

Case Study: Behavioural Finance and Investment Decision-Making

Introduction:

Behavioural finance is an area of study that explores the psychological and emotional factors that influence investor decision-making. It is a field that has gained increasing attention in recent years, as academics and practitioners have sought to better understand why individuals make the investment decisions they do, and how they can improve their decision-making processes.

Case Study:

Meet Sarah, a successful businesswoman in her late 30s. Sarah has been saving diligently for years, and she has built up a considerable investment portfolio. Recently, she decided to take a closer look at her investment strategy and consider making some changes.

As Sarah begins to review her portfolio, she realizes that she has a significant portion of her money invested in a few high-risk stocks. These stocks have performed well in recent years, and Sarah has made a good return on her investment. However, as she looks closer at the companies behind these stocks, she realizes that they are all in the same industry and are vulnerable to the same economic and regulatory risks.

Sarah understands the importance of diversification, and she knows that she should be spreading her investments across different asset classes and industries. However, she finds herself hesitating to sell her high-risk stocks. She has become emotionally attached to these stocks, and she feels that they are a part of her identity as an investor.

This is a classic example of the psychological biases that can influence investment decision-making. Sarah is exhibiting a bias known as "loss aversion," which refers to the tendency to prefer avoiding losses over acquiring gains. Sarah is so attached to her high-risk stocks that she is willing to take on additional risk and forgo potential gains in other areas of her portfolio, just to avoid the feeling of loss that she would experience if she were to sell these stocks.

Another bias that may be influencing Sarah's decision-making is "overconfidence." Overconfidence refers to the tendency to overestimate one's abilities and knowledge. Sarah may believe that she has special insight into the stocks she has invested in and that she can outperform the market by holding onto them. However, research has shown that the majority of individual investors do not consistently outperform the market over the long-term, and that overconfidence can lead to suboptimal investment decisions.

Conclusion:

Behavioural finance provides valuable insights into the psychological biases that can influence investment decision-making. By recognizing and understanding these biases, investors like Sarah can make better-informed decisions and improve the performance of their portfolios. In Sarah's case, she may benefit from speaking with a financial advisor or seeking out resources on diversification and risk management to help her overcome her emotional attachment to her high-risk stocks and make more rational investment decisions.