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Literature review on equity investment decision

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Abstract
Investor sentiment significantly influences market reactions and individual investment decisions. Evidence shows that individual investors often rely on sentiment-driven cues rather than purely fundamental information, which leads to systematic biases and deviations from rational decision-making. Understanding the determinants of investor sentiment and how it shapes investment behaviour is essential for academics and practitioners seeking to evaluate market efficiency and investor performance.
This paper critically reviews empirical literature examining how emotional factors such as fear, mood variation, and external influences (e.g., weather or social events) impact investor behaviour and stock investment decisions. The review shows that emotions interact with cognitive biases to influence market movements and investor actions, often leading to herding effects and suboptimal investment choices.
Through a systematic review of current literature, this study identifies key psychological and cognitive biases including herd behaviour, overconfidence, risk aversion, and emotional influences that significantly shape investment decisions in the Indian stock market. The findings underscore the importance of incorporating behavioural finance principles into stock market analysis and investment strategy formulation.

Keywords: Investor sentiment, Behavioral finance, Emotional influences, Cognitive biases, Investment decisions

Introduction

The study of equity investment decisions has evolved from traditional finance theories that assume rational investor behaviour to behavioural finance frameworks that recognise the influence of psychological factors on investment choices. Traditional models such as the Efficient Market Hypothesis and Modern Portfolio Theory emphasise rational evaluation of risk and return. However, empirical research suggests that investor decisions are frequently shaped by cognitive biases, sentiments, emotions, and social influences. Systematic reviews indicate that investor sentiment, overconfidence, herding behaviour, and emotional responses significantly affect investment decision outcomes, challenging the rational paradigm of decision making in financial markets. Such behavioural patterns have been documented across emerging and developed markets, emphasizing the need for integrated conceptual frameworks that account for both rational evaluations and behavioural influences in equity investment decisions.

Behavioural finance has become an essential lens for understanding the dynamics of equity investment decisions by highlighting how cognitive, emotional, and social factors influence investor choices. Unlike conventional financial theories that assume optimal decision-making, behavioural research reveals systematic deviations that arise from sentiments, heuristics, and biases. Reviews of literature on investor behaviour in stock markets demonstrate that psychological influences such as fear, overconfidence, risk perception, and social cues alter investment strategies and contribute to market inefficiencies. In emerging markets like India, where retail participation has surged, these behavioural elements are even more pronounced, making it imperative to study investment decisions from a behavioural perspective.

Literatures

Agrawal (2012) presented a detailed conceptual framework of various behavioral biases by explaining how they occur, their consequences and how they are interrelated with each other. He found that these biases cannot be studied in isolation; as they tend to originate from other biases and are likely to be active simultaneously.

As, it has been observed that despite of strong principles of Efficient Market Hypothesis, market experiences a number of anomalies that causes unnecessary volatility and results in irrational decision-making. These anomalies can be seen in the form of calendar effects, stock splits, contagious effect, investment after performance evaluation period, Tax benefits and many more. Ahmed (2006) [2] examined the Day-of the-week effect anomaly in the Indian equity market during the period of July 1997 to March 2006. He found the Day-of-the-Week effect anomaly in both the movements of BSE and NSE indices.

Chandra (2011) [3] confirmed the presence of calendar effects in SENSEX for the period April 1998 to March 2008. He used daily logarithmic market returns to test the calendar effects and found an evidence of monthly pattern of market returns in the index. He was of the view that mean returns in early days of a month were higher than remaining days of the same month and also found that stock returns 88 in different segments of a month were significantly different from each other. On the other hand,

Cheung (2010) [4] has undertaken three historical bubbles - Japanese bubble in the year 1990, Internet bubble in 2000 and subprime mortgage crisis in 2008 to investigate whether market is suffering from bipolar disorder or not. For this, he developed a Market Mood Model (MMM)and found that it has six phases- Normal, Hypomania, Mania, Moderate Depression, Major depression and normal and each phase

has its respective characteristics that explains the behavior of market for that particular phase. He also considered interest rate policy as the major factor for handling asset bubbles and consumer prices. His model explains that stock market bubbles are the result of market fluctuations as it suffers from bipolar disorder. Finally, he was of the opinion that by sustaining interest rate policy, it is possible to stabilize asset and consumer prices.

Findings

Behavioral biases are interconnected and do not operate independently, as they originate from and reinforce one another, making investor decision-making a complex psychological process.Despite the theoretical assumptions of the Efficient Market Hypothesis (EMH), empirical evidence suggests the persistent existence of market anomalies, which contribute to market inefficiencies and irrational equity investment decisions.

Calendar anomalies, such as the Day-of-the-Week effect and monthly return patterns, are evident in the Indian equity market, indicating predictable variations in stock returns (Ahmed, 2006 [2]. The presence of these anomalies leads to unnecessary market volatility, influencing investor behaviour and encouraging speculative trading rather than rational investment analysis.Empirical findings from Indian stock indices (BSE and NSE)demonstrate that stock returns differ significantly across different trading days and periods within a month, challenging the notion of random price movements.

Market behaviour is influenced by collective investor psychology, where emotional responses contribute to market bubbles and crashes rather than fundamental economic factors alone.The Market Mood Model (MMM)identifies distinct psychological phases of the market, each associated with specific behavioural characteristics that influence equity investment decisions.Asset price bubbles and market crashes are the result of extreme emotional states of investors, reflecting manic or depressive market conditions rather than rational expectations.Interest rate policy plays a critical role in moderating market sentiment, suggesting that macroeconomic interventions can help stabilize equity markets and reduce behavioural excesses.

Conclusion

The reviewed literature provides compelling evidence that equity investment decisions in the stock market are significantly influenced by behavioural and psychological factors rather than being solely driven by rational evaluation of information. The findings clearly demonstrate that behavioural biases are interrelated and operate simultaneously, reinforcing irrational decision-making among investors. This interconnected nature of biases challenges the traditional assumption that investor behaviour can be explained in isolation through individual cognitive errors.

Furthermore, the persistence of market anomalies such as the Day-of-the-Week effect and calendar effects in the Indian equity market highlights the limitations of the Efficient Market Hypothesis. Empirical evidence from studies on the BSE and NSE confirms that stock returns exhibit systematic patterns across trading days and monthly periods, leading to predictable return behaviour and unnecessary market volatility. These anomalies not only undermine market efficiency but also influence investors to engage in speculative and sentiment-driven trading strategies.

The literature also underscores the role of collective investor psychology in shaping market movements, particularly during periods of extreme optimism or pessimism. The Market Mood Model illustrates that stock markets undergo distinct emotional phases, which contribute to the formation of asset price bubbles and subsequent market corrections. Such behavioural fluctuations indicate that market dynamics are closely tied to emotional states rather than purely economic fundamentals.

Overall, the findings reinforce the relevance of behavioural finance in explaining equity investment decisions and market behaviour. Recognising the impact of behavioural biases, market anomalies, and emotional cycles is essential for investors, policymakers, and financial institutions seeking to promote rational investment practices and market stability. The conclusion emphasizes the need for integrated behavioural frameworks and effective policy interventions to mitigate irrational investor behaviour and enhance the efficiency of equity markets.

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