

A Study On The Contrasting Theories Of Investment Behaviour

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Abstract

The primary tenet of standard finance is that investors are logical and weigh all available information when making portfolio investment decisions. This is supported by the Efficient Market Hypothesis, a key theory of standard finance. Psychologists have questioned this premise over time, claiming that investors are not rational beings since cognitive and psychological flaws affect their decisions. Behavioural finance is a new area of financial economics that emerged as a result of the efforts made in this direction by some well-known psychologists. The study of behavioural finance takes into account how different psychological characteristics influence the choices that investors make. In light of this, the current research presents a thorough and unique analysis of hypotheses pertaining to investment behaviour, both in support of and opposition to long-held beliefs. Based on the literature study, it can be inferred that the goal of behavioural finance is to close the gap between predicted and actual behaviour. It is impossible to view behavioural finance as a distinct field; rather, it is a component of conventional finance. Compared to the Efficient Market Hypothesis, the adaptive market hypothesis provides a more thorough explanation of market behaviour.

Introduction

The study of stock market behaviour has undergone a paradigm shift in recent years, moving from the study of the "financial environment" to the study of the "agents of this environment." As a result, a new area of financial research called "behavioural finance" has emerged. The majority of financial research studies conducted up until the 1970s focused on the environment and how it worked. A variety of markets, such as bond, forex markets, stock, commodities, OTC (over-the-counter), real estate, cash or spot, and commodity markets, are part of the financial environment. (Khan, 2011) Following this stage, academics came to the conclusion that, in order to comprehend the environment as a whole, one must first comprehend the psychology of the environment's agents, or humans, since they are the only entities that exist in the financial environment. These environmental agents, which include fund managers, analysts, individual investors, brokerage houses, and the government, are recognized as new subjects of study. The idea that a small number of people cannot be considered to be representative of the entire population since humans are the most diverse species in the universe was another significant factor in the acceptance of individual agents as the study's subject matter, as opposed to a collection of agents (i.e., the market). (Durri, 2018) All of this led to the realization that environmental elements, or agents, are more significant when examining the financial system as a whole, and a new field of research known as behavioural finance resulted. Before the 1970s, financial scholars concentrated on explaining the rationale behind investors' decision-making processes and, consequently, how investors ought to think about these things. The environment itself was the subject of the study since it was believed to be important enough for changes in it to be evident. Generally speaking, this study era can be split into two

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stages. (Mohit Fogaat S. S., 2022) In the initial phase, which ended in 1952, classical finance theory dominated the market. This theory assumed that investors were well-informed, cautious, and unaffected by their feelings and that they had no trouble making financial decisions. The models in the conventional finance paradigm make the assumption that, when making decisions about portfolio investments, investors behave predictably and rationally in light of all the information at their disposal. (Birau, 2014) The conventional theory of finance also makes the assumption that all available information about a security is reflected in its present price and that security prices respond quickly to the introduction of fresh information in an efficient capital market. But one of the most contentious debates in finance studies these days is whether or not capital markets are efficient. (Bloomfield, 2014) Later, in the second phase of neoclassical finance, which took place in the 1960s and 1970s, the Capital Asset Pricing Model (CAPM), the Efficient Market Hypothesis (EMH), and the theory of arbitrage-based option pricing emerged as its main draws. (Brabazon, 2000) In order to detect portfolio anomalies of Traditional finance theory, the current study examines the body of literature already in existence on the many theories of investment behaviour. The goal is to develop a cohesive theory of behavioural finance.

Objectives of the Study

The following are the objectives the study attempts to achieve:

1. To provide a comprehensive literature review on theories of investment behaviour.
2. To debate in favour as well as against the long-held belief of different theories of investment behaviour.
3. To find a unified theory of behavioural finance that can be used to recognize traditional finance theory's anomalies in portfolios.

Review of Literature

The random walk hypothesis, which maintained that fluctuations in stock prices happened at random, served as the foundation for the majority of the earlier studies on efficient markets. This early academic work was heavily analytic but lacked a strong theoretical foundation. In this regard, an attempt was made to systematize the growing body of empirical evidence and formulate the theory. According to an academician, who introduced the efficient market theory using a fair game model, investors may be sure that the current market price accurately reflects all available security information and that the price that is expected to be paid based on this price is commensurate with the risk involved. (Fama, 1970) He goes one step further and says that a trading strategy based on available data could not possibly consistently produce excess returns. All of the main stock markets saw a significant decline as a result of the previous South Asian crises and the current sub-prime crisis. Although most stock markets had a negative reaction to these crises, these reactions are not particularly unusual. Nevertheless, despite the widespread belief that markets are efficient, what was noteworthy were the sharp swings in the stock market. How could there be such sharp variations? This question can only be partially explained by fundamentals. Another force has sufficient penetration to completely upend the financial industry. In this regard, a review of previous research by different researchers argued that the earnings revision that followed earnings shocks and led to the positive correlation of stock prices was the cause of the stock price drift (Belsky G. &, 2013) (Jureviciene, 2012). In a similar vein, an article (Belsky G. &, 1986) put forth a special trading rule for those hoping to profit from tax sales near year's end in order to record losses as falling stock values. The inclination is to either repurchase these equities or purchase other stocks that catch one's eye after the new year. (Kaneko H. , 2004) Stock prices are under pressure to decline at the end of the fiscal year and to rise at the start of the fiscal year under this scenario. Because arbitragers eliminate such seasonal patterns by buying at year-end and selling at year-beginning, they are incompatible with the Efficient Market Hypothesis (EMH).

The fundamental tenets of traditional finance theory were called into question in the 1980s, and it was discovered that investors rarely behaved in accordance with these presumptions. As a result, behavioural researchers concluded that, in the past 20 years, finance theory should take into account observed human behaviour in order to analyse changes in the financial markets and the influence of various human biases on the decision-making behaviours of the agents of this environment. (Chandra, 2008) As a result, behavioural finance—a new field of study in finance—was created. Its primary focus is on the psychology of financial decision-making. Researchers studying behavioral finance have recently developed a fascination with neuro-finance. (Dehnad, 2011) The topic of whether individuals are rational has been raised by the global stock market failures, the way economists are perceived, and the theories they adamantly adhere to. Or do moments of fear, confirmation bias, and greed influence them and cause them to make poor decisions? When investors are faced with uncertainty, patterns of irrationality, inconsistency, and incompetence are evident in their decision-making processes. Psychologists have therefore long since refuted the Efficient Market Hypothesis (EMH) that investors make impartial and rational decisions (Economo, 2010). This new paradigm originated from the theoretical and experimental work of two well-known psychologists, who made some outstanding contributions to the psychology literature. As a result, in the 1980s this new field of financial economics was added, and in the 1990s it was included in conventional finance theories. According to (Fagerstrom, 2008), the foundation of behavioural finance is the idea of bounded rationality. It refers to rational decision-making that considers the decision-makers cognitive constraints as well as knowledge and computational capability restrictions. Because of this, people are limited rather than fully rational organisms. Their limits in making rational decisions stem from aspects of their basic nature, such as emotions, limited brain ability, limited information, etc. (Gustavo, 2010) These constraints serve as barriers to rational thought. Restricted The main focus of behavioural approaches to economics, which are highly interested in how actual decision-making processes affect final outcomes, is rationality. Such inconsistencies in traditional finance that are not explicable by traditional financial theories are typically explained by behavioural finance. (Hassan, 2013) The study of behavioural finance takes into account how different psychological characteristics influence how people or groups behave as analysts, investors, and portfolio managers. Conventional finance views investors as rational, but behavioural finance views them as normal. A rational person would use features but not value pricey ones, have perfect self-control, never be afraid of risk, and never be afraid of regret. They would also never be confused by cognitive errors. Ordinary folks don't heedlessly conform to that trend. In 'Towards a Positive Theory of customer Choice,' contended that human psychology and biases have no place in the conventional economic model of customer behavior, which is essentially a concept of Robert-like specialists making financial decisions (Huberman, 2001). Traditional finance academics observe that people who are emotionally and mistake-prone do not occupy financial environments. Financial behaviorists want to substitute a more accurate model of the financial actor for Homo Economicus (Kahneman, 2003). Since people ultimately determine market performance, it is impossible to always assume that they are rational when making decisions about their investments, particularly in difficult financial times. (Kaneko, 2004) Instead, one must examine how investors process information in order to determine their preferences and make decisions about their investments (Kannadhasan, 2006). It is proposed under behavioural finance that a number of financial events could be better understood if the premise of complete rationality were loosened. Different models then emerged as a result. While some models include cases where investors update their ideas rationally but make narratively dubious decisions, others assume that investors simply fail to update their beliefs immediately. In order to determine the full model of human behavior in the process of making investment decisions, behavioral finance essentially aims to supplement traditional finance theories by fusing them with human psychology (Kiyilar, 2009) As a result, traditional finance remains at the core of behavioural finance (Lin, 2011). Behavioural finance does not attempt to prove any of the traditional theories obsolete.

Therefore, it would be expensive to find the answer to the questions of where behavioral finance originated and what causes people to question the long-held belief in the rationality of traditional finance.

Efficient Market Hypothesis (EMH)

The notion known as the efficient market hypothesis holds that prices in the stock market accurately represent all available information. (Fama, 1970) Paul Samuelson and Eugene Fama came up with the concept on their own in the 1960s, and it soon spread throughout the financial industry and was incorporated into conventional financial education. (Gabriela, 2015) The efficient market hypothesis' central claim is that equities are already priced using all available information, making it difficult to continuously outperform the market. The semi-strong tenet states that stock prices are factored into all publicly available information, the strong tenet that all information is already integrated into the stock prices, and the weak premise that stock prices reflect all available information. Though it sounds fantastic, there are some drawbacks to this theory: The efficient market hypothesis first presupposes that every investor views every piece of information in exactly the same way. The EMH's validity is challenged by the various approaches to stock analysis and valuation. Second, the efficient market hypothesis states that no investment can ever be more profitable than another with the same amount of money invested. Thirdly, if all investors and funds put in their best efforts, they should never be able to outperform the market or the average yearly returns, according to the efficient market hypothesis. (Aniket, 2021) The efficient market theory, which is Controversial for several reasons, contends that an investor cannot continuously beat the market using any particular strategy. According to EMH, occasionally outperforming the market is possible with enough luck, but only if higher risk is taken. Stock is valued appropriately unless a future event modifies the valuation. As a result, there are no cheap stocks, making it redundant to forecast market trends by estimating a stock's intrinsic value based on both qualitative and quantitative characteristics. (Andrew, 2022) The primary point of contention with this theory is the 2008 stock market crash. According to EMH, the stocks of companies that had a 20% or greater loss in value in a single day accurately reflected those companies' worth. Contrary to the notions of the Efficient Market Hypothesis (EMH), investors such as Warren Buffett have regularly outperformed the market by identifying irrational pricing within the general market.

Capital Asset Pricing Model (CAPM)

In the financial sector, the capital asset pricing model (CAPM) is frequently employed, particularly for riskier investments. The market risk premium is included in the model's formula since it is predicated on the notion that investors should earn larger yields by making more high-risk investments. (David W. Mullins, 2002) An idealized representation of how financial markets value securities and, consequently, calculate expected returns on capital investments is provided by the capital asset pricing model (CAPM). The model offers a process for measuring risk and converting it into projected return on equity projections. The objective character of the anticipated costs of equity that the model may produce is one of CAPM's main advantages. Because CAPM inevitably simplifies the world of financial markets, it cannot be employed in isolation. (Cautero, 2023) To create practical and realistic cost of equity calculations, financial managers might utilize it in addition to their judgment and other methods. Even though there is still a lot of dispute surrounding its use, current financial theory is now routinely used in investment management. Additionally, corporate finance issues are increasingly being helped by the same methods. It promises to be just as passionate in reaction. The theory is embodied in the capital asset pricing model, or CAPM. The cost of equity capital for a business can be estimated using the Capital Asset Pricing Model (CAPM), a theoretical depiction of the behavior of financial markets. The model can be a helpful addition to the analytical toolkit of the financial management, notwithstanding its limitations.

Prospect Theory

This theory, which was created by Tversky and Kahneman, explains why people behave irregularly when they take on risk in the face of uncertainty. He talked about a number of mental states that can affect an investor's choice of course of action. The following are the main ideas he covered: **Aversion to Loss:** A key psychological idea is loss aversion, which holds that when investors experience losses, they become risk-takers; conversely, when they experience winnings, they become risk-averse. (Alistair, 2008) About twice as much psychological suffering results from losing something as gains in the same amount. For instance, if an investor is losing money, he will start taking more risks because he is aware that he would lose some of it. Conversely, when an investor is making money, on the other hand, he starts to become risk averse because he is making money and he won't take any risks in exchange. **Regret aversion** is a psychological error that results from placing an undue emphasis on regretting a failed decision. The primary reason for this kind of miscalculation is investors' aversion to owning up to their mistakes. For instance, investors frequently hesitate to sell companies that are losing money. They don't sell the stock because they believe that doing so would be an admission of poor investing judgment. **Bias in Mental Accounting:** Mental accounting is the inclination for individuals to divide their resources into various categories and give each category a distinct purpose. Their actions and behaviors are sometimes negatively impacted by this division and assignment, which is frequently illogical. (Androniki, 2012) Set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities is how described mental accounting. It alludes to the codes that individuals employ to assess investing choices. Mental accounting consists of three elements. The first part of mental accounting describes how decisions are further assessed and how the results are felt and experienced. Assigning activities to particular accounts is the second component. It considers the sources as well as the uses of financial resources. The frequency of account evaluations is the subject of the third component. Accounts can be reviewed on a daily, monthly, annual, and so forth basis (Monti, 2014).

People's views of gain and loss are skewed, according to prospect theory, often known as loss aversion theory. Investing behaviour is the focus of these theories rather than investing method. According to the hypothesis, most investors will favour an investment that appears to have a lower chance of loss even though it may result in smaller rewards. Overcoming the investor's emotional inclination to place an excessive amount of weight on unfavourable prospects will allow them to apply detached logical analysis to make bold decisions about their approach, ultimately resulting in the desired profits.

Behavioural Finance

The study of investor behaviour in the financial markets is known as behavioural finance. Psychological considerations have an impact on investors' behaviours. Below is a discussion of some of the most important definitions of behavioural finance. (Parikh, 2011) defines behavioural finance as the study of how psychology affects the behaviour of financial professionals and how that behaviour affects markets. Science studies hypotheses and research pertaining to the outcomes of investors' decisions that are based on feelings or intuition. According to (Pompian, 2006), behavioural finance is a quickly expanding field that examines how psychology affects the behaviour of financial professionals. Behavioural finance is better known as behavioural economics. This is because behavioural economics integrates the fields of psychology and economics to explain why and how people make decisions about their spending, investing, saving, and borrowing that appear to be illogical or irrational. Therefore, behavioural finance is a branch of finance that, as opposed to writing off stock market abnormalities as chance results consistent with the market efficiency hypothesis, suggests an explanation for them based on psychological biases that have been uncovered. (Reedman, 2014) Information structure and different features of market players are thought to impact individual investors and market results.

The alternative theory that underpins behavioural finance is that investors—or at least a sizable minority of them—are susceptible to behavioural biases that make it possible for their financial decisions to be less than totally rational. Usually, cognitive psychology literature has provided evidence of these biases, which are subsequently utilized in a financial setting. (Ritter, 2003) First, overconfidence and overoptimism: investors overestimate their skills and the veracity of the information they have. This is an example of a bias. Second, Representativeness: Rather of considering underlying probability, investors evaluate events based on their outward appearances. Thirdly, conservatism: in the face of fresh data, forecasters cling to preexisting assumptions. Fourth, availability bias occurs when investors overestimate the likelihood of occurrences they have recently witnessed or experienced because their memories are still vivid. Fifth, frame reliance and anchoring: how information is presented can have an impact on the choice that is made. Sixth: Mental accounting: people divide up their wealth into different mental categories while ignoring correlation and fungibility effects. (Hooshmand, 2013) Last but not least is regret aversion, which occurs when people make choices that would spare them from suffering emotionally in the case of a bad result. The usage of traditional utility functions, which are predicated on the notion of risk aversion, is likewise contested by behavioural finance. As an example, prospect theory is put forth by (Shefrin, 2001) as a descriptive explanation of decision-making in dangerous circumstances. Investors are loss-averse, acting risk-aversely in the face of gains and risk-seeking in the face of losses. Results are assessed in relation to a subjective reference point, such as the purchase price of a stock.

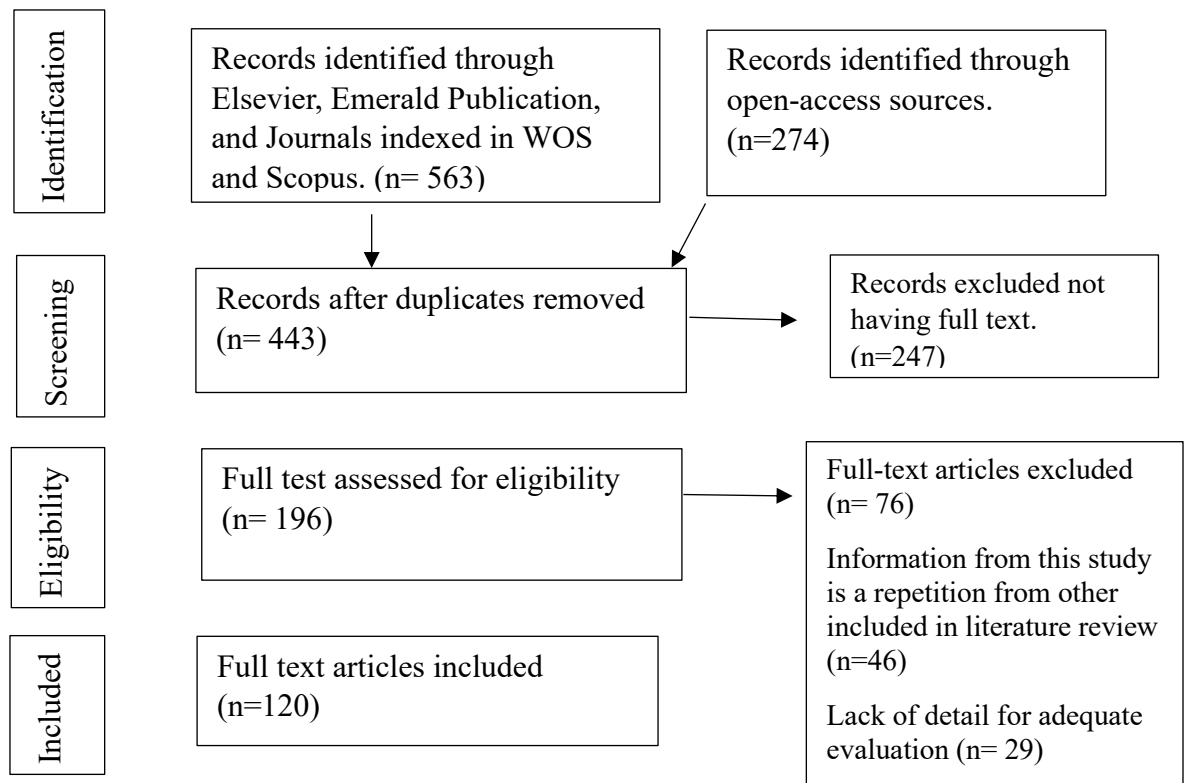
Adaptive Markets Hypothesis

The Adaptive Market Hypothesis (AMH) blends behavioural finance with the well-known and frequently contentious efficient market hypothesis (EMH). The creator of the hypothesis, Andrew Lo, thinks that although most of the time individuals are reasonable, they occasionally have a tendency to overreact when market volatility is high. According to AMH, people are driven by their own interests, prone to error, and able to grow from their mistakes. (Zhang, 2022) The AMH brings behavioural economics' claim that markets are irrational and inefficient into line with the EMH's theory, which holds that markets are rational and efficient. The EMH has dominated theory for a long time. According to the strongest interpretation of the Efficient Market Hypothesis (EMH), it is impossible to "beat the market" since stocks are always valued fairly, meaning that it is never viable to purchase cheap stocks or sell them for a premium. Later, behavioural finance evolved to refute this idea by highlighting the fact that equities did not always trade at their fair value during financial crises, crashes, and bubbles, and that investors were not always logical. These economists try to use psychological ideas to explain abnormalities in the stock market. The AMH takes into account both of these opposing viewpoints in order to explain market and investor behaviour. It applies the concepts of behaviour and evolution to financial transactions and argues that rationality and irrationality coexist. The foundational principles of the AMH are as follows: People are driven by their own self-interests, to start. They also inadvertently make mistakes, which they then learn from and adjust to. The AMH contends that while investors are not entirely rational, they are generally so. Instead of maximizing behaviour, they participate in satisficing behaviour. They also create heuristics for market behaviour based on a sort of market-based natural selection mechanism (profit and loss). (Ariely, 2005) This makes markets, in situations when those heuristics are applicable, operate primarily rationally, in line with the EMH. The market's evolutionary environment does, however, alter in response to significant changes or economic shocks, and even heuristics that are adaptable may become maladaptive. This implies that the EMH might not hold during times of abrupt change, stress, or unusual circumstances. (Daniel, 2022) Scholars have expressed scepticism towards AMH, citing its deficiency in mathematical models. Since market participants were found to have rational expectations, the earlier idea of adaptive expectations in macroeconomics which went out of favour during the 1970 is

essentially all that the AMH echoes. Drawing on ideas from behavioural economics, the AMH is essentially a step back from rational expectations theory.

Design/Methodology/ Scope of the Study

Three key areas make up the review and discussion of the literature: studies supporting theories of investment behaviour; studies in favour and against these theories; and studies on behavioural finance. This study collected data from journals and various research articles from Emerald Publishing House, Elsevier Science Direct, and various open-access sources. The study incorporates around 20 writers' contributions to the subject of behavioural finance, 38 publications from the Journal of Behavioural Finance, and 62 research articles related to investment behaviour. The relevant research works from 2000 to 2023 are taken into consideration and only the significant studies prior 2000 is reviewed for fulfilling the aim of the present study.



Originality/ Value

This comprehensive and unique study examines ideas of investment behaviour and how they support and contradict long-held views. The results of this study may be of interest to a new researcher who is interested in the subject of investment behaviour.

Implication for Further Studies

Researchers are more interested in this topic, as evidenced by the discussion based on various theories and the application period, and the number of publications is rising in the direction of the most recent years of research (Mohit Fogaat S. S., 2022). This demonstrates the increasing need for additional research to create a comprehensive hold of this topic. The majority of the hypotheses examined are grounded in investor behaviour. Other participants in the financial environment, including exchanges, analysts, middlemen, the media, workers, managers, non-managers, legislators, and so on, could also be the subject of future research. The financial sector as a whole would have additional opportunities as a result.

Conclusion

The agents of the environment were predicated on certain fundamental tenets of conventional finance theory until the 1970s, when environmental research became the primary emphasis. Because these presumptions were unreasonable, incorrect conclusions were reached. People, or the agents of the environment and decision-making process, became the subject of the study during the 1980s when these assumptions were questioned. This led to the development of behavioural finance, a distinct area of finance that examines the impact of psychological biases on judgment. This field attempted to improve decision-making process models and ease the rigid constraints of conventional finance theory. Based on the literature review analysis, it can be concluded that there is currently no single theory of behavioural finance. Instead, the focus has been on identifying psychological traits in individuals or groups that can explain portfolio anomalies. This is because leveraging behavioural bias can lead to the development of highly profitable portfolios. It also highlights the fact that rational behaviour and profit maximisation are incomplete because they ignore the unique behavioural traits and biases of analysts, investors, and portfolio managers. Furthermore, because behavioural finance explains events that traditional finance theory is unable to explain, it serves only as an addition to regular finance theory. Based on the models of standard finance, behavioural finance theories can assist investors in better understanding their own behaviour and, consequently, in making better decisions while keeping the models of traditional finance theories in mind.

Studies provide evidence to support the viewpoints. It is not possible to rule out the possibility of any theory working. When traditional finance theory is unable to explain a phenomenon, behavioural finance steps in to provide an explanation (Akkaya, 2013). Based on traditional finance models, behavioural finance theories can assist investors in better understanding their own behaviour and, consequently, in making better decisions (Tseng, 2006) According to (Srivastava, 2012) research, financial planners who are aware of their own and their clients' behavioural biases can make better investment selections. Individual investors can also benefit from behavioural understanding of the decision-making process. Consequently, they are assisting both themselves and the clients in overcoming these prejudices, as these biases may be addressed by adhering to straightforward advice from experts. Personal characteristics can impact an individual's behaviour, which in turn can impact their financial choices. Behavioural finance has introduced certain assumptions on cognitive limits to the fundamental models of standard finance in order to accommodate the limitations of the standard finance model. In contrast to the EMH, the adaptive market hypothesis provides a more thorough explanation of market behaviour. Behavioural finance is a component of mainstream finance rather than a distinct field. It is impossible to explain the failure of the efficient model theory to a change in tax laws, price index errors, or data

errors. This idea is so powerful that, in light of the new knowledge gained from behavioural finance, we must reinterpret and adapt our legal foundations.

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