This thesis seeks to find the influence of certain identified behavioral finance concepts (or biases) namely representative bias, overconfidence bias, regret aversion, mental accounting and herd behavior on decision making process of individual investors in Indian Stock Market. Traditional economic theories contend that an investor’s assessment of financial risk as a purely an intellectual affair- requiring the calculation of asset returns probabilities, and optimum allocation of capital- carried on for the most part rationally. This explanation of rational behavior is considered incomplete because it fails to recognize the aversion of risk which investors possess in varying degrees. It shows that the emotions of greed and fear too get involved in the decision making process. The financial crisis of 2007-2008 is a clear proof of the irrational behavior of investment banks and consumers of sub prime mortgages in the US. The bank’s greed in the creation of sub-prime mortgage bonds and the resulting abnormally high leveraging of capital was a clear proof of their irrationality in decision making. Logic and caution were abandoned. It became quite evident that Harry Markowitz’s “Modern Portfolio Theory” which considers investors as rational, needs major modification.

The studies show that individuals’ behavior is different from what modern financial theories draw for rational human behavior. Harry Markowitz formulated the first “Modern Portfolio Theory” which was the first systematic financial theory. The theory evaluates return and risk of assets, using mean, standard deviation and variances. A normative pattern was generated by evaluating the performance of security and forecasting of returns. But contrary to the expectation, there was a huge gap between the available return and actually received return. The gap found is due to the abnormal events that create maximum harm in the financial markets, named as “market anomalies”. Cognitive errors and extreme emotions were found to be the major causes for market anomalies which generate bad investment decisions. Hence an alternative approach named behavioral finance was developed, which incorporates psychological and sociological issues in investigating market anomalies and defining portfolio.
Prospect theory of Daniel Kahneman suggests that individuals make decisions based on potential losses and gains relative to a reference point rather than the final outcome of the decisions. The prospect theory is developed to model real-life choices and incorporate an explanation of the inconsistencies and seeming irrationality that more accurately describe human decision making under risk as compared to expected utility theory. Human brains process information using shortcuts and emotional filters even in investment decisions. This thesis is an attempt to explain how the psychological dimensions influence investment decisions of individual investors. It is worth exploring whether the field of psychology helps investor to make more reasonable investment decisions.

The data was collected from the state of Kerala. As the population is found to be very large, snow ball sampling techniques was adopted for data collection. Salaried employees with high risk profile were taken as sample for the study. The collected data was compiled and grouped according to the geographical spread of Kerala.

Various statistical tools and test tools were used for checking data consistency and also hypothesis. Using multivariate analysis the various behavioral factors and investment strategies of investors of Kerala were extracted. Further the extracted variables were analyzed using demographic and socio economic back ground of investors. However the study supports that, among the Kerala investors there exists no gender difference. Change in the role of female investors in decision making is one of the notable findings of the study. Behavioral portfolio model was developed using metric variables such as representative bias, overconfidence, regret aversion, mental accounting, herd behavior, financial statement analysis, corporate social regulations, technical chart analysis and opinion analyst.

This research will provide a very valuable input for the portfolio managers to develop an optimal portfolio for their clients. The study also is useful to the retail investors for taking better financial decisions. Understanding the investor behavior will improvise the performance of the portfolio by reducing the bias and judgmental errors.