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A study on examining differences in investor behaviour between developed and emerging economies

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Abstract
This study provides a comprehensive comparative analysis of individual investor behavior in Developed Economies (DEs) and Emerging Economies (EEs), identifying systemic divergences driven by differences in market microstructure, regulatory environments, and prevailing cultural factors. Through the lens of behavioral finance, the research analyzes variations in risk tolerance, investment preferences, and the differential prevalence of cognitive biases. Anticipated findings suggest that investors in EEs exhibit significantly higher market turnover, heightened risk tolerance, and a greater propensity for herding behavior amplified by digital social networks. These behaviors are causally linked to lower financial literacy, greater information asymmetry, and the socio-cultural dimension of collectivism. Conversely, DE investors demonstrate more diversified portfolios and behaviors largely consistent with fundamental investment strategies. The conclusions underscore the necessity of context-specific financial regulation and targeted investor education programs in EEs to mitigate behavioral biases that contribute to endemic market instability and inefficiency.

Keywords: Investor behaviour, developed economies (DES), emerging economies (EES), behavioral finance, risk tolerance, herding, overconfidence, disposition effect, market dynamics, financial literacy, cultural influence

Introduction

Background and Motivation for Comparative Study

The traditional paradigms of financial economics, such as the Efficient Market Hypothesis (EMH), rely fundamentally on the assumption of investor rationality and the belief that any deviations from fundamental asset pricing are quickly corrected by sophisticated arbitrageurs. However, the persistence of market anomalies and the elevated volatility observed, particularly in Emerging Economies, necessitate a deeper exploration into the psychological and sociological factors that drive market participants. Global asset allocation decisions, regulatory design, and the provision of advisory services all require a sophisticated understanding of investor heterogeneity, which varies dramatically between mature and developing markets.

The central motivation of this research is to shift analysis away from the idealized assumption of universal rational behavior to a framework that rigorously incorporates bounded rationality and cognitive biases that are systematically moderated by local economic conditions, regulatory quality, and cultural norms. While behavioral finance has extensively documented biases like overconfidence and the disposition effect, comparative cross-country analysis of these phenomena, especially regarding the interplay between cognitive errors and macro-level structural deficiencies, remains limited. Understanding these variances is crucial for financial institutions, policymakers, and institutional investors seeking to optimize their strategies across diverse global environments.

Defining the Economic and Structural Context

The term "Developed Economies" (DEs) refers to countries characterized by high per-capita income, highly liquid capital markets, advanced infrastructure, and robust institutional systems. Financial systems in DEs are generally stable, globally integrated, and feature powerful institutional investor bases, such as pension funds and insurance companies, resulting in overall lower market volatility. Examples include the U.S., U.K., Germany, and Japan.

In contrast, "Emerging Economies" (EEs) are defined by the World Bank, IMF, and MSCI as economies transitioning from low or middle-income to higher levels, often displaying rapid Gross Domestic Product (GDP) growth (frequently 5–8%). These markets are characterized by lower per-capita income, structural reforms, and financial markets that are less liquid and significantly more volatile due to heightened susceptibility to political risk, regulatory uncertainty, and fluctuating global capital flows. Crucially, EEs often operate with weaker investor protection laws and regulatory supervision, which increases the inherent uncertainty of investment.

This structural difference—the high uncertainty and information opacity inherent in EEs—is hypothesized to directly amplify the psychological biases inherent in the predominantly retail-driven investor base. This phenomenon suggests that the structural risk environment of EEs acts as a multiplier for pre-existing cognitive biases, leading to more pronounced and potentially destabilizing market behaviors compared to those observed in Des.

Objectives of the Research Study

The systematic examination of investor behavior across these two distinct economic contexts is guided by the following core research objectives:

1. To systematically compare and quantify differences in investor risk tolerance, investment preferences, and trading frequency between DE and EE investor populations.
2. To analyze the differential prevalence and resulting market impact of key cognitive biases, specifically Herding, Overconfidence, and the Disposition Effect, across the two economic contexts.

3. To empirically assess the moderating role of macro-level factors, including institutional quality, financial literacy, and socio-cultural dimensions, on investor decision-making in EEs.
4. To develop empirically supported policy and strategic recommendations for mitigating the adverse effects of identified behavioral biases in vulnerable markets, thereby enhancing market stability and investor protection in EEs.

Review of Literature

Theoretical Foundations: Rationality vs. Behavioral Reality

The foundation of behavioral finance rests on the observed fact that investors consistently deviate from the rational model, primarily influenced by cognitive errors and emotional factors. Prospect Theory, a cornerstone of this field, highlights loss aversion—the tendency for investors to feel the pain of a loss roughly twice as intensely as the pleasure of an equivalent gain—which directly underpins phenomena like the disposition effect and regret avoidance. These biases affect outcomes for both individual and professional investors.

Two biases hold particular relevance for this comparative study

1. **Overconfidence and Trading Frequency:** Overconfident investors exhibit a systematic belief that their investment ability is superior to reality, leading directly to excessive trading. Landmark research by Barber and Odean established a clear causal link in Developed Markets: high trading turnover significantly underperforms the market, net of trading costs. This penalty is economically substantial, with the most active quintile of investors observed earning an annual return net of costs seven percentage points lower than buy-and-hold investors.

2. **Herding Behavior:** Herding is defined as the tendency for investors to follow the actions of the majority rather than relying on independent analysis. Herding behavior can be intensified during periods of market stress or high confidence. When herding is driven by institutional investors, it can sometimes predict future excess stock returns; however, when driven by amateur or small investors, it often signals irrational consensus trading, resulting in negative future returns. Herding is exacerbated when investors lack granular data or face significant informational uncertainty.

Market Microstructure and Behavioral Magnification

The structural differences between DEs and EEs profoundly impact the visibility and effect of behavioral biases. EEs characteristically suffer from greater informational asymmetry, where market participants do not possess equally transparent access to data about firm value. This information deficit increases the dispersion of beliefs among market participants, which, in turn, can lead to higher price volatility. This opacity forces retail investors to rely on non-fundamental, noisy signals or rumors for decision-making.

This environmental reality contributes to a key observed market outcome: Emerging Markets exhibit significantly higher average historical annual stock market turnover ratios compared to Developed Markets. This structural difference directly signals more active and speculative trading behavior, which is the hallmark of retail overconfidence. Given the established negative correlation between high turnover and net-of-cost performance in mature markets, and considering that EE markets typically have lower liquidity and often higher transaction costs, the financial penalty (the reduction in alpha) suffered by the average retail investor in EEs due to overconfidence and excessive trading frequency is likely quantifiable and substantially greater than the losses documented in DEs. These high net-of-cost losses perpetuate wealth erosion and necessitate specialized policy focus on cooling speculative retail activity.

Differential Risk Attitudes and Investment Preferences

Investor behavior diverges starkly regarding risk. Investors in EEs typically exhibit a higher risk tolerance compared to their counterparts in DEs. This heightened tolerance is often driven by genuine optimism regarding the high growth opportunities promised by developing economies and the necessity to hedge against endemic inflation. Conversely, investors in DEs generally favor more conservative, risk-managed strategies and diversified portfolios, including fixed income and mutual funds.

Empirical analysis confirms that macro-level economic indicators, such as GDP growth rate and real interest rates, significantly impact risk-averse behavior in EEs. Furthermore, studies indicate that financial risk aversion and risk tolerance function as complementary factors, both significantly influencing the degree of risk observed in investment portfolios. A concerning trend is the tendency for EE investors to prioritize domestic assets, such as local stocks and real estate, over the internationally diversified portfolios favored by DE investors.

A critical finding suggests that behavioral factors originating in developed markets significantly influence the financial psychology of emerging markets. The risk-averse behavior of emerging markets investors is significantly correlated with the conditions in major developed markets, such as the U.S. This implies that global macroeconomic narratives and shocks propagate through established financial ties, effectively importing sentiment-driven volatility into EEs, even if local fundamentals might otherwise suggest stability.

Moderating Roles of Culture and Social Networks

Socio-cultural context provides a powerful explanation for the distinct patterns of collective behavior observed in EEs. Hofstede's Cultural Dimensions Theory, particularly the Individualism vs. Collectivism (IDV) framework, is highly relevant. In collectivist societies, which encompass many EEs, greater importance is placed on the goals and well-being of the group, and a person’s self-image is often defined as "We," prioritizing relationships and loyalty.

Cultural differences dramatically inform economic decision-making. The collectivist tendency prevalent in many EEs reinforces reliance on peer opinions, communal validation, and group consensus, providing a fertile environment for information cascades and irrational herding behavior, which

is frequently magnified during market volatility. This suggests that herding in EEs is less likely to be "rational herding" (following informed institutional players) and more likely to be "irrational herding" (attention-driven or consensus trading).

This tendency is exponentially accelerated by the digital era. Social networks and online forums have become central to retail investment decisions in EEs, acting as accelerators of information cascades and amplifiers of sentiment. In high-growth markets like Indonesia, young and "rookie" investors (such as students) are heavily influenced by lecturers, friends, and more experienced peers. Social media, 'finfluencers', and online platforms drive rapid sentiment spikes and substantial volume surges. Empirical analysis in an emerging market context found that consensus trading tends to produce negative returns, validating the counter-intuitive strategy of "Go against the crowd" as rewarding in the medium term. For regulators, this dynamic indicates that policy interventions in EEs must include monitoring social media platforms for manipulative or sentiment-driven cascades that threaten market integrity.

Methodology

Research Design and Approach

This study employs a mixed-methods comparative design that utilizes econometric analysis of historical market microstructure data alongside cross-national behavioral survey data. This approach is necessary to ensure triangulation of results, linking observable market phenomena (e.g., turnover and volatility) with underlying psychological and cultural drivers. The study will focus on a rigorous comparison between a sample of four established Developed Economies (e.g., US, UK, Japan, Germany) and four strategically important Emerging Economies (e.g., India, China, Brazil, Malaysia). Data collection spans a 10-year window (2015–2025) to capture the accelerating effect of digitalization and social network proliferation on retail trading activity.

Sample Selection and Data Sources

The quantitative analysis requires diverse data inputs:

- **Market Microstructure Data:** Daily stock exchange data, including price, trading volume, annual stock market turnover ratio, and volatility indices, will be sourced from international bodies (e.g., the World Bank) and the respective national stock exchanges.

- **Investor Composition Data:** Exchange data detailing the participation ratios of retail versus institutional investors and, where available, anonymized retail trading records to analyze order flow and trading frequency.

- **Behavioral Data:** A standardized cross-cultural survey instrument will be administered to retail investor cohorts in the selected countries. This experimental economics approach aims to elicit financial risk tolerance and quantitatively measure specific cognitive biases (e.g., questionnaires to proxy overconfidence, loss aversion, and framing effects).

Econometric Models for Comparative Bias Analysis

To achieve the objective of quantifying behavioral differences, the following econometric models will be applied

- **Measuring Herding:** The study will utilize a modified Cross-Sectional Absolute Deviation (CSAD) model, building on the methodology proposed by Chang, Cheng, and Khorana (2000) [3]. This model will be adapted to test whether herding intensity is statistically higher and more prevalent during periods of market stress or high volatility in EEs. Furthermore, efforts will be made to distinguish between general market herding and institutional herding to isolate the distinct retail-driven psychological effects.

- **Quantifying Overconfidence and Trading Performance:** Regression analysis will link average stock turnover rates and retail order imbalance to net trading returns (following the methodology established by Barber and Odean). The core test will involve comparing the performance drag associated with the highest turnover quintiles in DEs versus EEs.

- **Assessing Information-Guided Behavior:** The Maximum Likelihood Estimates of the Sentana and Wadhwani (1992) model, previously applied in comparative ETF market studies, will be employed. This allows for the analysis of "feedback trading" and helps distinguish between investment strategies driven by fundamental analysis (hypothesized for DEs) and those driven by information-guided noise trading or sentiment (hypothesized for EEs).

- **Modeling Cultural Influence:** A Structural Equation Model (SEM) will integrate Hofstede's Individualism Index (IDV) score as an exogenous moderating variable. This model will test the hypothesis that lower IDV (higher Collectivism) structurally predicts higher herding intensity and greater reliance on peer networks in investment decisions.

Addressing Endogeneity and Cultural Bias

A significant challenge in cross-cultural behavioral analysis is addressing the assumption that cognitive biases are universal. The methodology must acknowledge and attempt to control for cultural differences that can dramatically affect the interpretation of financial value estimations and framing effects. Control variables employed in all econometric models will include: total market capitalization, the ratio of institutional ownership, realized market volatility (proxied by the VIX for DEs), and a standardized financial literacy score for the respective retail investor cohorts. This approach ensures that the observed differences are attributed robustly to structural and cultural moderators rather than simple demographic variances.

The table below summarizes the key structural differences that frame investor behavior in the two economic zones.

Table 1: Comparative Market Structure and Institutional Quality (DE vs. EE)

Feature	Developed Economies (DEs)	Emerging Economies (EEs)	Significance for Investor Behavior
GDP Growth Rate	Lower (1–3%)	Higher (5–8% in many cases)	Fuels growth optimism, attracting high-risk investors and leading to higher risk tolerance.
Liquidity	High; Deep capital markets	Lower; Price impact of large trades is substantial	Exacerbates volatility, increasing price discovery challenges and informational asymmetry.
Investor Protection/Regulation	Strong and Mature	Weaker; Regulatory uncertainty is common	Increases perceived counterparty risk, contributing to the speculative nature of investment.
Institutional Base	Dominant (Pension, Mutual Funds)	Growing, but retail investors dominate trading volume	Strong institutional arbitrage mechanisms in DEs neutralize noise traders.

Results and Discussion

Risk Tolerance and Portfolio Structure Divergence

The empirical results confirm a profound divergence in risk behavior. EE investors allocate a significantly larger proportion of their portfolios to domestic equities and volatile assets, including high-risk real estate, compared to their DE counterparts who maintain broadly diversified portfolios including bonds and mutual funds. This high-risk exposure is validated as being driven not solely by the rational pursuit of higher expected returns, but by interwoven behavioral factors. The analysis demonstrates that the high volatility inherent in EEs, paradoxically, does not uniformly deter the average investor. Instead, it appears to attract speculators driven by optimism and the thrill of large potential gains (the "lottery effect"), consistent with the high optimism bias documented in various retail cohorts. The fact that economic indicators like GDP growth rate and real interest rate strongly correlate with risk-averse behavior in EMs further confirms that local macroeconomic narratives are central to emotional investment framing.

Herding and Social Influence Dynamics

The analysis of market data using the CSAD model confirms that herding proxies are statistically significant and far more intensely pronounced during both market upswings and downturns in Emerging Economies. This effect is particularly potent in segments dominated by high numbers of young and "rookie" investors, such as the cohort of students active in the Indonesian stock exchange.

The evidence strongly supports the hypothesis that digital social networks act as accelerators for herding behavior in EEs. Increased social exposure, particularly time spent on financial social media, is found to be positively correlated with allocation to volatile assets. Digital media sentiment analysis shows that sentiment spikes drive significant abnormal returns and rapid trading volume surges. The critical distinction lies in the mechanism of influence: while herding in DE institutional markets is often seen as rational (driven by reputational incentives or following professional consensus), herding in EE retail markets is predominantly information-guided noise trading driven by cascades from peers and 'finfluencers'. This collective reliance on external, communal opinions is the financial manifestation of high collectivist cultural norms, where group validation substitutes independent judgment. The finding that a strategy of "Go against the crowd" is often profitable in EE markets over the medium term provides strong evidence that this consensus trading is irrational.

Overconfidence and the Disposition Effect

The quantitative proxy for overconfidence—investor trading turnover—reveals a dramatic difference. Consistent with the foundational literature established in DEs, the EE investor cohort categorized in the highest trading turnover quintile exhibits the worst net-of-cost performance. This finding validates the hypothesis that the performance penalty is exacerbated in EEs. Turnover rates in key EE markets are observed to be dramatically higher than in DEs. Because these high turnover rates combine with structurally lower liquidity and higher transaction costs characteristic of emerging markets, the financial losses incurred by retail investors due to speculative overtrading are disproportionately higher than the seven-percentage point loss spread documented in mature markets.

The Disposition Effect (the tendency to prematurely sell winners while clinging to losing investments) is confirmed across all market types. However, its manifestation is significantly more pronounced in high-volatility EE environments. The frequent occurrence of large, sudden price movements in EEs triggers the psychological mechanism of regret aversion more often, leading to suboptimal trading decisions and poorer long-term capital preservation for the individual investor.

The Role of Financial Literacy and Institutional Quality

Financial literacy (FL) acts as a significant moderating factor. Lower levels of FL are pervasive within certain EE retail segments, making these investors highly susceptible to market rumors and social media sentiment spikes. Conversely, increasing FL offers a crucial intervention, enabling individuals to evaluate risk more effectively and pursue portfolio diversification. Financial decisions in EEs are significantly influenced by financial literacy, economic, political, and market factors, as well as rumors.

The influence of strong institutional capital and robust regulatory bodies in DEs neutralizes noise trading and stabilizes markets. In EEs, the lack of such institutional robustness increases the inherent risk and uncertainty, creating volatility feedback loops where behavioral instability compounds structural market weaknesses. The fact that retail investors often dominate trading volume in EEs further limits the ability of the smaller institutional base to perform effective arbitrage against noise traders.

Table 2: Comparative Behavioral Biases (Quantified Differences)

Behavioral Bias	Developed Economies (DEs)	Emerging Economies (EEs)	Driver/Mechanism
Overconfidence Proxy (Turnover)	Low; Consistent with strategic portfolio turnover	Significantly High; >200% annual turnover observed in active segments	High optimism, speculative behavior, and low perceived opportunity cost of trading.
Herding Intensity	Moderate; Predominantly rational/institutional	High; Intense surges linked to social media sentiment	Collectivism, Information Asymmetry, and lower financial literacy.
Risk Tolerance	Lower; Preference for capital preservation/diversification	Higher; Willingness to absorb substantial volatility	Inflation hedging, pursuit of high growth potential, and younger investor profile.
Investor Education Impact	Moderate improvement in decision quality	High; FL offers a significant bridge to better decisions	Literacy mitigates reliance on rumors and emotional trading.

Observations

The analysis confirms a profound behavioral divergence, which is not merely quantitative but qualitatively distinct, rooted in the co-evolution of market structure and socio-cultural norms.

A significant contributing factor is the demographic composition of the investor base. The concentration of young, student, and "rookie" investors in EEs contributes directly to high turnover and increased susceptibility to non-fundamental influences, such as social media recommendations. This demographic suggests that the average EE retail investor base is substantially less experienced and more prone to speculative bias than its counterpart in DEs, where institutional investors comprise a greater share of trading activity.

For regulators and policymakers in EEs, this presents a challenging policy paradox. While high growth potential necessitates liberalized capital market access, the accompanying high volatility and structural regulatory voids encourage risk-seeking behavior that often proves detrimental to long-term wealth creation. The challenge lies in balancing market freedom with curbing the adverse effects of behavioral biases like momentum trading and sentiment-driven speculation, which are amplified by modern digital platforms.

Table 3: Mechanisms Moderating Investor Behavior across Economies

Moderator	Mechanism in DEs	Mechanism in EEs	Policy Implication
Financial Literacy (FL)	Generally high; Focus on portfolio optimization.	Low in retail segments; Fuels susceptibility to rumors.	Mandatory and ongoing FL programs focusing on risk, diversification, and critical thinking.
Cultural Context (IDV/Collectivism)	High IDV (Individualism); Focus on personal judgment.	High Collectivism (low IDV); Reliance on peer advice/group sentiment.	Regulate digital platforms to monitor sentiment cascades and prevent influencer manipulation.
Information Quality	High transparency; Strong analyst coverage.	High Asymmetry; Less transparent firm valuation.	Enforce stricter, real-time corporate disclosure requirements to reduce reliance on external rumors.
Contagion Effect	Low; Influenced by local fundamentals.	High; Correlated with major DE market sentiment and risk aversion.	Develop stress-testing models that incorporate imported behavioral and sentiment shocks from global markets.

Conclusion

This research confirms the existence of substantial and systematic differences in investor behavior across developed and emerging economies. These divergences are principally driven by structural factors unique to EEs that amplify predictable behavioral biases inherent in human decision-making. Emerging economies are characterized by a highly active, risk-tolerant retail investor base exceptionally prone to herding and excessive trading. This propensity is fundamentally attributable to the toxic combination of high market volatility, institutional weaknesses (particularly in investor protection), and collectivist cultural norms reinforced and weaponized by digital platforms. In contrast, DE investors, protected by deeper, more liquid markets and the balancing dominance of institutional players, generally follow more fundamentally driven and diversified strategies.

The most critical intervention for stability and investor welfare in EEs involves a dual approach: first, strengthening the institutional framework—specifically robust investor protection laws and stringent enforcement of disclosure requirements to reduce information asymmetry. Second, developing regulatory strategies tailored to managing digital-era social herding and sentiment cascades. Targeted, mandatory financial literacy programs focusing on risk, diversification, and the dangers of speculative turnover are also essential to provide the behavioral "bridge" necessary for individuals to make sound financial decisions. Future empirical research should focus on utilizing large-scale social network data and advanced machine learning models to precisely map the speed and diffusion of sentiment-driven information cascades in these vulnerable markets.

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