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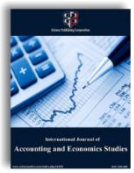

Examining The Influence of Behavioural Finance on Institutional Investors and Their Financial Decisions Making in Financial Markets

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Abstract

Traditional economic theory suggests that investment is all about making smart choices that maximize one's well-being. Behavioral finance takes issue with this by showing how investors can be impacted by cognitive, emotional, and psychological biases. This research focuses on institutional investors and the role of behavioral finance in affecting their investment decisions. This study seeks to evaluate the effect of some of the most important cognitive biases, such as mental accounting, herding, overconfidence, and prospect theory, on investment choices-es made by dominant institutions.

Institutional investors have vast amounts of data and analytics; however, their possible biases can lower market efficiency and create financial issues. This article synthesizes recent studies of institutional investment behavioral biases and their impact on portfolio management, market volatility, and regulatory policy. The study seeks to improve decision-making models, risk management practices, and regulatory policy that foster rational investing behavior by discerning these biases. The results inform regulators, investment managers, and financial professionals how to lessen the negative impacts of behavioral biases in institutional investment strategies.

Keywords: *Behavioural Finance; Institutional Investors; Prospect Theory; Overconfidence Bias; Herding Behaviour; Anchoring Heuristic; Mental Accounting; Investment Decision-Making; Financial Market Stability; Regulatory Frameworks.*

1. Introduction

Conventional economic theory within finance has assumed that investors are rational decision-makers who constantly strive to maximize utility and make the best investment choices. Yet the situation is much more complex since psychological, emotional, and cognitive factors, which cannot be captured in the rational model, regularly influence the way that investors make choices (Waweru et al., 2008). Behavioral finance is a new field of finance that attempts to justify why investors' investment decisions do not always align with what mainstream economics predicts they should. Research in behavioral finance shows that investors' choice depends a lot on their emotions, heuristics, and biases (Vaid & Chaudhary, 2022). Herd behavior, bad choices, and incorrect calculations caused by these behavioral biases may result in market inefficiencies and increased volatility. To improve understanding of financial market behavior and maximize investment returns, both investors, financial institutions, and lawmakers need to appreciate the role of behavioral finance in investment choices (Polychronakis, 2023).

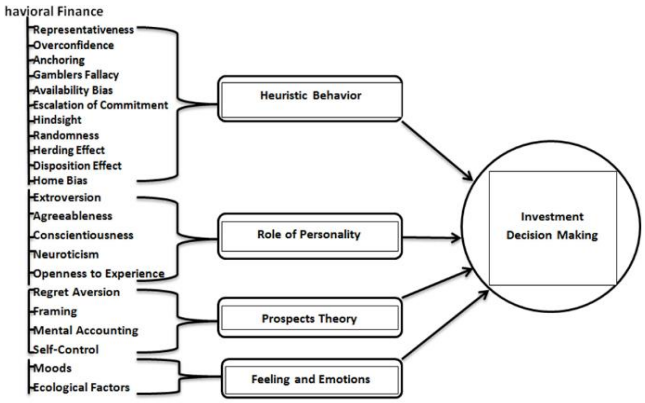

Fig. 1: Influence of Behavioural Finance on Institutional Investors and Their Financial Decision-Making.

Source:https://www.semanticscholar.org/paper/Behavioral-Finance-Biases-in-Investment-Decision-Sattar-Toseef/64d768aa10cc6dbc158cbd4952012d9146eaee9a/figure/0.

This research is greatly relevant to many people working in the finance industry.

A knowledge of the intricacies of behavioral finance has the capability to empower individual investors to make wiser and more logical choices, resulting in better investment outcomes and continuous financial security (Mohammadi, 2024). This data can aid financial institutions and counselors in understanding client behavior and making necessary adjustments in investment plans. The policymakers can use this research to further the stability and effectiveness of financial market regulations by using the principles of behavioral finance. This research explains the role of behavioral finance, thus complementing financial theory and encouraging a better understanding of investment choice-making in real situations (Peteros & Maleyeff, 2013). Behavioral finance is a branch of finance that examines the influence of emotions and cognition on money-making decisions. Traditional finance theoretical models presume that investors act rationally and make money-making decisions to maximize their financial returns. Behavioral finance examines the influence of emotions, cognitive constraints, and biases on irrational investment decisions. This research aims to explore the impact of behavioral finance in investment choice-making through a study of its central principles and empirical evidence. (Costa et al., 2019).

1) Prospect Theory and Loss Aversion: Prospect theory was developed by Kahneman and Tversky, which states that individuals fear losses more than they value gains. That is, investors tend to be cautious or even irrational when they lose ₹100 compared to when they gain ₹100. The theory is that individuals have divergent perspectives regarding winning and losing, and that they are loss averse, being more sensitive to losses than to equivalent gains. This loss aversion induces investors to take excessive risk in an effort not to lose money or hold onto investments that are not making them money, even when it does not make sense to do so. Understanding prospect theory explains why risk-averse behavior is so common in investment choices. (Kahneman & Tversky, 2013).
2) The Overconfidence Bias in Investment Decision Making: Many investors suffer from the overconfidence bias. When individuals believe they are superior to what they are and are smarter than they are, they trade more and are more aggressive. This study by Odean examines how overconfident investors tend to hold their winning positions for too long while quickly selling off their losing ones, and subsequently, they incur mediocre investment performance. This study proves the negative effect of overconfidence on investing outcomes. (Howard, 2012).
3) Collective Behaviour and Market Speculations: Herding behavior refers to the situation where investors move in groups rather than view an issue individually. This research provides a model of herding behavior, whereby individuals imitate others under the assumption that other people have better information. Herding can cause market bubbles and eventual crashes, as shown by numerous past financial crises (Banerji et al., 2023). Anchoring means that people give too much weight to the first number or piece of information they see, even if it's not accurate. For example, if a stock was once valued at ₹500, investors may think it's still worth close to that, even when fundamentals suggest otherwise. The anchoring and adjustment heuristic elucidates how individuals often rely on the initial piece of information encountered (the anchor) to inform their judgments, regardless of the information's arbitrary or irrelevant nature to the decision being made. This article analyzes the impact of anchoring on investment decision-making and how investors' perceptions of stock values may be swayed by extraneous influences.
4) Mental Accounting and Framing Effects: "Mental accounting" describes how people often divide up their money into different "mental accounts," each with its own set of rules for how to spend it. Investors' perceptions of money change based on its source and purpose, according to this study by Richard Thaler, which investigates the impact of mental accounting on investment choices. In addition, the impact of framing effects on investment decisions is discussed. These effects happen when the presentation of information influences decision-making. (Waweru et al., 2008).

Behavioural finance has significantly enhanced our understanding of the impact of psychological biases and heuristics on financial decision-making. The research analysis demonstrates that investors exhibit behavioural biases and do not consistently make rational selections. By recognizing these biases and their implications, investors and financial professionals can develop strategies to improve decision-making and optimize investment outcomes. Incorporating insights from behavioral finance into financial planning and investment strategies can improve the effectiveness and resilience of portfolio management (Kanapickienė et al., 2024).

Beyhaghi and Hawley (2013) assert that traditional financial theories, like the "Efficient Market Hypothesis (EMH)" and "Modern Portfolio Theory (MPT), have historically served as a foundation for the examination of financial decision-making. Fama's (1970) definition of the EMH says that asset prices reflect all relevant information at any given time, which shows that financial markets are efficient. If this idea is right, then smart investors can't count on getting returns that are higher than average without taking on a lot more risk. (Gunawan, 2024). Markowitz (1952) also came up with MPT, which puts a lot of value on diversification as a technique to get the most return with the least risk. It presupposes that investors are rational decision-makers who base their selections on expected value and risk aversion (Blommestein, 1998).

A growing corpus of empirical research contests these assumptions by illustrating that investors frequently deviate from rational decision-making due to psychological and cognitive influences. The advent of behavioral finance resolves these inconsistencies by synthesizing concepts from psychology and economics (Waweru et al., 2008).. Daniel Kahneman and Amos Tversky, among others, came up with the idea. Behavioral finance looks at how cognitive biases, heuristics, and emotions affect judgments about investments.

This increasingly extensive literature argues that investors, not just private ones but institutional investors as well, are not always rational but are subject to systematic biases affecting financial decision-making (Bhanu, 2023).

2. Institutional Investors and Their Role in Financial Markets

Institutional investors, such as “mutual funds, pension funds, insurance companies, hedge funds, and sovereign wealth funds, are key players in financial markets”. Together, they oversee trillions of dollars of assets, have substantial influence on market trends, liquidity, and asset prices, and support the stability of financial systems at large. Their investment patterns, buying and selling behavior, and attitudes towards risk influence financial markets by altering the stock prices, volatility, and capital inflows (Davis, 2003).

Institutional investors are believed to be more rational than individual investors since they enjoy superior access to cutting-edge research laboratories, superior data analytics, and professional financial advisers. Institutional investors are also bound by fiduciary responsibilities, which urge them to act in the best interests of their shareholders or clients. Institutional investors have recently been found not to be totally immune from behavioural biases. Cognitive biases such as "overconfidence, herding, loss aversion, and anchoring are prone to bias their decision-making towards non-optimal investment decisions, excessive risk-taking, and market inefficiencies (Davis, 1996). For instance, herding of institutional investors can fuel market bubbles and crashes, like in the 2008 Global Financial Crisis. Similarly, overconfidence bias could cause fund managers to overestimate their ability to predict the direction of the market, resulting in excessive trading and heightened costs of transactions. Identification of such behavioural biases is important since institutional investor choices have far-reaching effects on market stability, asset pricing, and investor sentiment (Huang, 2015).

For example, institution herding among investors can create market booms and busts, as in the 2008 Global Financial Crisis.

Hedge funds, investment banks, and pension funds collectively accumulated additional exposure to mortgage-backed securities during this period in the face of warning signs about deteriorating loan quality. Empirical evidence from Shiller (2008) and Gorton (2010) suggests that institutional herding amplified systemic risk because funds followed each other to shift into highly leveraged positions, creating an asset bubble that eventually burst when defaults intensified. Similarly, the overconfidence of fund managers and rating agencies led portfolio risks to be underestimated, as attested by the widespread mispricing of collateralized debt obligations (CDOs). Following the crisis, portfolio analysis revealed that efforts at diversification were hampered by asset classes that were interconnected. This revealed how susceptible institutional investors could be to cognitive biases. The studies point out that behavioral biases are not limited to individual investors but have a systemic influence on macro-level institutional decision-making..

Table 1: Behavioural Biases, Their Impact on Institutional Investors, and Mitigation Strategies

Bias	Description (Simplified)	Impact on Institutional Investors	Possible Mitigation Strategies
Prospect Theory & Loss Aversion	Fear of losses outweighs the value of equivalent gains. Example: investors avoid selling at a loss.	Leads to holding unprofitable assets too long and excessive risk-taking to recover losses.	Incorporate stop-loss rules, emphasize long-term performance over short-term losses.
Overconfidence Bias	Overestimating knowledge and forecasting ability.	Excessive trading, underestimating risks, and high transaction costs.	Bias-awareness training for fund managers; performance audits; decision-making checklists.
Herding Behaviour	Following the crowd instead of independent analysis.	Amplifies bubbles and crashes (e.g., 2008 crisis).	Diversification rules; regulatory oversight of large asset flows; AI-based detection of correlated trading.
Anchoring	Relying too much on first information (e.g., initial stock price).	Mispricing assets, poor adjustment to new information.	Use scenario analysis; update valuations regularly, and independent peer review of assumptions.
Mental Accounting	Treating money differently based on its source or category.	Inefficient capital allocation; separating portfolios irrationally.	Holistic portfolio evaluation; investor education on fungibility of funds.
Framing Effects	Decisions change based on how choices are presented.	Poor risk evaluation, depending on the report wording or presentation.	Standardized risk disclosures; emphasize downside as well as upside scenarios.

3. Rationale and Research Scope

It is important to analyze the impact of behavioural finance on institutional investors for several reasons:

1) Institutional investors are in control of financial markets and can shape investment patterns, corporate governance, and overall market efficiency. If their investment choices are based on cognitive biases, the impact goes beyond specific companies to the overall economy.
2) Even with access to rich financial data and analytical capabilities, institutional investors are not immune to behavioural biases, which may give rise to systemic risks, misallocation of capital, and poor portfolio performance.
3) Institutional investor behavioural tendencies can lead to financial instability, as evidenced in past market plunges and economic recessions. It is important to understand these tendencies to formulate risk-containment strategies and regulatory policies that induce more rational investment behaviour.
4) Although behavioural finance studies have predominantly centered on individual investors, the influence of behavioural biases on institutional investors is not well understood. Due to their distinct role, access to resources, and fiduciary responsibilities, it is essential to examine how psychological influences determine their financial choices.
5) Behavioural finance insights can be used to guide policy suggestions and enhance investment decision-making models. By recognizing the behavioural traps that influence institutional investors, financial experts and regulators can create more effective decision-making models, risk management, and governance policies that make markets more efficient.

This review will synthesize current literature from peer-reviewed journals, empirical research, and theoretical frameworks, mainly from Scopus, Web of Science, and other top financial databases. Through synthesizing major findings, this research will add to the scholarly literature on the nexus between behavioural finance and institutional investment approaches, as well as provide practical suggestions for policymakers, investment managers, and financial experts. Along the way, this paper hopes to contribute to the enhanced comprehension of how behavioral biases drive institutional investor behavior, assess risks of such biases, and propose evidence-based interventions to facilitate more rational financial decision-making.

3.1. Aim and objective of the study

This research aims to perform a systematic literature review on the impact of behavioral finance on institutional investors' financial decision-making. This research aims to bridge a gap in the literature by bringing together theoretical perspectives and empirical evidence to shed light on the persistence of behavioral biases among institutional investors even when they have expert information and analytical tools at their disposal. The ultimate objective is to institutionalize investment more rationally and efficiently by enhancing its decision-making mechanisms, risk management strategies, and regulatory systems.

3.2. Objective of the study

To explore the impact of behavioural finance on institutional investors and their financial decision-making in financial markets.

4. Review of Literature

To comprehend the influence of psychological elements on financial decision-making, one should examine the behavioral finance literature. While proponents of rational finance assert that investors behave logically, empirical studies indicate that emotional factors and cognitive biases significantly influence investor behavior. A plethora of research has examined the impact of behavioral biases on investment decisions, encompassing heuristics, overconfidence, herding, loss aversion, and prospect theory.. This section seeks to elucidate the evolving comprehension of behavioral finance and its significance for both institutional and individual investors by examining pivotal findings from several research studies.

In 2008, Waweru et al. investigated how institutional investors at the Nairobi Stock Exchange made investment decisions influenced by behavioral finance and investor psychology. Using data from 23 institutional investors, the study found that the NSE's institutional investors were impacted by several behavioral factors when making decisions. These factors included: overconfidence, anchoring, representationality, loss aversion, regret aversion, availability bias, and mental accounting. Also, when making investment decisions, these people would often act like sheep and look at what other institutional investors were doing in the market.

Assumptions given in business school courses on investment decision-making are not consistently upheld by the investment decision-makers. Despite evidence to the contrary, long-standing theories maintain that investors act rationally. Consequently, students in introductory investment courses frequently overlook the impact of investor behavior on investment outcomes. To address this disparity and improve investment results, it is important to incorporate behavioral finance and data-driven decision-making into investment decision-makers' early education. Instead of being revolutionary, this change would be seen as progressive (Peteros & Maleyeff, 2013).

In 2017, Almansour and Arabyat performed research into the impact of psychological variables on investment risk-taking behavior. This study aimed to identify the ways in which cognitive biases such as familiarity bias, self-attribution, market sentiment, heuristics, and herding could influence financial investing decisions. The results of this study show that self-attribution bias, market circumstances, herding, heuristics, and prospect theory all have a role in how investors take risks. Financial investment risk-taking is unaffected by the familiarity bias.

Using the behavioural finance paradigm as a lens, Ahmad et al. (2017) set out to investigate institutional investors' biases in terms of both theory and evidence. It mainly looks at studies that deal with institutional investors' biases in global investment management. To gather and incorporate evidence regarding the behavioral biases of institutional investors, a literature review is carried out. The following findings are derived from the survey and analysis. The field of behavioural finance has failed to address the underlying theory of investors' illogical actions. Heuristics and biases in behavior are complex and ever-changing. Third, it's important to draw on ideas from psychology, sociology, and biology to understand the roots, reasons, and effects of behavioral biases.

Investigating the effect of behavioral biases on investing decision-making under uncertain settings is the goal of the study by Sattar et al. (2020. Investment decision-making, the dependent variable, is complex and involves more than simply one's own resources. With an emphasis on the role of behavioral finance in the decision-making process, this study investigates the ways in which rational and irrational human conduct affect investment options. According to the results, investment choices were affected by behavioral biases. Heuristic behaviors, rather than prospects and personality qualities, are the most important factors in investment decision-making, according to empirical data.

Although the current study targets institutional investors, behavioural biases are just as salient among retail investors. For example, herding behaviour has been shown in cryptocurrency markets, where individual investors tend to follow social media cues over fundamentals, with the result of wild price oscillations. Conversely, loss aversion affects small equity investors to keep falling stocks for longer than is best, reflecting bias present in institutional settings. Significantly, retail and institutional dynamics often cross over: institutional investors can strengthen retail-led trends (e.g., meme stocks), while retail fervour can increase institutional herding.

Traditional finance emerged in the '50s and '60s and quickly won over the academic community. However, cracks appeared in the traditional paradigm of finance due to growing market inefficiencies and the innate irrationality of human behavior, which presented difficulties and criticism. Behavioural finance emerged as a new field that draws on research techniques from cognitive psychology, behavioural economics, and traditional finance to address the shortcomings of conventional wisdom. It offers theories grounded in psychology to explain stock market anomalies, with an emphasis on how individual investors' less-than-ideal actions influence the market. The purpose of this research by Sharma et al. (2021 is to investigate the psychological impact on people's decision-making processes, to assess the merits of classical financial theories, and to explore how behavioral finance has contributed to the field by adding behavioral components to current theories.

Ogunlusi and Obademi's (2021) research looked at how certain investment banks' decision-makers utilise behavioural finance. Consistent with and supporting previous research, the empirical results showed that behavioral finance is positively correlated with investment decisions. The results show that heuristics have a strong negative correlation with investment decisions, prospect theory has a significant correlation with individual investment decisions, and there is a significant relationship between the two. There is a strong and unfavorable relationship between prospect theory and investment choices.

More recent research in 2025 builds further on these findings. Klein and Roberts (2025) point out that regulatory models increasingly include consideration of behaviour, referencing the efficacy of mandatory disclosure of cognitive risk indicators. Likewise, Zhou et al. (2025) illustrate that algorithmic trading systems are also subject to behavioural distortions since they tend to mimic human herding dynamics through data feedback loops. These research works support the premise that traditional rational models and behavioural models coexist, under which rational assumptions apply under some stable conditions, and behavioural biases prevail during uncertainty and market stress.

There are studies, for instance, indicating that biases decrease with the experience of investors and their exposure to analytical tools, suggesting that experience offsets behavioural distortions (e.g., Davis, 2003). However, findings from more recent research (e.g., Mohammadi, 2024) contend that the existence of biases among professionals is so entrenched, particularly in highly pressured situations. In addition, behavioural propensities can be more intense within emerging economies, where there is limited information and poor regulations that amplify herding, as opposed to advanced economies with institutional controls that help to somewhat temper such influences. Such contradictions indicate that behavioural finance cannot be everywhere dominant, but context-sensitive and combined with institutional and market structures.

5. Research Methodology

This research applied a systematic review approach to analyze the influence of behavioral finance on financial decision-making among institutional investors in the markets.

As a review article, the research used mostly secondary literature that includes peer-reviewed journals, empirical studies, and theoretical frameworks retrieved from databases such as Scopus, Web of Science, and other major financial libraries. The research incorporated an in-depth synthesis of literature on behavioral biases, such as prospect theory, overconfidence bias, herding, anchoring, mental accounting, and framing effects, to examine their effect on investment decisions in institutions. The research was conducted qualitatively with the aim of critically analyzing past research findings, specifying gaps in research, and determining the implications of behavioural finance towards market efficiency, asset pricing, and risk management. The review further reviewed studies identifying deviations of institutional investors from the classic rationality models, even though they have access to advanced financial instruments and data analytics. Drawing from theoretical lenses and empirical evidence, this paper hopes to contribute to the current literature on behavioural finance and provide insights to policymakers, financial analysts, and investment managers regarding how cognitive biases can be lessened and decision-making in institutional investment can be improved.

6. Discussion

The study of behavioural finance in institutional investment choices underscores the powerful influence that psychological heuristics and biases exert in financial markets. Whereas classic finance theory, such as the "Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT)" hypothesize that investors act rationally given information, empirical evidence increasingly shows that investors, including institutional investors, are susceptible to cognitive biases. The research summarized demonstrates that psychological factors, such as overconfidence, herding, anchoring, and loss aversion, play a dominant role in determining investment choices, resulting in market inefficiencies and financial instability. The institutional investor plays an especially important role because their massive investments determine market trends, liquidity, and asset pricing. Despite being exposed to sophisticated financial instruments and professional wisdom, institutional investors do not lack behavioural biases that will lead them into excessive risk exposure, resource misallocation, as well as exposure to speculative manias.

In implementing these recommendations, there is a need for precise implementation strategies. Firstly, fund manager training programs need to be institutionalized and emphasize awareness of cognitive biases like overconfidence and herding, backed by case-based simulations. Second, regulators would implement monitoring tools for algorithmic trading, subjecting automated systems to stress-testing for behavioural threats, and with aligned disclosure of assumptions built into the systems. Third, investment policy would incorporate behavioural nudges like default diversification requirements, framing disclosure highlighting downside risks, and cognitive reminders for long-term horizons. These steps would operationalize behavioural finance knowledge into effective safeguards within financial systems.

Evidently, the conclusion based on studies done by Waweru et al. (2008), Almansour and Arabyat (2017), and Ahmad et al. (2017) agrees with the fact that institutional investors display similar behaviour biases as do ordinary investors and affect their choice procedures. In addition, the research of Sattar et al. (2020) emphasizes the value of incorporating behavioural knowledge into investment strategy to overcome irrational financial decisions. Policymakers, investment advisors, and investors must understand such biases to frame policies that mitigate their negative effects. Another empirical illustration is taken from the 2008 Global Financial Crisis, where herding by institutions and overconfidence were widely documented. Institutional herding and overconfidence led large pension funds and mutual funds to buy large quantities of mortgage-backed securities, anticipating a tough market while underestimating the systemic risk. Gorton (2010) contends that the crisis in the housing market accelerated losses because of the standard operating practices by institutions. The case illustrates that even experienced investors who have access to advanced analytics can fall prey to deleterious practices. This teaches the importance of putting regulations in place and educating people on the right conduct. The integration of principles of behavioral finance into financial education, investment advisory services, and regulatory structures can enhance the decision-making process by considering psychological factors influencing financial behavior.

This research enhances the understanding of investment decision-making in financial markets and has implications for improving risk management, legislation, and investment planning to foster increased financial stability and market efficiency.

7. Conclusion

This research advances the literature by reconciling practice and theory, demonstrating how behavioral finance enriches conventional rational investment models. A Bias-Mitigation Framework for Institutional Investors has been established, incorporating awareness training, regulatory safeguards, and technological supervision to alleviate systemic hazards. The study offers insights for policymakers, fund managers, and scholars seeking to establish more stable and resilient markets by establishing practical strategies alongside theoretical understanding.

In terms of policy, a number of mechanisms can institutionalize behavioural protection. First, compulsory disclosure of behavioural risk in institutional reports would increase transparency and accountability. Second, regulatory audits for herding-induced systemic risks would enable oversight authorities to pre-empt market-wide exposures. Third, AI-based monitoring technology to detect abnormal trading patterns in real time could be used to raise alarms, allowing regulators and firms to react in advance. Jointly, these steps would enhance the robustness of financial markets to behavioural distortions.

By applying behavioural finance findings to financial planning, investment management, and policy formation, investors and financial professionals can counter the adverse effects of cognitive biases and enhance decision-making processes. Future research should continue

to explore the interplay between behavioral finance and institutional investing by utilizing experimental frameworks and real-time market data to better understand investor behavior. Experimental methods and real-time market data can be used to identify and address behavioral biases, resulting in more resilient and efficient financial markets, which in turn will ultimately benefit individual and institutional investors.

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