

CHAPTER 2

Does Sentiment and Behavioural Biases Shape Equity Decisions? An Investigation in India

Shivika Saxena, Sarah Fatima Sheikh** and Swati Kashinath Patekar****

ABSTRACT

This study examines the extent to which investor sentiment and behavioural biases influence equity investment decisions in India. While rational frameworks such as the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT) assume logical decision-making, real-world practices reveal significant deviations. Key behavioural patterns such as herd mentality, overconfidence, loss aversion, recency bias, and confirmation bias are investigated. Data is drawn exclusively from secondary sources, including market sentiment indices, financial reports, and news headlines. Quantitative sentiment analysis will map emotional trends against actual equity choices, including Systematic Investment Plan (SIP) participation and stock selection. To structure the research approach, the TCCM (Theory–Context–Characteristics–Methodology) framework will be presented and modified to align with the study’s specific focus on behavioural finance in the Indian context. The study contributes to financial literacy by helping individuals recognize cognitive distortions and adopt strategies that promote rational, disciplined, and informed investment decisions.

Keywords: Behavioural Finance, Investor Sentiment, Equity Investments, India.

1.0 Introduction

The classical theory of finance presupposes that investors are rational and that they process information in an objective manner in order to maximize utility. Efficient Market Hypothesis (Fama, 1970), the Modern Portfolio Theory (Markowitz, 1952) and others are models that assume that markets are effective at incorporating all the information in them to diversify by means of optimal risk-return.

**Corresponding author; Student, NICMAR Business School, NICMAR University, Pune, Maharashtra, India (E-mail: p2367005@student.nicmar.ac.in)*

***Student, NICMAR Business School, NICMAR University, Pune, Maharashtra, India (E-mail: p2367007@student.nicmar.ac.in)*

****Student, NICMAR Business School, NICMAR University, Pune, Maharashtra, India (E-mail: p2201004@student.nicmar.ac.in)*

Nevertheless, empirical deviations such as bubbles, volatility and abnormal trading undermine this rationality leading to the development of behavioural finance which sees the application of psychology to explain investor decision in conditions of uncertainty (Barberis and Thaler, 2003). As the equity market of India is fast growing, retail investors are becoming highly dependent on sentiment based biased decisions in the face of easy access to information particularly among the youthful investors in the age group of 22-30, which is high growth segment.

1.1 Rationale of the study

The investments made in India by retail have been on the rise, with the inflows of mutual funds SIP amounting to over 20,000 crore each month (AMFI, 2024). Although this helps to create long-term capitals, most investors often rebalance portfolios, prematurely cancel SIPs and trade on sentiment, which has a detrimental impact on returns. Social media and digital trading increase the speed of the spread of information, noise, herd behaviour, and FOMO and exacerbate behavioural biases. In spite of its topicality, there is a lack of empirical studies of Indian socio-economic and cultural backgrounds. Since India is a country of demographics, financial literacy and risk culture, it is critical that it should be analyzed contextually. This paper employs sentiment-based behavioural finance to establish systematic patterns, which are used in educating the investor, advising, policymaking, and financial products that match the behaviour of the user.

1.2 Problem statement

Indian retail equity investors often do not act rationally in regard to investment behaviour despite the improved accessibility to financial information, analysis tools and professional advice. Herding, overconfidence, loss aversion, recency bias, and confirmation bias are psychological biases that play a major role in investment decisions, which usually lead to inappropriate results, such as overtrading, poor time to trade in the market, holding on to a loss, and poor performance of a portfolio.

In addition, no formal, data-based constructs exist to objectively quantify the investor sentiment and bias in behaviours in the Indian equity market. This restricts the potential of investors, advisors and institutions to integrate behavioural knowledge into evidence-based portfolio building and risk management decisions.

This study seeks to answer the following questions:

- What are the main ways that thinking errors affect how individual investors in India make choices about stock investments?
- How does what people read, hear, and feel about the market change when they invest and what stocks they pick?

- Do things like age, job, income, and culture change how thinking errors show up or how much they matter?
- Can we use numbers and models to understand how investors usually act, and can this understanding assist us in making better financial plans and tools?

2.0 Methodology of the Literature Review

2.1 Purpose and approach

This review aims to examine how sentiment and biases influence investment decisions in the Indian stock market. We are not just going to summarize what has already been done. Instead, we want to link different ideas together. We will demonstrate how these ideas have evolved, where they align, and what questions remain unanswered. We have used a qualitative approach, looking for common themes, similar to how grounded theory is used in social science. The point is to understand patterns of thought from different sources, like research papers and reports published from 2014 to 2025, rather than to measure things. We have chosen studies based on three main points:

- How ideas about behavioural finance have grown and been used in India.
- Which biases have the biggest impact on Indian investors.
- What an overall investor sentiment, whether positive or negative, affects what happens in the market and how people invest.

2.2 Source identification and selection

To ensure a detailed and reliable study, the review included scholarly articles, working papers, and reports from 2014 to 2025. Key databases like ScienceDirect, Emerald Insight, JSTOR, ResearchGate, and Google Scholar were searched using keywords and Boolean operators. The search terms included:

- “Behavioural finance AND India”
- “Investor sentiment AND stock market India”
- “Behavioural biases AND equity investment”
- “SIP behaviour AND risk perception”
- “Herding bias OR overconfidence OR loss aversion India”

2.3 Method of Analysis

The review organized the findings into five major themes using interpretative analysis and thematic coding:

1. Behavioral Finance’s Development in India
2. Market Behavior and Investor Sentiment

3. Biases in Behavior Improving Investment Choices
4. Sentiment algorithms and digitalization
5. Institutional Leveraging and Debiasing Techniques.

Each subject incorporates direct quotations to strengthen the integrity of the writers' voices throughout the grouping while synthesising empirical information. To understand investor behavior, quantitative approaches like Principal Component Analysis (PCA), Structural Equation Model (SEM), and GARCH volatility models were interpreted qualitatively.

2.4 Maintaining credibility

Cross-verifying results from other studies increased the validity of insights. For instance, Yadav and Chakraborty (2022) and Sardar and Khan (2024) independently verified the sentiment indices' ability to predict NIFTY returns, and Dave and Vaid (2025) and Gabhane et al. (2023) identified similar behavioural patterns among Indian investors, such as herding and overconfidence.

When appropriate, actual quotes are used in this chapter to maintain authenticity. For example, "overconfidence and loss aversion jointly explain more than 60% of poor trading timing among retail investors," according to Dave and Vaid (2025). In a similar vein, Gupta and Goswami (2024) observed that "social media and peer influence dominate analytical reasoning in equity investment choices among young investors." These quotes shed light on the real-life experiences that underlie statistics.

2.5 Moral aspects

Using APA 7th edition referencing, all concepts, quotes, and data have been correctly acknowledged to their original authors. This review adheres to academic integrity and transparency by not reproducing any data without attribution.

3.0 Thematic Literature Review

3.1 Behavioural finance's development in the Indian setting

The constant interventions in the market caused academics and practitioners to start doubting these rational assumptions. The Harshad Mehta scam 1992 was an investment swindle just as much as it was an eye-opener that the elements of trust, media hype and blind optimism could get their way with rationality. In a similar manner, the Global Financial Crisis of 2008 caught the Indian investors unawares when they thought that India had not been hit by the shocks of the rest of the world due to high economic growth. The raw psychology of investors panic selling became more familiar to people because of more recent events like the

COVID-19 crash of 2020. These have led to the emergence of the belief that markets are operating more by emotion than they do by economic data.

This action can be summarized in what Robert Shiller terms as “irrational exuberance” (2000), whereby the collective optimism drives the prices of securities too high in areas that they are not worth. This irrationality tends to boil over in Indian markets when there is a bull run, or a boom in the issue of a new stock, or a sector rally, and it is being fuelled by the financial media and social media. Investors tend to run with the pack instead of doing a logical analysis of risks involved. This fact was also supported by Prosad (2014) who stated that overconfidence and herding behaviour continue to dominate the price changes in Indian equities, as a result of the social aspect of Indian investment.

As behavioural finance developed, Indian scholars started moving away towards the application of Western theories and instead focus on contextualizing the Indian investor behaviour in the context of Indian socio- economic conditions. In India, few monetary choices are made without consulting family members, peers, cultural risk aversion, and financial enlightenment. Sharma and Firoz (2020) established and clarified that the biases of herding, optimism, and disposition effect are involved in various stages of investment decision making. A behavioural analysis of 400 retail investors revealed that even seasoned investors tend to employ illogical behaviour when the markets become turbulent as experience and awareness are overwhelmed by emotion. The recent research supports this idea. Gabhane et al. (2023) have discovered that portfolio decisions are influenced by overconfidence, anchoring, and loss aversion. Most investors hold on to declining stocks, anchor on previous prices or over rate predictive ability thus experiencing poor results.

Behavioral finance has become a widely used paradigm of thinking about Indian markets, as it does not recognize investors as rational actors but as human beings who cope with uncertainty, hope, fear, and ambition.

3.2 Investor sentiment and market behaviour

Investor sentiment is the general attitude or mood of investors in finance. This emotional appeal that is either negative or positive can push the market regardless of economic indicators. It is a manifestation of the combination of feelings, opinions and expectations that influence the perception of the information and reaction of the investors to the market changes. Investors often remain very optimistic thus purchasing more, which increases the prices. The increasing prices support optimism and it becomes a self-generating cycle. On the other hand, pessimism may cause massive sell-offs causing sharp price movements and swings on the market.

A study conducted by Baker and Wurgler (2006) established that investor sentiment greatly affects the stock market activity. Their research revealed that sentiment is a good

predictor of stock returns especially in smaller, risky, non-dividend-paying companies that are hard to value on the basis of conventional financial metrics. Such a conclusion is particularly topical in terms of such markets as India, where there is a high level of information dispensability and speculative transactions.

Building on the previous article, Yadav and Chakraborty (2022) created an Indian investor sentiment index that is based on seven market indicators and ten years of information. Their findings revealed that the short-term trend in NIFTY returns is attributed to a significant extent to sentiment, meaning the fluctuations in stock price are usually influenced by sentiment change, as opposed to by economic fundamentals.

In their study with the help of Vector Autoregression (VAR) and Granger causality models, Sardar and Khan (2024) discovered that the sentiment of the investors Granger-cause the returns in India, which implies that investor sentiment can predict the future changes in prices. Haritha and Rishad (2020) also demonstrated that sentiment as a predictor makes the market volatile hence the noise-trader hypothesis.

Online platforms and social media are creating herding based on sentiment particularly on the part of young online traders in India. Comprehensively, empirical studies affirm that the investor sentiment is decisive in determining prices, the trading volume and volatility in the Indian stock market.

3.3 Behavioural biases influencing investment decisions in India

The Indian stock market is a unique behavioural environment where the decision of the investors is influenced not only by the data but also by the psychological preconceptions. Among them the most notable are overconfidence, herding, anchoring, loss aversion, and confirmation bias.

Belief in a greater predictive power is a major contributor to the trading behavior in India, and the term is referred to as overconfidence. *Dave and Vaid (2025)* discovered that overconfidence and loss aversion jointly contribute to more than 60 percent of overtrading, under-diversification, and overtrading risk tolerance. Likewise, *Rizwana and Zaidi (2024)* also noted that the frequent use of the app and real-time notification increases overconfidence and representativeness bias to provide an illusion of ability that drives speculative trading and consumes returns through transaction costs.

The loss aversion also affects investor behavior, and people do not want to incur losses. *Kahneman and Tversky (1979)* demonstrated that more intensity of losses is experienced than equal gains. On the Indian scenario, *Gautam, Raman, and Kumar (2021)* observed that investors tend to hold the loss-making stocks in hope of rebound, which strengthens the disposition effect and leads to poor performance of their portfolio.

The other common pattern is Herding behaviour, *Sharma and Firoz (2020)* noted how it affects the security selection, and *Prosad (2014)* affirmed its presence both in the bull and bear markets. This trend has been enhanced by digital platforms and social media. *Chauhan and Patel (2024)* and *Chavhan and Waiker (2025)* discovered that risk-taking is taken up by the media discourse and group feeling, and it is frequently subject to independent fundamentals.

Decision making is also distorted by anchoring and confirmation bias. *Khaleel and Dhakshayani (2024)* found out that investors anchored to the previous prices and selectively process information. These trends indicate that the Indian investors are boundedly rational and behave within the predictable psychological boundaries, which aligns with the systematic irrationality theory by *Thaler (2016)*.

3.4 Digitalisation, retail participation, and sentiment amplification

Indian financial markets have experienced a significant revolution within the last ten years through technology which has made the investment process easier and more convenient to millions of people who can only have a mobile phone and internet access. More than 60 million new demat accounts were registered between 2020 and 2025 alone to make India one of the most rapidly expanding retail investor markets in the world (NSE, 2025).

This fast financialization has enabled the young professionals, students, first time earners and investors in smaller towns. Technological ease has however increased behavioural biases too. The aspect of making emotional decisions has gained more ground in place of analytical reasoning as investing turns out to be faster and more convenient. According to *Gupta and Goswami (2024)*, urban investors tend to place more importance on emotion, peer pressure, and a feeling of missing out (FOMO) rather than financial literacy, and social validation and viral stories can become more important than fundamental in stock selection.

This behaviour has been strengthened by gamification which involves price alerts, rewards, and visual progress indicators, which are available in the online trading platforms and which have erased the distinction between investing and entertainment. Media reporting also serves to boost the frenzy in the market, establishing feedback processes where escalating prices contribute to optimism which then leads to further price hikes, but followed by periods of excessive corrections during crunch periods.

Studies also point at geographical and demographical differences. *Kumar and Jha (2024)* discovered that overconfidence was more eminent in some areas whereas herding was the dominant characteristic in the urban places. The younger investors react more to short-term news compared to the older participants (*Rizwana and Zaidi, 2024*). All in all,

digitalization did not wipe off bias but only exacerbated it, so emotion by the investor became a major factor in influencing market activity in India.

3.5 Institutional interventions and debiasing strategies

Behavioural biases are not unique to naïve investors but are the normal working of human processes. Fear, overconfidence, regret, and the desire to be socially validated influence people no matter how experienced and sophisticated they are. However, it is not realistic of expecting investors to be all-rational in circumstances of uncertainty and the flow of information. Consequently, behavioural finance has moved to the behaviour of correcting biases to systems that can aid in making better decisions despite their existence.

One of the most valuable contributions in this field is Nudge Theory by Thaler and Sunstein (2008) that suggests that people need to be steered towards making a better choice but free will at the same time should be preserved. Instead of unwilling the rationality, investment settings can be arranged in a way that detersives the impulsive behaviour and can promote the longer-term thinking.

Francis (2023) underlined the checklist reviewing, rules-based rebalancing, and educating the investors as the methods to curb the emotional behavior. These strategies bring some order in the decision-making process without seeking to transform investor personalities. Also, Gotte (2023) discovered that the emotional reactions of mutual fund investors following a Systematic Investment Plan (SIPs) are more stable, since automation decreases the sensitivity to shifts in the market. Automation in such instances is an emotional controller. Increasing focus is also on institutional support. Rao and Tandan (2025) provided the support of behavioural financial education and social sentiment dashboard to warn investors in times of undue fear or excessive euphoria. Chavhan and Waiker (2025) advocated real-time sentiment analysis to be used in detecting bubbles or panic early.

Although this is an important initiative by SEBI (2024) in financial literacy, their coverage is still smaller than emotional stories on social media. Regulators, fintech platforms, educators, and intermediaries should hence work together in debiasing. It is necessary to not only be aware of these things but have structural and technological nudges in place to translate knowledge into action.

4.0 Insights and Synthesis of Literature

The literature synthesis based on the identified themes can be interpreted as the same and repeating tendencies of Indian investor behaviour. All in all, the studies have shown that the trends in the Indian equity market are not influenced by economic fundamentals, and firm specific information alone, but also due to psychological factors like sentiment, perception, and social imitation.

First, investor sentiment turns out to be a strong short-run force of the market. Empirical research indicates that the variation in the mood of investors is a major predictor of short-term returns and stock volatility. Yadav and Chakraborty (2022) illustrate that sentiment indices are a good explanation of NIFTY returns especially when sentiment is strong. Equally, Sardar and Khan (2024) determine that market returns are Granger caused by investor sentiment, which implies that emotional impetuses are usually the antecedents of price changes. All these findings have a cumulative negative impact on the assumption of complete informational efficiency in Indian markets.

Second, behavioural biases are more likely to cluster up and support each other as opposed to acting independently. Loss aversion, herding and overconfidence often interact in a way that gives rise to cycles of emotional decision-making. Investor fear of loss combined with their overestimation of their predictive capabilities and the tendency to engage in crowd behaviour are a key point in studies by Gautam et al. (2021) and Sharma and Firoz (2020), which shows that investors act poorly due to incorrect timing, poor diversification, and poor responsiveness to market signals.

Third, digitalisation has enhanced behavioural biases instead of eradicating it. In as much as technology has minimized transaction costs and created access, it has also enhanced emotive-driven trading. This study by Rizwana and Zaidi (2024) and Chauhan and Patel (2024) confirms that mobile trading applications, real-time alerts, and social media spur more overtrading, speculation, and the feeling of missing out, among digitally-active retail investors.

Fourth, the investor behaviour is influenced by socio-demographic differences. According to Kumar and Jha (2024), urban investors tend to be overconfident and have a higher trading frequency than rural and semi-urban investors, and the latter are more loss-averse and socially impacted. Age, location, digital exposure and financial literacy have major influence on decision making in situations of uncertainty.

Lastly, the literature proposes that successful debiasing should involve education together with behavioural design. Research by Francis (2023) and Gote (2023) demonstrates that disciplined investing is promoted by behavioural nudges, automatic investment strategies like SIPs, and rule-based rebalancing. In general, the Indian equity market does not come out as a system that is entirely rational, but a system where optimism and anxiety can be seen as interacting constantly.

5.0 Conclusion

Although there has been an advancement in the study of behavioural finance in India, there are a number of gaps that can encourage this research. To begin with, not many studies

have been done to study both of these together to see how individual psychology influences market behavior; most research has either studied individual biases, through surveys (e.g., regression, SEM), or studied market-level sentiment, through time-series (PCA, VAR, GARCH). Second, little is known about young investors (22-30 years) and their utilization of online platforms, social media, and real-time information. Third, biases are not adequately investigated in terms of regional and cultural effects, which restricts the possibility of generalization. Fourth, sentiment and behavioural measures with portfolio performance AI-ready datasets are not available. Lastly, there is still a limited practical use of behavioural insights. This research will fill these gaps by incorporating investor sentiment and behavioural biases to young Investors in India, who are retailers.

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