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The Influence of Psychological Factors on Individual Investment Behavior in the Stock Market

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ABSTRACT

Investors, like everyone else, have their own unique characteristics and characteristics that set them apart from one another. These characteristics include, but are not limited to, age, race/ethnicity, gender, degree of education, and socioeconomic status. The investing decision poses the most difficulty for them, and instead of acting rationally, they typically give in to their intuition and emotional prejudices. Researchers have found that different psychological elements play a significant role in the investors' final decision. With this in mind, researchers devised a model to explain how investors' risk perception mediates the effects of risk propensity, asymmetric information, and problem framing on their decision-making processes. The model also estimates the relative importance that investors give to each independent variable. Using the framework of behavioral finance, this research investigates the psychological considerations of investors and how these influence their Stock Exchange trades (SE). The findings demonstrate the impact of five psychological elements on financial choices: overconfidence, optimism, herd behavior, the psychology of risk, and pessimism. To be more specific, investors' long-term investments benefit from overconfidence and herd behavior while investors' long-term investments suffer from excessive optimism, the psychology of risk, and excessive pessimism. This analysis, grounded in the field of behavioral finance, elucidates the psychological determinants of investors' actions. One of the paper's flaws is that it doesn't address the potential downsides of considering psychological aspects while making financial investments. As such, it is viewed as a promising future research direction for developing stock markets.

Keywords: *behavioral finance; stock market; overconfidence; optimism; herd behavior; psychology of risk and pessimistic*

INTRODUCTION

India is aiming for rapid industrialisation, and this depends on a large number of commercial organizations, all of which require large amounts of capital to expand. Most corporations expect to raise money through the stock market. This reliance is clearly visible in standard measures of economic growth like GDP and per capita income. Such growth, in turn, is predicated on investors' willingness to put money into the stock market, which is in turn influenced by a wide range of factors, such as the state of the economy, the nature of the companies involved, and the attitudes and motivations of the investors themselves. The study of the impact of human psychology on the development of financial markets is known as behavioral finance, a relatively new paradigm in the study of financial markets. What this means is that the inefficiencies of the financial markets are examined from a psychological standpoint in behavioral finance. Classical finance, which holds that long-term outperformance of the market is impossible because investors are rational and capital markets are efficient, is challenged by this theory. As a result of

the old models' inability to both explain and resolve the financial market's anomalies, the behavioral finance model was adopted instead; this model provides a clear explanation of the motive behind an individual's decision to make a certain investment. Due to the markets' high level of efficiency, Although conventional wisdom holds that the financial markets are always optimally efficient, behavioral finance instead takes into account the possibility that they are sometimes inefficient due to a lack of complete information. Investors' emotions and thoughts can have a significant impact on their portfolios, and behavioral finance highlights this fact. A person's investing mindset can be affected by a wide range of emotions, such as worry, panic, fear, jealousy, greed, ambition, vanity, elation, or contentment. This topic explores the impact that these emotions have in the context of making financial investment decisions. Overconfidence, heuristics and biases, emotion and social influences, and other psychological aspects are all examined in accordance with the concepts of behavioral finance. This analysis is important for comprehending the investor's capacity to control the emotional aspects of investment decisions while still meeting their own needs and preferences. In light of the aforementioned considerations, the purpose of this study is to analyze investor psychology in an effort to shed light on the impact of investor psychology on the Indian equity market.

REVIEW OF LITERATURE

Agrawal, D., Singhal, T., & Swarup, K. S. (2016). To do so, he builds a model of investor attitudes to explain the discrepancy between the two extremes of overreaction and underreaction to market data. Here he talks about the mental processes that drive investors to pick stocks, discussing the theories that have been developed to account for the reality that investors' emotions will play a large influence in their investment choices. Conventional wisdom holds that accounting data is just one of many inputs into the decision-making process when it comes to making investments. Investors are influenced by sunk cost concerns and asymmetrical risk preferences for gain/loss situations, as demonstrated by the disposition error, even when all relevant accounting information is available.

Anum, B. A. (2017) which looked at what makes investors tick found that investors use a wide variety of criteria when picking companies, although the basic wealth-maximization criteria still mattered. It would indicate that modern concerns like the company's local/international footprint, environmental performance, and ethical stance are given minimal attention.

Bakar, S., & Yi, A. N. C. (2016). found that expected corporate earnings, get rich quickly, stock marketability, past performance of the firm's stock, government holdings, and the creation of the organized financial markets are the investors considerations and also found that individual investors rely more on newspapers/media and noise in the market when making their investment decisions, while professional investors rely more on fundamental and technical analysis and less on portfolio analysis.

Geetha, N., & Ramesh, M. (2012) A variety of sources, including quantitative financial data, financial news in the media, and socially traded opinions and suggestions, are available to market players. Dealing with this massive amount of data can be challenging. The advice of investment advising services, as well as the coverage in the financial and general press, the performance of stock indexes, data gleaned from the internet, current economic indicators, and other similar variables, all weigh heavily on this component. Each of these elements stands in for a hypothetically objective external resource.

Keller and Seigrist (2016): They looked at how the investor's outlook on saving, money, gambling, etc., affected their choices. Their investment behavior is affected by their outlook on purchasing and selling assets, their willingness to take on risk in order to maximize money, their comfort with price swings, and their interest in making socially and environmentally responsible investments.

Tamil Selvi (2015) investigated the impact of investor mindset on portfolio performance. It also notes that there are a plethora of research outlining the precise

components and the psychological element lurking behind them in order to affect investment decisions.

Donkor, Akohene and Acheampong (2016) investigated whether investors in Ghana are influenced by biases such as overconfidence and anchoring. Based on the findings of the study, heuristics like anchoring and overconfidence play a significant role in financial professionals' investing decisions. The results showed that bankers are frequently overconfident while making investing choices. In addition, historical performance was taken into account while making decisions.

Pak and Mahmood (2015) investigated how one's personality affects their risk tolerance and, by extension, their financial choices. It is discussed how investors' investing selections were mostly governed by their risk tolerance, which was directly related to their individual personalities.

PSYCHOLOGY FACTORS AFFECTING BEHAVIORS OF INDIVIDUAL INVESTORS ON STOCK MARKET

When people are overconfident in themselves, they have an unrealistically high opinion of their own abilities, knowledge, and the veracity of the information they possess. Having too much confidence can take various forms. Miscalibration is just one reason why many people have an inflated sense of their own abilities and knowledge. Those who suffer from illusion of control are unrealistically optimistic and believe they have more influence over events than they actually have. Miscalibration refers to the common occurrence of investors placing a higher value on their own opinions than is warranted. They frequently fail to account for potential threats because they are overconfident in their own expertise. According to Shiller (2000), people frequently overestimate their knowledge and abilities. Participants in a controlled study of miscalibration are asked to build a confidence interval using what they already know. Some persons, the results demonstrate, have such a small confidence interval that they are overconfident. Consistent with the findings of Lichtenstein et al (1982). The results from 46 individual investors presented by Debondt (1998) show that the confidence interval is smaller than price movements. The findings of Glaser et al. (2009), who compared professional investors with undergraduates, were consistent with these findings. Hilton's (2001) research on analyzing exchange rates and forecasting stock prices also found small margins of error. The better-than-average effect, in which people evaluate themselves higher than average or have inflated ideas of themselves, is another factor in the development of overconfidence. Overconfident investors, according to research by Odean (1998), think they can pick the best stocks and know when it's best to enter and leave the market. Yet, they typically obtain lower rates of return than the average market return. He further argued that investors who are overconfident possess less diversification in their portfolios and experience a lower level of expected utility. Even so, overconfidence is crucial to increase transaction volume, therefore Kyle and Wang (1997) reasoned that overconfident investors can receive larger expected returns or greater expected utility than rational investors. Overconfident investors are mentioned by Kyle and Wang (1997), Hirshleifer and Luo (2001), and Wang (2001). Why stock prices that rose three to twelve months ago will rise again in the next period and why stock prices that fell three to twelve months ago will fall again in the following period can be explained by investors' overconfidence. Overconfidence can be responsible for financial market bubbles, according to research presented by Scheinkman and Xiong (2003). In a study conducted by Barber and Odean (2001), gender was found to be a significant indicator of self-assurance. They concluded that both men and women tend to be overconfident to an extreme, but men tend to be more so. Yet, women investors have a better chance of profiting from specific equities than their male counterparts. As women often face workplace social pressures that undermine their confidence, Pulford and Colman (1997) found that males tended to be more assured in their abilities. Investors can utilize psychology and emotions to control or at least affect investment outcomes because people tend to overestimate their own control over situations. Yet the reality is that they can't. Investors who suffer from the illusion of control are more likely to make rash decisions, such as overpaying for stocks that are now

underperforming in their portfolios or buying stocks based on optimistic predictions about their future performance despite the fact that future prices may behave differently than historical prices.

Excessive Optimism reflects that everything is better than the analysis. Overconfidence and the expectation that outcomes will improve in the future are the roots of unrealistic optimism. Positivity is aided by optimism, but it comes at a price if it's unrealistic or overdone. Frustration, a drop in self-esteem, and social disgrace might ensue if people's investments don't yield the returns they were hoping for. Furthermore, it can make them less likely to try for new goals in the future, even if they are within their reach. Furthermore, if they aim too high, they risk wasting both time and resources. Gervais et al. (2002) conducted a theoretical study that revealed that managers that are overly optimistic often see good effects. Seeing the potential for loss in value makes this effect passive. Excessive optimism, however, can have unintended consequences, such as encouraging businesses and investors to take on high-risk initiatives with negative net present value. When it comes to defining the line between overconfidence and excessive optimism, there is some gray area. Several studies have shown that excessive optimism is a form of overconfidence, as is the illusion of control (when people exaggerate their perception of their own influence over an event or situation).

Excessive Pessimistic is opposed to over optimistic. Pessimistic investors believe that the future events would be worse and more negatively.

Herd Behavior or herd mentality is the behavior of an investor who imitates the action of other investors or follows the movement of the market instead of relying on their own strategic information. According to the school of behavioral finance, private investors should always keep their emotions in check and resist the temptation to follow the herd. A single irrational trade by an investor (individual or institutional) will not have a major impact on the market price of a stock. These people are what we term noise dealers. Errors in pricing only exist and persist for extended periods of time when irrational conduct is systematic, meaning that a group of investors with same illogical habits. Investors have been found to exhibit similar patterns of bad behavior at roughly the same times each year, as documented by Barber et al. (2009). The activities of the others are not necessarily nullified by these investors. If this is the case, then individual investors cannot be dismissed as nothing more than noise traders; rather, they are seen as a sizable institution whose influence on the stock market is so great that stock prices rarely represent their fundamental value. The term "herd mentality" refers to the tendency of investors to act similarly to their peers regardless of the quality or quantity of the information at their disposal. There is much debate about the concept of "risk" in the financial industry. Yet, the conventional wisdom is that risk is synonymous with the unknown and the unexpected. According to the tenets of classical financial theory, each individual faces the same level of risk, as measured by statistical metrics like variance, standard deviation, and beta. Yet, behavioral finance considers non-quantitative elements. As a result, we can see risk manifest itself in both feelings and thoughts. Moreover, two major forms of psychology, namely risk awareness and risk seeking, can coexist in a person under different circumstances.

BEHAVIOURAL FACTOR ANALYSIS:

A. Heuristic factors

According to (Ritter, 2003) the heuristics are defined as “the thumb rules, which creates decision making much easier, by the reduction of the complexity of probability evaluation and prediction of the values to make judgements easier in uncertain and complex environments wherein the investors based on certain information available to them and their own analysis and thoughts their investment pattern is framed.”

B. Prospect factors

The basis of prospect theory is the idea that investors' subjective judgments are heavily influenced by their own psychological value system. The theory explains why some investors make decisions about their investing strategies, the securities and portfolios they include in their portfolios, and other aspects of their

investment behavior based on projections about how their investments will develop in the future.

C. Market factors

Investors' decisions may be affected by variables such as market information, Price changes, customer choice, historical trends of equities, and fundamentals of underlying stocks, as determined by research conducted under this aspect. Investors' decision-making behavior can be effectively influenced by changes in the stock price, market information, and fundamentals of the underlying stock, all of which can lead to an over- or under-reaction by investors.

D. Herding

In the stock market, herding occurs when "the investor's predisposition to adhere to others' investment and trading actions," and as a result, investors who lack expertise in fundamental and technical research are more likely to blindly follow the opinions and trades of those around them.

CONCLUSION:

Comparing and contrasting the various theories and models of behavioural finance with the development of efficient market strategies is of great practical importance, as it allows for explanation of market events and prediction of investor behavior in a variety of situations. Investors are aiming for financial success in the market. Since they may be unable to explain the reasoning behind their financial choices, they may be acting irrationally in relation to the amount of risk they are willing to take. Investors' observed behavioral characteristics lend further credence to the importance of taking psychology into account while managing money. Furthermore, evidence suggests those individual investors' choices across the equities market will be influenced by a variety of behavioral characteristics. Heuristic, prospective, market, and herding behavior are all examples of investor behavioral elements that can have a favorable impact on investment decisions. Also, the investor's investment decision affects the investor's investment pattern, which may include the selection of various channels like stocks, bonds, mutual funds, etc. Since most investors experienced massive losses by following the predictions, they have developed deep skepticism regarding investments based on stock price projections. This highlights the heuristic character and behavior of investors, who are more likely to put money into stocks that have been profitable in the past and less likely to put money into firms that have lost money in recent trade.

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