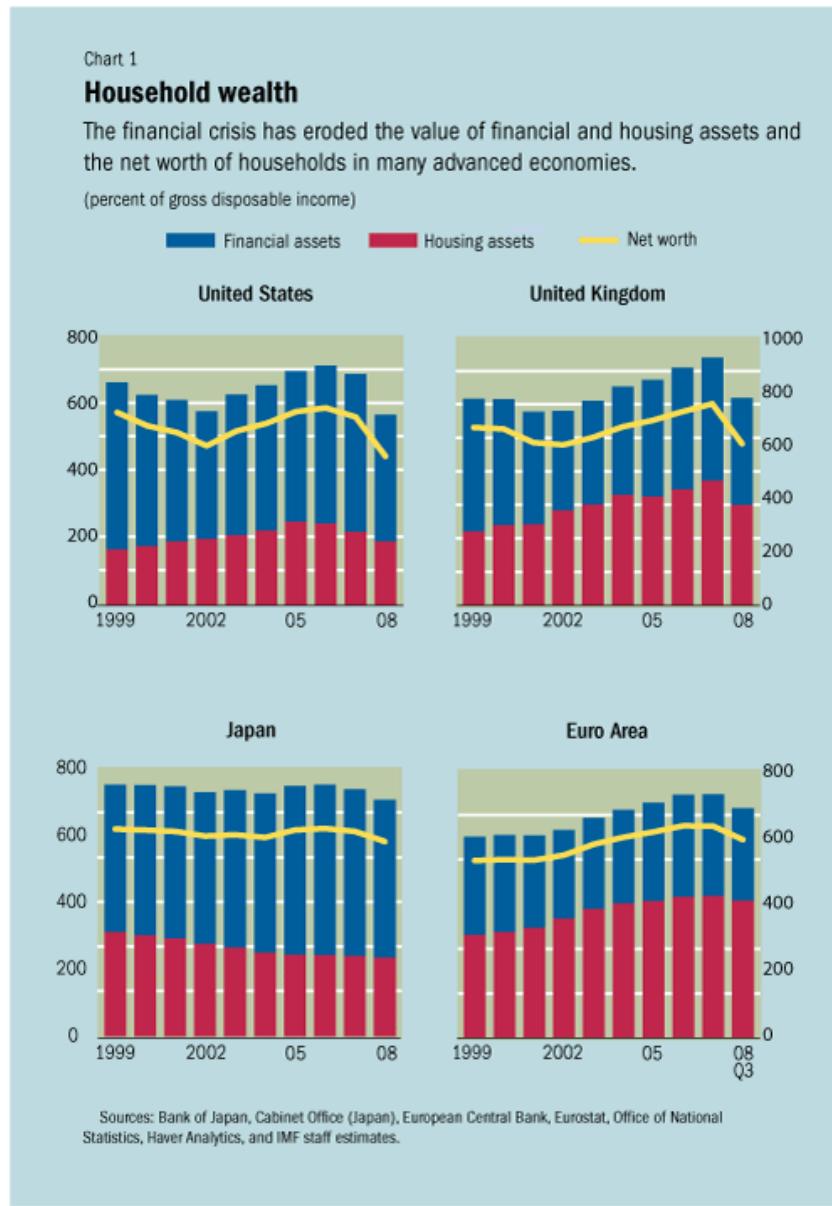


Figure: Household Wealth
Source: (Brooks, 2009)

Similarly, during the COVID-19 pandemic, retail trading volumes surged worldwide, with India witnessing retail participation rise to 52% of equity trading in 2023, up from 42% in 2019 (Joseph, 2024). These shifts showed that retail investors often trade on speculation, rumours, or emotional impulses rather than on careful analysis. Many individuals buy during market highs driven by optimism and fear of missing out, and sell during downturns due to panic, even when fundamentals remain strong (Mohanty et al., 2024). Such repeated deviations from rational behaviour highlighted the need for a framework that could explain the psychological drivers of financial decision-making.

Behavioural finance emerged as a response to these gaps, integrating insights from psychology with financial theory. It recognises that biases, heuristics, and emotions strongly influence investment choices, shaping how investors perceive risk, react to uncertainty, and evaluate outcomes. Rather than treating investors as perfectly rational agents, behavioural finance portrays them as human decision-makers influenced by overconfidence, loss aversion, optimism, and social pressures (Ayaa et al., 2022). This perspective offers a more realistic explanation of why markets sometimes deviate from efficiency and why retail investors frequently underperform despite access to the same information as professionals. By acknowledging these psychological influences, behavioural finance provides a richer understanding of real-world financial behaviour.

Theme 2: Overconfidence and Excessive Trading

Overconfidence is one of the most significant behavioural biases influencing retail investors. It occurs when individuals overestimate their financial knowledge, analytical skills, or ability to predict market movements (Ayaa et al., 2022). Many retail investors believe they possess unique insights or superior judgement, which often leads them to ignore risks and undervalue the role of chance in investment outcomes. This inflated self-belief encourages decisions that deviate from disciplined, long-term strategies.

A major outcome of overconfidence is excessive trading. Retail investors frequently buy and sell securities in the hope of capturing short-term gains, assuming that active participation will increase returns. However, evidence repeatedly shows that higher trading volumes are usually associated with weaker performance. A study of U.S. investors found that the most active traders underperformed the market by an average of 6.5% annually, largely due to trading costs and poor timing (Fajasy, 2023). Similarly, in India, retail investors accounted for over 75% of daily equity trades in 2022, yet surveys revealed that more than half reported below-market returns. Transaction costs, brokerage fees, and timing errors reduce profits, while the constant search for opportunities often leads to chasing trends rather than building stable portfolios. Investors convinced of their skills may trade impulsively, overlooking diversification and risk management.

Overconfidence also reinforces the widespread assumption that individuals can consistently “beat the market.” While institutional investors rely on advanced research, algorithms, and professional expertise, retail investors often lack these resources yet still expect to outperform (Talwar et al., 2021). This misplaced confidence leads to concentrated investments, speculative trades, and frequent reactions to short-term news. Instead of achieving superior returns, many retail investors underperform market benchmarks and passive index funds.

Ultimately, overconfidence distorts judgment and encourages riskier behaviour than intended. Retail investors, believing strongly in their predictive abilities, may undermine their financial objectives by engaging in patterns of frequent, poorly timed trading (Almansour et al., 2023). Recognising the impact of this bias is essential, as it highlights the importance of financial education, self-awareness, and disciplined strategies designed to reduce the destructive effects of overconfidence on long-term investment outcomes.

Theme 3: Loss Aversion and Prospect Theory

Loss aversion, a central idea in behavioural finance, explains why investors fear losses more intensely than they value equivalent gains. In simple terms, the emotional impact of losing money is stronger than the satisfaction of making the same amount (Syarkani and Alghifari, 2022). For example, the pain of losing ₹10,000 outweighs the pleasure of gaining ₹10,000, even though the amounts are identical. Studies show that losses are felt about twice as strongly as equivalent gains, highlighting the powerful psychological imbalance that drives financial decisions. This causes retail investors to act defensively, often avoiding risks that could yield long-term benefits or clinging to poor investments in the hope of recovery.

A key outcome of loss aversion is the disposition effect, where investors hold on to losing stocks longer than rational analysis would suggest. Research indicates that investors are 50% more likely to sell winning stocks than losing ones, preferring to “lock in” small gains while avoiding the pain of realising losses (Dhungana et al., 2022). Rather than selling a declining asset and reallocating funds to more promising opportunities, many retail investors delay decisions, unwilling to accept a loss on paper. This behaviour is emotionally driven, as selling a losing stock converts a

“temporary setback” into a permanent loss, something investors are psychologically resistant to acknowledge. Unfortunately, this tendency often results in larger losses over time, as poorly performing assets continue to decline. Loss aversion also affects portfolio risk-taking and long-term wealth creation. Surveys show that nearly 60% of retail investors avoid equity investments altogether because of perceived risk, despite equities historically offering higher long-term returns (Challa, 2024). Conversely, some may take excessive risks to recover earlier losses, attempting to “break even” rather than making rational, forward-looking decisions. Both extremes hinder wealth accumulation. By avoiding calculated risks, investors miss growth opportunities; by chasing recovery, they expose themselves to greater volatility and deeper losses.

All in all, loss aversion reveals how emotions prevail over rationalizing in financial decisions. It not only informs short-term trading decisions, but also has long-term implications on portfolio performance and wealth-building, and thus the importance of being aware and maintaining disciplined portfolio strategies (Bihari et al., 2022).

Theme 4: Herd Behaviour and Social Influence

Another particularly strong bias that influences retail investor choice is herd behaviour. It happens when people follow what the majority of people are doing instead of making use of their analysis. This trend is particularly pronounced with market bubbles or/and market crashes, when panic and euphoria intensify the crowd behaviour (Gabhane et al., 2023). To give examples, in times of market highs, investors may end up purchasing highly priced stocks due to the movement of others to purchase, and in times there are market highs, investors will sell pushing stocks to even lower prices due to the panic. Research indicates that close to 70 percent of retail investors confess to moving along with market trends as opposed to making independent decisions of their own, which compounds volatility and predicates market cycles that defy rational approaches to investment (Baig et al., 2022).

The rise of social media and digital trading platforms has intensified herd mentality. Online forums, financial influencers, and instant news updates expose retail investors to a constant flow of opinions and predictions. A 2021 Deloitte survey found that over 55% of Gen Z and millennial investors rely on social media for investment ideas, while 43% make trading decisions based on peer discussions (Ahuja and Grover, 2023). The availability of commission-free trading apps makes it easier for investors to act quickly on collective sentiment, often without assessing the risks involved. As a result, short-term hype frequently overrides long-term investment discipline.

Recent examples highlight the scale of retail-driven surges. During the COVID-19 pandemic, over 10 million new brokerage accounts were opened in the U.S. in 2020 alone, with trading volumes dominated by retail participation (Deloitte, 2025). Stocks like GameStop and AMC witnessed price spikes of over 1,500% within weeks, driven almost entirely by coordinated activity on platforms such as Reddit’s WallStreetBets (Simpson, 2023). Similar trends were observed in India, where retail trading activity rose by nearly 45% in 2020–21, pushing certain mid-cap and penny stocks to unsustainable levels before sharp corrections followed.

Herd behaviour demonstrates how social influence can overwhelm rational judgment, leading to exaggerated market movements. While it offers opportunities for quick gains, it often exposes retail investors to significant risks and losses, underscoring the need for independent decision-making and financial literacy (Bihari et al., 2025).

Theme 5: Confirmation Bias and Mental Accounting

Confirmation bias is a well-known psychological social tendency to get rid of or reject information that contradicts their beliefs. Retail investors tend to get emotionally involved in a certain stock, industry, or certain strategies and will disregard new information that fails to corroborate their beliefs (Padmavathy, 2024). Consider an example where an investor is optimistic about the growth outlook of a company and may over rate positive news and ignore the caution about a lack of financial stability. Survey data indicate that more than one in two retail investors say that they follow news sources that support their opinion, whereas less than one in four at all actively seeks out opposing information (Reichenbach and Walther, 2024). Such selective attention causes illusion and they develop poor judgment and tardy response to market changes.

Mental accounting is also instrumental in retail investment behaviour alongside the confirmation bias. This notion refers to the illogical practice to be able to attribute money to different accounts basing on the origin or purpose,

though money is interchangeable. Indeed, the analysis shows that about half of the investors also consider windfall gains (e.g., bonuses, lottery wins) as their risk capital when they are extremely conservative about regular salaries and savings (Yasmin and Ferdaous, 2023). Investors can feel free to spend bonuses, gifts or other windfall earnings on more riskier investments than be too conservative with their pay or savings. Likewise, they can classify investments into inflexible mental containers, so they cannot make flexible reallocation to enhance portfolio returns.

The two biases have profound implications on the diversification of investment and management of risk. Surveys show that 40 percent of retail investors have a high balance of a limited number of well-known stocks, partially because of confirmation bias and cognitive representations that recognize the mental accounting defect. In the long-term, such behaviours jeopardise an effective portfolio construction and contributors to the risk that investors should not be exposed to (Suresh, 2024).

Combined, mental accounting and confirmation bias show the effect of psychological shortcuts on financial decisions. Instead of rationally analysing opportunities, investors rely on selective reasoning and artificial distinctions, often leading to missed opportunities and reduced wealth. Addressing these biases is crucial for promoting diversification, improving risk management, and achieving sustainable financial outcomes (Ogunlusi and Obademi, 2021).

Synthesis and Gap

The literature highlights how cognitive biases such as overconfidence, loss aversion, herd behaviour, confirmation bias, and mental accounting strongly influence retail investor decisions, often leading to excessive trading, poor diversification, and long-term underperformance. While existing studies provide valuable insights, most focus on isolated biases or specific market events, limiting a holistic understanding of their combined impact on retail investors. Moreover, much research emphasises developed markets, with fewer studies addressing emerging economies where retail participation is rapidly growing. This gap justifies further study to explore these behavioural patterns in broader contexts, offering strategies to improve financial decision-making and investor outcomes.

V. CONCLUSION

Behavioural finance provides a powerful lens to understand why retail investors often deviate from the rational assumptions of traditional financial theories. The review of key behavioural patterns highlights how psychological biases such as overconfidence, loss aversion, herd mentality, confirmation bias, and mental accounting shape financial decisions in ways that can undermine long-term performance. Instead of relying solely on data and analysis, investors frequently allow emotions, selective reasoning, and social influence to dictate their choices.

The consequences of these biases are evident in excessive trading, reluctance to accept losses, concentration of investments, and susceptibility to market fads. These behaviours do not only cause individual underperformance but also market volatility. Although behavioural finance has come a long way toward explaining such patterns, there are gaps to be filled in terms of how various biases affect different markets and cultural contexts.

The results underline the importance of increasing financial literacy, more disciplined investment choices, and insightfulness of psychological human behaviour among individual investors. Understanding these behavioural pitfalls can help individuals to minimise it and make better decisions. The end result of working to mitigate these biases is that investors will have more stable financial performance and overall improved healthier and more resilient financial markets.

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