International Journal of Advance and Applied Research
www.ijaar.co.in
ISSN – 2347-7075 Impact Factor – 8.141
Peer Reviewed Bi-Monthly UGC Care Listed
Vol. 6 No. 41 November - December - 2025

# Investor Psychology and Market Anomalies: A Behavioural Finance Perspective

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**DOI - 10.5281/zenodo.17726609**

***Abstract:***

*Behavioural finance challenges the traditional assumption of fully rational investors by demonstrating that psychological biases systematically influence financial decisions and market outcomes. This study examines how investor psychology contributes to the existence and persistence of market anomalies such as overreaction, underreaction, herding, and momentum effects. By integrating behavioural theories with empirical observations, the research explores key cognitive and emotional biases—including overconfidence, loss aversion, anchoring, representativeness, and herd behaviour—and their impact on investment patterns. Using secondary data from academic studies, market reports, and behavioural models, the study identifies strong evidence that psychological biases distort individual and institutional decision-making, leading to mispricing and short-term inefficiencies in financial markets. The findings indicate that market anomalies often arise when collective investor biases cause deviations from fundamental values. The study contributes to behavioural finance literature by offering insights into how investor sentiment and cognitive errors shape market dynamics, and highlights the need for financial literacy and behavioural-based investment strategies.*

***Keywords: Behavioural Finance, Investor Psychology, Market Anomalies, Overconfidence, Herd Behaviour, Cognitive Biases, Prospect Theory, Investor Sentiment.***

**Introduction:**

Traditional finance assumes that investors are rational, markets are efficient, and asset prices reflect all available information. However, recurring market anomalies—including momentum effects, reversals, bubbles, and crashes—indicate that markets often deviate from efficiency. These deviations cannot be fully explained by classical theories but align closely with behavioural finance, which incorporates psychology into financial decision-making.

Investor behaviour is influenced by emotions, heuristics, and cognitive biases that distort judgement. Overconfidence leads investors to overestimate their abilities; loss aversion causes risk-averse behaviour in gains and risk-seeking behaviour in losses; anchoring and framing distort perceptions; and herd behaviour leads to collective irrationality. These biases create mispricing, excessive volatility, and predictable return patterns known as market anomalies.

Financial markets have traditionally been studied through the lens of classical finance theories, which assume that investors are rational, markets are efficient, and asset prices fully reflect all available information. According to the Efficient Market Hypothesis (EMH), deviations from fundamental values are quickly corrected as rational investors exploit mispricing. However, repeated real-world observations—including stock market crashes, bubbles, sudden reversals, and persistent return patterns—challenge these assumptions. These market anomalies suggest that investor behaviour is not always rational, and market outcomes are often influenced by psychological and emotional factors.

Behavioural finance emerged as a response to these limitations in traditional finance. It integrates insights from psychology, cognitive science, and behavioural economics to explain why investors make systematic errors in judgement and how these errors contribute to inefficiencies in financial markets. Pioneering work by Kahneman and Tversky (1979) showed that individuals rely on heuristics and exhibit predictable biases that affect decision-making under risk. These biases—such as overconfidence, loss aversion, anchoring, representativeness, and herding—distort investor perception and lead to irrational market behaviour.

Investor psychology plays a crucial role in shaping market dynamics. For example, overconfidence can lead to excessive trading and momentum effects, while herding behaviour contributes to the formation of speculative bubbles and market crashes. Loss aversion and mental accounting cause investors to hold losing stocks for too long, resulting in underreaction to new information. Such behavioural tendencies generate predictable patterns known as market anomalies, which cannot be fully explained through rational models.

The growing influence of behavioural finance has transformed the study of investment decisions and market outcomes. By recognising that investors are influenced by emotions, social pressure, and cognitive limitations, behavioural finance provides a more realistic framework for understanding financial behaviour. Market anomalies, once considered mere statistical irregularities, can now be linked to underlying psychological processes.

The present study aims to explore how investor psychology contributes to the existence and persistence of market anomalies. By examining key behavioural biases and linking them to well-documented anomalies, the study provides a behavioural explanation for deviations from market efficiency. Understanding these psychological influences is essential for investors, policymakers, and financial institutions seeking to improve decision-making and reduce irrational market behaviour.

This study investigates how investor psychology contributes to such anomalies, emphasising the behavioural mechanisms that drive irrational market movements. By linking psychological constructs with empirical evidence, the study enhances understanding of why markets deviate from rational expectations.

**Review of Literature:**

**1. Behavioural Finance Foundations:**

Kahneman and Tversky's (1979) Prospect Theory laid the foundation for behavioural finance, demonstrating that investors evaluate gains and losses asymmetrically. Shefrin (2000) and Thaler (1993) further explained how cognitive errors influence financial behaviour.

**2. Cognitive Biases and Investment Behaviour:**

Studies show that **overconfidence** leads to excessive trading and mispricing (Barber & Odean, 2001). **Anchoring** causes investors to rely too heavily on initial information, while **representativeness** leads to misjudging probabilities based on stereotypes.

**3. Emotional Biases and Market Movements:**

Emotional factors such as **fear** and **greed** contribute to bubbles and crashes. Loss aversion results in disposition effects—holding losing stocks too long and selling winners too quickly (Odean, 1998).

**4. Market Anomalies Explained by Psychology:**

Behavioural biases help explain anomalies including:

- **Momentum and reversal effects** (Jegadeesh & Titman, 1993)
- **Post-earnings announcement drift**
- **Herd behaviour and market bubbles**
- **Value-growth anomalies**

**5. Investor Sentiment and Market Outcomes:**

Baker and Wurgler (2006) highlight how investor sentiment influences risk preferences and asset prices, causing deviations from fundamental values.

## Research Methodology:

**1. Research Design:**

A descriptive and analytical research design is adopted to examine investor psychology and market anomalies through behavioural finance frameworks.

**2. Data Source:**

The study uses **secondary data** from research articles, behavioural finance textbooks, market studies, and global financial reports.

**3. Variables of Study:**

Key behavioural biases:

- Overconfidence
- Loss Aversion
- Anchoring
- Herd Behaviour
- Representativeness

Market anomalies examined:

- Momentum
- Overreaction/Underreaction
- Bubbles and crashes
- Post-earnings drift

**4. Method of Analysis:**

A qualitative content analysis approach is used to synthesise findings from existing behavioural and empirical studies. Patterns are identified linking biases to anomalies.

The study employs a qualitative and descriptive analytical approach to examine how investor psychology influences the emergence of market anomalies. Since the research is based primarily on secondary data, the method of analysis focuses on synthesising existing empirical findings, behavioural models, and theoretical frameworks presented in academic literature.

**A. Content Analysis:**

A **systematic content analysis** technique is used to identify recurring behavioural patterns and link them to specific market anomalies.

- Research papers, behavioural studies, and market reports are reviewed.

- Relevant information on cognitive and emotional biases is extracted.
- Patterns are categorised under major behavioural constructs such as overconfidence, loss aversion, anchoring, representativeness, and herd behaviour.

**B. Thematic Analysis:**

A **thematic classification** is conducted to group findings into broad themes:

- Behavioural biases affecting investment decisions
- Psychological factors contributing to anomalies
- Investor sentiment and its market impact
- Evidence from global and emerging markets

Themes are analysed to identify the strength of relationships between behavioural tendencies and observed anomalies.

**C. Comparative Analysis:**

A comparative analysis approach is used to contrast traditional finance explanations with behavioural finance perspectives.

- Market anomalies such as momentum, reversals, bubbles, and underreaction are examined under both frameworks.
- Behavioural explanations are compared with classical theories to highlight differences and identify gaps.

**D. Integrative Framework Development:**

Based on the synthesised findings, the study develops an **integrative behavioural framework**, establishing clear relationships between:

- Investor psychology
- Bias-driven decisions
- Market anomalies

This framework helps in identifying which behavioural biases are most responsible for specific anomalies.

**Results:**

Findings indicate strong evidence that psychological biases significantly contribute to market anomalies:

- **Overconfidence** increases trading volume, causing momentum and price reversals.
- **Loss aversion** produces disposition effects that lead to underreaction in markets.
- **Herd behaviour** creates bubbles and sudden crashes as investors mimic collective trends.
- **Anchoring** leads to sluggish price adjustments after earnings announcements.
- **Investor sentiment** strongly influences short-term volatility and mispricing.

Overall, the results suggest that market anomalies cannot be fully understood without considering the behavioural tendencies of investors.

**Discussion:**

The findings align with behavioural finance theories by demonstrating that investor psychology is central to explaining deviations from market efficiency. Behavioural biases distort rational decision-making, creating predictable return patterns that contradict the Efficient Market Hypothesis (EMH).

The study highlights:

- Market anomalies persist because human emotions and heuristics are systematic.

- Institutional investors are also subject to behavioural errors.
- Understanding behavioural patterns can improve investment strategies, risk management, and policy design.

**Conclusions:**

The study concludes that behavioural biases significantly influence investor decisions and contribute to market anomalies in financial markets. Traditional models fail to capture these psychological factors, making behavioural finance a more realistic approach to understanding market dynamics. Investors, policymakers, and financial institutions must recognise psychological influences to make informed decisions and design better financial systems.

This study highlights the crucial role of investor psychology in shaping financial market behaviour and contributing to the emergence of market anomalies. Traditional finance theories, which assume rational decision-making and market efficiency, fail to fully explain the recurring patterns of overreaction, underreaction, momentum, speculative bubbles, and other deviations observed in real-world markets. Behavioural finance bridges this gap by incorporating cognitive and emotional biases into the analysis of investment decisions.

The findings demonstrate that behavioural biases such as overconfidence, loss aversion, anchoring, representativeness, and herd behaviour systematically influence investor judgement. These biases not only distort individual decision-making but also collectively lead to market inefficiencies and mispricing. Overconfidence fuels excessive trading and momentum effects, while loss aversion and mental accounting contribute to underreaction. Herd behaviour often drives asset bubbles and subsequent crashes, and anchoring affects the speed at which markets adjust to new information.

The study concludes that market anomalies are not random occurrences but predictable outcomes of psychological patterns embedded in human decision-making. As behavioural tendencies are stable and widespread, anomalies can persist over time despite the presence of sophisticated investors. Recognising these psychological influences is essential for improving investment strategies, financial education, and policy interventions.

Overall, the study reinforces the importance of behavioural finance as a more realistic framework for understanding market dynamics and investor behaviour. It encourages investors and financial institutions to account for psychological biases in decision-making, thereby contributing to more informed, disciplined, and resilient financial practices.

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