The Impact of Behavioural Biases on Investment Decision Making: Reference to Individual Investors of Colombo Stock Exchange

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Abstract

The classical decision theory, model portfolio theory, and capital asset pricing model of traditional finance assume that investors are rational in their investment decision making. However, they failed to explain behavioural biases in the stock market. Investors suffer from cognitive and emotional biases and act irrationally. The prospect theory, heuristics, bounded rationality and framing reveal that humans behave irrationally in their investment decisions. Most of the previous studies concern about institutional investors' biases in Sri Lanka. However, conflicting findings and narrow approach to the study variables of previous studies in Sri Lanka justify the present study. The impact of behavioural biases on individual investment decisions was explored in this research. The independent variables are overconfidence, loss aversion and herding while investment decision making is the dependent variable. A structured questionnaire based on five-point Likert scale was distributed to the sample of 200 individual investors who are active in the Colombo Stock Exchange using a convenient sampling method. The results show thatoverconfidence has a positive and significant impact on investment decision-making. As a result of the uncertainty of information and volatility of the Sri Lankan stock market, herding and loss aversion have a significantly positive impact on investment decision- making. The study has made a theoretical contribution of overconfidence and herding forheuristic theory and loss aversion for prospect theory. The study has implications to individual investors to get a better understanding of own behaviour, policy makers to examine biases prior policy changes, build sustainable investment management practices, and financial advisors to improve their proficiency.

Keywords: Behavioural finance, herding, investment decision making, loss aversion, overconfidence