



The Impact of Behavioral Finance on Investor Decision-Making

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Abstract

This study examines the impact of behavioral finance on investment decision-making. Behavioral finance acknowledges that investors are not always rational and that their decisions can be influenced by psychological biases. The primary data was collected through a questionnaire and total 106 responses were generated based on which this research was done. Herding, Heuristics and prospect theory were the independent variables where as the investment decision making was the dependent variable. Furthermore, heuristics and investing decisions have a strong positive connection, suggesting that Pakistani investors tend to make better decisions when heuristics are more frequent. In the same way, investing decisions are positively and significantly correlated with herding behavior. Prospect theory shows a beneficial association with investment decisions despite not showing a significant correlation. Through an analysis of various psychological biases and market deficiencies, this study demonstrates how behavioral finance challenges traditional finance theories and offers new insights into investor behavior and market dynamics. By understanding and addressing behavioral biases, investors and financial professionals can make more informed decisions and improve investment outcomes. This abstract includes the key findings and implications of the study, highlighting the importance of using behavioral finance principles into investment decision-making processes.

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Keywords: Behavioral Finance, Investment decision-making, Psychological biases

1. Introduction

Over time, the financial and investing industries have undergone an immense amount of change, with the increasing effect of behavioral finance challenging established models and theories. The multidisciplinary area of behavioral finance investigates how investors' decision-making processes are influenced by biases in psychology and emotional considerations, frequently deviating from the expectations of conventional financial theories. Understanding how behavioral finance affects investment decision-making is especially vital in the perspective of Pakistan, a nation with a diversified investor base and a rising financial sector. The goal of this study is to find out how behavioral finance influences the investment choices made by a few Pakistani investment banks. In order to shed insight on the practical uses of behavioral finance throughout the Pakistani financial landscape, this study looks at the cognitive and emotional aspects that impact investors' decisions. The goal of the research is to shed light on how much behavioral biases influence risk assessment, investing strategies, and portfolio management in this field. The research holds significance as it has the potential to improve comprehension of how personality traits, including but not limited to overconfidence, fear of loss, and herding behavior influence investment decisions in the context of Pakistan. In doing so, the research will include to the growing body of knowledge on behavioral finance and its effects on institutional and individual investors. Moreover, the results of this study may have beneficial effects for Pakistani investment banks and other financial organizations, supporting the creation of stronger plans and procedures for risk management. The conceptual foundations of behavioral finance will be further explored, along with the particular biases and heuristics that influence investing

decisions, in the sections that follow. After that, the study methodology and goals will be covered. Our goal is to conclude this study with a thorough examination of the ways that behavioral finance affects investment decision-making in a few Pakistani investment banks. This will help to enhance our understanding of financial behavior in the context of the nation's changing financial environment. This study aims to investigate "The Impact of Behavioral Finance on Investment Decision-making" in order to understand how behavioral biases and psychological variables influence risk management, investment strategies, and financial results. This paper aims to give a thorough analysis of this trend, with a focus on its effects for financial institutions and individual investors. This study's focus is on a few investment banks in Pakistan, a country with a developing financial sector and an expanding investor and financial institution community. Similar to many other emerging countries, Pakistan presents certain opportunities as well as obstacles for investors. Comprehending the significance of behavioral finance within this particular framework is important in order to encourage better-informed investment choices and augment the nation's general financial stability.

Problem Statement

The choices that investors make in the stock market have a significant influence on market movements, which in turn affect the economy as a whole. As a result, it's critical to investigate the psychological variables influencing investors' decisions and understand how these variables affect their investing results. This study aims to shed light on the influence of behavioral finance on investors' decisions by examining the behavioral aspects of investment decision-making. The findings could offer useful insights for improving the success of investments. Investors can use a foundation of understanding typical behavioral patterns to justify their decisions in an effort to improve returns. Finding out how behavioral finance affects decision-making is the problem statement. The research objectives of this study are:

1. The behavioral variables influencing individual investment decision makers include various factors that impact their decisions.
2. The behavioral factors influence individual investment decisions at various impact levels.
3. Behavioral factors influence the investment performance of investors at certain impact levels.

Significance of the study

For many stakeholders and for expanding our knowledge of financial behavior in Pakistan, this research is extremely important. This study advances the field of academia by adding to the body of knowledge already available on behavioral finance. Enhancing the global understanding of financial behavior, it offers insights into how behavioral biases impact investment decisions within a particular geographic and cultural setting. Pakistani authorities, financial institutions, and investment banks can immediately implement the study's conclusions. These organizations may create better risk management procedures, investment strategies, and financial products that cater to the psychological and emotional needs of Pakistani investors by having a better understanding of the function of behavioral finance. Knowing how behavioral biases affect risk assessment is important because financial markets can be unpredictable and unstable in a place like Pakistan. This

study can help banks and investors create ways to reduce the risks connected to making emotional decisions. Investors can benefit from the findings by learning more about the psychological aspects of decision-making. This can therefore result in better informed and sensible investment decisions. The knowledge gathered from this study can be utilized by policymakers to create rules and guidelines that combat behavioral biases and advance a fair and open financial system.

In conclusion, the research is important because it can help Pakistan's financial markets become more stable, better at managing risk, and make better investment decisions. By analyzing these variables in a particular geographic setting, it also advances the area of behavioral finance as a whole, which eventually helps investors and financial experts together.

2. Literature Review

In finance world, rationality and logic have long been considered the cornerstones of sound investment decision-making. Traditional economic models have often assumed that investors make choices based on careful analysis and the pursuit of their self-interest. However, in reality, human behavior is rarely as rational as these models suggest. The field of behavioral finance emerged to recognize and understand the substantial impact of psychological and emotional factors on investment decisions. This discipline explores how cognitive biases, heuristics, and emotional responses can significantly influence financial choices, sometimes leading to suboptimal outcomes. This introduction sets the stage for an exploration of how behavioral finance has reshaped our understanding of investment decision-making and its real-world implications. Psychologists have found that strong emotions and cognitive mistakes frequently lead to illogical financial decisions. The basis of behavioural finance is this irrationality. In contrast to Shiller's article, Heukelom (2014) offers an in-depth discussion of the human foundations of behavioral economics and finance. The field of behavioral economics, which encompasses the study of behavioral finance according to various definitions, originated mostly from prospect theory, created by Amos Tversky and Daniel Kahneman. It's essential to remember that Tversky and Kahneman were psychologists with less or no background in traditional finance. However, because Prospect Theory aims to simulate human decision-making rather than depending solely on the utility methods of decision-making that comprise the concept of finance, it has proven beneficial to economics. Prospect theory, according to Heukelom, argues that people make decisions based more on prospective profits and losses than on overall utility. Prospect Theory was extended to financial markets by Richard Thaler, a finance theorist who had previously studied economics and finance. In the field of behavioural finance, Amos Tversky, Richard Thaler, and Daniel Kahneman are regarded as pioneers. According to Meir Statman (2010) "Behavioral finance is a field of study that investigates the gap between traditional theories that expect rational navigation and irrational profound way of behaving of financial investors. It tries to grasp the explanations for this gap and its implications for financial markets".

According to Daniel Kahneman (2013) ^[2] "Behavioral finance is the investigation of how individuals pursue monetary choices in reality, where they face vulnerability and

have restricted cognitive assets. It tries to reveal the mental inclinations and alternate routes that impact financial decisions.”

The theory states that an overconfident investor will not "hold water" in their actions because they will buy and sell stocks without sufficient conviction and reason. They interpret this behavior as a mix of herd mentality and overconfidence because the investor will keep making the same investment because of past success and will not consider the changes that must be made for future decision-making. As a result, he relies on his skills and intuition in others to function. A thorough discussion of herding will be addressed in this study (Prat and Vaquero, 2014) ^[6].

Lingesiya and Navaneethakrishnan (2014) conducted a study to explore the influence of behavioral variables on investment decisions and performance, focusing on investors in the Colombo Stock Exchange. Their findings support the goal of illustrating a common pattern of investor behavior as opposed to concentrating on a particular instance. Individual investors completed questionnaires that collected data for the study and revealed important information about the variables influencing their choices. Following data collection, SPSS was used for analysis. The research findings indicated that prospect theory, heuristics, herding, and market are the four primary elements influencing investing decisions on the Colombo Stock Exchange. It was discovered that heuristics had a major influence on investing decisions, while market and prospect theory had small effects. Herding behavior had no effect at all.

A study by Alalade, Okonkwo, and Folarin (2014) ^[8] examined the returns of the Nigerian stock market as well as the behavioural patterns of financial investors. The need to comprehend the fundamental causes of the 2008 meltdown of the Nigerian Stock Exchange served as the driving force for the study. Utilizing a survey-based methodology and a primary data approach, the study looked at how societal biases affected stock market outcomes in Nigeria. The study also used surveys as a tool, secondary data from the Nigerian Stock Exchange, and Pearson correlation to analyze the data. One hundred and ten carefully chosen individuals with investments in the Nigerian stock market participated in the poll. The results showed a slight negative correlation between social prejudices and stock market returns in Nigeria, suggesting that social biases do present in the Nigerian stock market, but not primarily.

3. Research Design and Methodology

The data is collected through questionnaire from the sampled respondents. There are many theories in behavioral finance but specifically we will be examined these three theories of finance namely, Heuristics, Prospect theory, and Herding behavior and how these variables affects investors decision making process.

According to Kahneman and Tversky's (1974) ^[9] description, the heuristic theory refers to mental shortcuts or rules of thumb that people use to make difficult decisions easier, even though they can occasionally result in biases. Daniel Kahneman and Amos Tversky introduced Prospect Theory in 1979, which is a novel idea in the field of behavioural economics. It represents a fundamental departure from traditional rational choice theory and explores how

individuals perceive and evaluate risk and uncertainty in decision making. The Prospect Hypothesis presents the idea of reference focuses, which act as anchors for navigation. Individuals assess results corresponding to these reference point, like their ongoing monetary status or previous encounters. These reference impact whether a specific result is seen as an increase in his/her wealth or decrease.

Herding behavior in the context of behavioral finance refers to the tendency of individuals to follow the actions or decisions of a larger group, often without conducting independent analysis or critical thinking. Herding behavior challenges the traditional finance assumption that all market participants make rational, independent decisions based on available information. Understanding this behavior is very much important for investigators and policymakers as it reveals insight into the psychology and elements of financial sectors (Banerjee, A. V. (1992) ^[10].

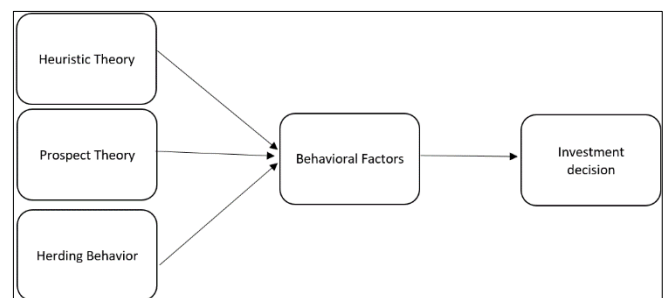


Fig 1: Conceptual Framework

Table 1: Demographic Details of Respondents

Demographics Variables	Category	Percentage (%)
Gender	Male	67%
	Female	33%
Marital Status	Married	21.7%
	Non-married	74.5%
	Divorced	3.8%
Age	Below 21	21.7%
	21–29	64.2%
	30–39	12.3%
	Above 40	1.9%
Qualification	Intermediate	25.5%
	BSC	51.9%
	MBA/MSC	22.6%
	Any other	0%
Do you have knowledge of financial management?	Yes	45.3%
	No	38.7%
	Maybe	16%

Table 1 show that the demographic breakdown of the respondents indicates that 67% are male, with the remaining 33% being female. In which the proportion of married investors was 21.7%, single investors are 74.5% and divorced investors are 3.8%. The age profile suggests that 21.7% respondents are (Below 21), 64.2% are (21-29), 12.3% are (30-39) and 1.9% are above 40. Qualification profile suggests that 25.5% are from intermediate, 51.9% are from undergraduate and 22.6% are from postgraduate. As per the knowledge of financial management 45.3% respondent have sufficient knowledge while 38.7% do not have any financial management knowledge and 16% respondent are in doubt of whether they have a little bit knowledge of financial management or not or maybe they do not even know whether they do.

3. Data Analysis and Findings

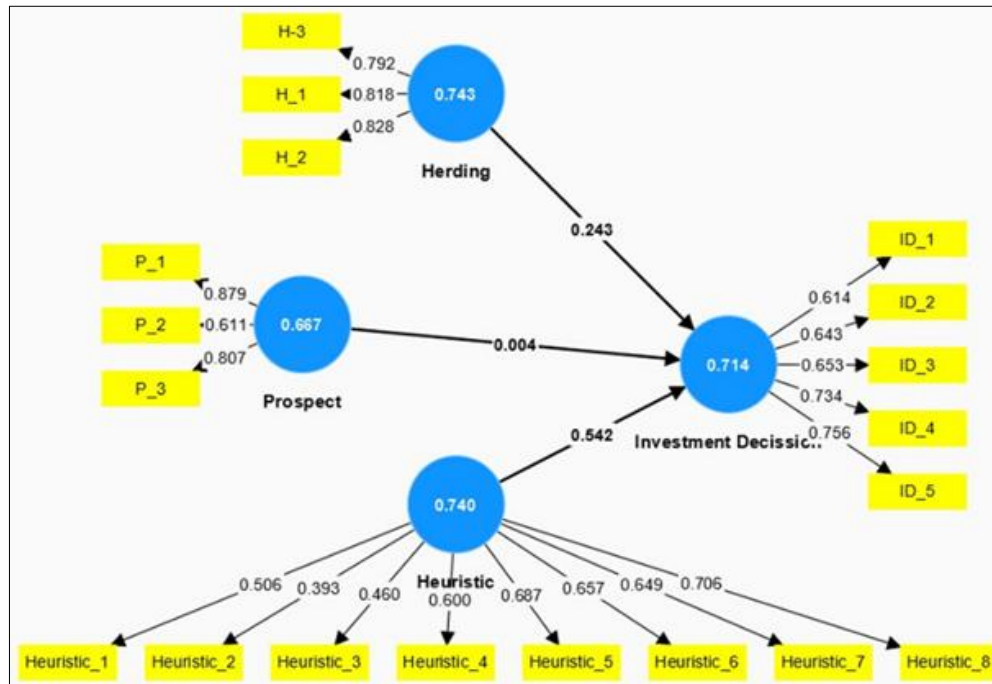


Fig 2: Measurement Model

Table 2: Reliability and Validity

	Composite reliability (rho_c)	Average variance extracted (AVE)
Herding	0.854	0.660
Heuristic	0.807	0.351
Investment Decision	0.812	0.465
Prospect	0.814	0.599

Table 2 presents the results, which show that all composite reliability values are above 0.70 and that two Average Variance Extracted (AVE) values exceed 0.5. The composite reliability of the variables Heuristics and Investment Decision is higher than 0.6, but their individual values are below 0.5 for AVE. Consequently, since

none of the latent variables differ from the predetermined criteria, it can be said that all of the latent variables, as evaluated using data from Pakistani investors, satisfy the conditions of convergent validity.

Table 3: Discriminant Validity

	Herding	Heuristic	Investment Decision	Prospect
Herding	0.813			
Heuristic	0.410	0.592		
Investment Decision	0.467	0.644	0.682	
Prospect	0.441	0.594	0.433	0.774

The results presented in Table 3 reveal that the squared Average Variance Extracted (AVE) values, indicated in the horizontal line, surpass the Pearson correlation values. This indicates that all variables utilized in the study are distinct and unique from each other.

Table 4: Correlation

		Herding	Prospect	Heuristic	Investment decision
Herding	Pearson Correlation	1	.462**	.403**	.462**
	Sig. (2-tailed)		0.000	0.000	0.000
	N	106	106	106	106
Prospect	Pearson Correlation	.462**	1	.574**	.396**
	Sig. (2-tailed)	0.000		0.000	0.000
	N	106	106	106	106
Heuristic	Pearson Correlation	.403**	.574**	1	.580**
	Sig. (2-tailed)	0.000	0.000		0.000
	N	106	106	106	106
Investment decision	Pearson Correlation	.462**	.396**	.580**	1
	Sig. (2-tailed)	0.000	0.000	0.000	
	N	106	106	106	106

**, Correlation is significant at the 0.01 level (2-tailed).

As per table 2 heuristic and investment decision are positively and strongly correlated $r = 0.580$ and $p = 0.000$ which means

higher the involvement of heuristic better the investment decision. Similarly herding and prospect are also positively and strongly correlated with investment decision.

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.631a	0.399	0.381	0.464

Table 6: ANOVA

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	14.573	3	4.858	22.538	.000b
	Residual	21.984	102	0.216		
	Total	36.557	105			

a. Dependent Variable: ID

There was discovered a substantial regression equation $F, 3,102=22.538$ $p<0.00$ with R-square 0.399 (Table 5). Participants' projected decision of investment is equivalent to 0.234 (herding) 0.534 (heuristic) (see table 7). For every unit increase in herding, the investment decision increases by

0.234. Likewise, each unit increases in heuristic the investment decision increases by 0.534. Both herding and

heuristic are significant and critical predictors of investment decision because both have $p < 0.005$.

Table 7: Coefficients

	Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.717	0.323		2.222	0.028
	HERDING	0.234	0.076	0.273	3.095	0.003
	PROSPECT	0.001	0.082	0.001	0.009	0.993
	HEURISTIC	0.534	0.109	0.469	4.914	0.000
a. Dependent Variable: ID						

4. Conclusion and Implication

This study aims to investigate how investing decisions are impacted by behavioural finance. The results show that behavioural finance has a major overall influence on how investors make decisions. According to the research, when making investing decisions, investors frequently depend on heuristics and herding behavior. Furthermore, heuristics and investing decisions have a strong positive connection, suggesting that Pakistani investors tend to make better decisions when heuristics are more frequent. In the same way, investing decisions are positively and significantly correlated with herding behavior. Prospect theory shows a beneficial association with investment decisions despite not showing a significant correlation.

While behavioral finance cannot claim that all investors have the same delusions, it does highlight the steps that must be taken to prevent them from interfering with decision-making, especially while investing. Investors may buy high and sell low due to emotional responses to short-term market swings, which might undermine their long-term financial objectives. Investors can maintain discipline and focus on their long-term goals by being aware of and taking steps to mitigate these biases. All things considered, behavioral finance offers a more sophisticated explanation of investor behavior and challenges the conventional rational operator model of finance. Investors can enhance their ability to make better investing decisions and attain superior long-term results by recognizing and minimizing behavioral biases.

5. Limitation and Future Recommendation

Future research could take into consideration additional factors that might affect the choices made by specific investors. It is advised that further behavioral finance research be conducted to examine the behaviors of institutional investors at the PSE that impact their decision-making. These studies may be useful in evaluating the suitability of using behavioral finance in a variety of securities markets with a wide range of investor constituents. A mass of behavioral bias issues limit investors' ability to make profitable investment decisions. This work can serve as a foundation for future research on other behavioral bias elements and how they affect investors' investment behavior. This is an interesting area of study for future researchers. Behavioral finance may disregard other significant elements like market fundamentals, economic indicators, and industry trends in favor of a heavy emphasis on psychological biases and heuristics. Behavioral finance challenges the efficient market hypothesis, which holds that asset prices fairly reflect all available information. Although behavioral biases can lead to market inefficiencies, there is disagreement over how much of an impact they have on investment outcomes. Although it can spot illogical behavior patterns, behavioral

finance isn't always able to provide investors with useful information. It can be challenging to forecast market movements. It is important to recognize these limits when applying the ideas of behavioral finance to investment decision-making, even if it has increased our understanding of investor behavior and offered insightful information about the shortcomings of classical finance theory purely from behavioral biases, and it can be dangerous to time the market based on these insights.

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