Behavioral biases in financial decision-making: A hidden cost to investors.

Marcu Tan*

Psychological Health & Readiness, Naval Health Research Center, San Diego, CA, USA

Introduction

Modern financial theories like the Efficient Market Hypothesis (EMH) assume investors act rationally and markets reflect all available information. However, real-world evidence contradicts this notion. The 2008 financial crisis, the dot-com bubble, and the GameStop frenzy of 2021 illustrate how investor psychology can influence market dynamics. Behavioral finance — an interdisciplinary field combining finance, psychology, and economics — seeks to understand why investors deviate from rationality. At the heart of this deviation lie **behavioral biases**, unconscious mental errors that skew decision-making and potentially erode wealth [1].

Overconfidence occurs when investors overestimate their knowledge or ability to predict market movements. This can result in excessive trading, under-diversification, and poor risk assessment. A study by Barber and Odean (2000) found that overconfident investors trade more frequently and earn lower net returns than their less active peers. Overconfidence also drives individuals to disregard expert advice or underestimate market volatility [2].

Coined by Kahneman and Tversky in Prospect Theory, **loss aversion** refers to the tendency to fear losses more than valuing gains. For instance, the pain of losing $1,000 is psychologically more intense than the pleasure of gaining $1,000. Investors affected by this bias often hold on to losing stocks in the hope of recovery, while prematurely selling winners to "lock in" gains — a behavior known as the **disposition effect [3]**.

Humans are social creatures, and in the financial realm, this manifests as **herding** — the tendency to mimic the actions of a larger group. While sometimes driven by shared information, herding can lead to irrational exuberance or panic. The dot-com bubble is a classic example, where investors followed each other into tech stocks without fully understanding their fundamentals, leading to inflated valuations and a dramatic crash [4].

Anchoring occurs when investors fixate on irrelevant reference points, such as a stock's past high price, and base decisions around them. For example, an investor might refuse to sell a declining stock until it returns to its original purchase price, even when market conditions have fundamentally changed. This bias distorts valuation judgment and encourages emotional rather than strategic decisions [5].

Investors often seek information that confirms their preexisting beliefs while ignoring contradictory evidence — a phenomenon known as **confirmation bias**. This can lead to "echo chambers" where investors become entrenched in their views, ignoring red flags and doubling down on poor investments [6].

These biases may seem minor, but their cumulative effect can be profound. Poor timing of trades, inadequate diversification, missed opportunities, and emotional trading all contribute to diminished returns. A study by DALBAR (2023) revealed that the average equity fund investor underperformed the S&P 500 by several percentage points annually, largely due to irrational investment behavior [7].

Additionally, behavioral biases increase market volatility. When large groups of investors act on emotions rather than fundamentals, markets can overreact to news — both good and bad — leading to bubbles or crashes. This unpredictability hurts not just individual portfolios but market stability as a whole [8].

Understanding common biases is the first step in combating them. Financial literacy programs can teach investors to recognize emotional triggers.Adopting a diversified investment strategy and maintaining proper asset allocation helps manage risk and limits the damage of impulsive decisions [9].

Robo-advisors and algorithmic trading platforms remove emotional decision-making by following predetermined rules. Investors can commit in advance to rules such as dollar-cost averaging or setting stop-loss limits to reduce the likelihood of emotional reactions [10].

Conclusion

Behavioral biases are subtle yet powerful forces that shape financial decision-making. Though often unconscious, their impact is measurable — from diminished investment returns to increased market volatility. Investors, regulators, and financial advisors must acknowledge these psychological influences and take proactive steps to mitigate their effects. A more behaviorally informed approach to investing can protect wealth, enhance decision quality, and contribute to a more stable financial system.

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***Correspondence to:** Marcu Tan, Psychological Health & Readiness, Naval Health Research Center, San Diego, CA, USA . E-mail: marcus@tn.org

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