International Journal of Scientific Research and Modern Technology (IJSRMT) ijsrmt.com
Volume 4, Issue 8, 2025
DOI: https://doi.org/10.38124/ijsrmt.v4i8.751

Behavioral Economics in Strategic Investment Decision-Making: A Critical Review

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Publication Date 2025/09/10

ABSTRACT

Behavioral economics has nowadays become an important framework to understand decision-making processes underlying investment strategies. The present critical review hereby assesses how behavioral economics impacts the strategic decision of investment by highlighting psychological biases and heuristics caused by which the investor allocates capital. While traditional economic model of decision-making depicts investment decisions as being rational, behavioral economics states that cognitive biases like overconfidence, aversion to loss, and anchoring can affect them. Through review of previous works on investor behavior, the study looks into how these biases affect individual and institutional investors toward making subpar investment choices and creating inefficiencies in the market. This study further considers how behavioral economics can be employed to improve investment decision strategies and better financial outcomes. This work proceeds to expand the understanding of the psychological factors that influence strategic investment decisions and sets a foundation for future in-depth research into behavioral finance.

Keywords: *Behavioral Economics, Investment Decisions, Cognitive Biases, Decision-Making, Strategic Investment, Investor Behavior, Behavioral Finance, Market Inefficiencies, Psychological Factors, Heuristics.*

I. INTRODUCTION

Investment decision-making processes have always fallen under great interest in economics and finance. Theoretical economic thought has generally believed investors to act in a rational manner: to maximize utility and returns through objective and informed decisions. However, with the last couple of decades on the road to growth, the behavioral finance field has proven to be strong in analyzing the intricacies of investment decision processes in the real world. Behavioral economics draws from both psychological and economic perspectives in explaining how investors tend to deviate from rational conduct, emphasizing cognitive biases, emotional factors, and heuristics in the decision process.

The germinal and obvious notion of behavioral economics postulates that individuals do not sometimes decide in their best financial interest. Instead, they are influenced by the contamination of a plethora of biases to-orange their grasp of risk, reward, and investment opportunities. Such biases---and there are several types! will inculcate systematic errors in judgment, which are sometimes considered irrational or suboptimal by the strict economic point of view. Thus, memos of some forms of such cognitive biases and how they get to influence investment behavior to cause inefficient markets would include: overconfidence, loss aversion, anchoring, and framing.

In this review, the focus will be on some confusion of behavioral economics and its influence on the process of strategic investment decision-making, concentrating on the effect of cognitive biases and psychological factors on individual and institutional investors. In trying to achieve this, this paper intends to provide the knowledge and understanding of how the field of behavioral economics comes under the umbrella of investment strategy through the study of investor behavior and the process involved in decision-making. Furthermore, it also tries to shed some light on ways of countering or minimizing those biases with the intent of enhancing investment results.

The scope of this critical review is to synthesize existing research on the intersection of behavioral economics and strategic investment, to pinpoint decision-making implications raised by behavioral biases, and to propose areas of future inquiry. The aim of the study is to bridge the gap between the traditional economic models of investment decision-making and the behavioral aspects

Georgiou, E. (2025). Behavioral Economics in Strategic Investment Decision-Making: A Critical Review. *International Journal of Scientific Research and Modern Technology*, *4*(8), 109–117
https://doi.org/10.38124/ijsrmt.v4i8.751

that influence decisions in practical finance. This understanding is necessary for both investors and investment institutions seeking to better strategize investments and make informed choices in the highly complex and volatile market environment.

II. A REVIEW OF THE LITERATURE

Behavioral economics has changed the way we look at investment decision-making, opposing the traditional economic models that assume rationality. This section contains a literature review on behavioral economics with special reference to cognitive biases and heuristics generally involved in shaping investor behavior. It deals with the effects of psychological factors upon decision-making and illustrates how these biases cause departing from rational economic behavior and sometimes metamorphose into less-than-ideal investment strategies. The theories of behavioral economics such as Prospect Theory and the empirical evidence of the existence of biases in financial decision-making are also reviewed.

➢ *An Overview of Behavioral Economics*

The field of behavioral economics arose as a result of inadequacies with classical economic models that were sometimes unable to accommodate irrational behaviors observed in financial markets. Where traditional models say that individuals make decisions by logically evaluating available information and weighing possible outcomes, behavioral economics holds that decision making may be affected by emotions, social factors, or cognitive limitation (Kahneman & Tversky, 1979). The very basic idea is persons are those who do not act rationally and are sometimes in need of making choices that violate their best interest owing to psychological bias.

In theory, investors are not always driven by the desire to maximize wealth or utility, according to behavioral economics. They are influenced by myriad biasing forces that distort their perception of risk and reward. These biases are systematic and predictable and thus follow a repeatable pattern of behavior observed across many different groups of investors. For instance, some investors might hold on too long to losing investments (loss aversion), while others might grossly overestimate their ability to forecast market movements (overconfidence bias).

➢ *Common Behavioral Biases in Investment Decisions*

- *Several cognitive biases are often reported in investment decisions; some of the most important ones are:*

✓ *Overconfidence Bias:*

It happens when investors overestimate their knowledge or ability to predict certain outcomes in the future. As a result, this causes these investors to trade more, take more risk, and underestimate losses in case of adverse results. Several studies have found that overconfident investors trade more frequently and take excessive risks than would otherwise be considered rational (Barber & Odean, 2001).

✓ *Loss Aversion:*

According to Prospect Theory, loss aversion refers to an investor's tendency to feel the pain of losses more than the pleasure of gains. This bias causes investors to hold onto losing investments too long, wishing for prices to rise, rather than selling losses and putting their resources to better use (Kahneman & Tversky, 1979).

✓ *Anchoring:*

The investor sets or establishes on an initial piece of information when making a decision. An anchoring example would be where an investor set a price at which asset could have been bought in the past and thereby use that as an Heuristic reference point, irrespective of changed market conditions. Such instances yield poor decisions. The failure of investors to change their expectations when new information becomes available is in essence what was termed, "Anchoring" by Tversky & Kahneman (1974).

✓ *Herding:*

Herd behavior-endowed individuals follow the majority in many cases, forming bubbles or causing crash. In the financial markets, herding leads to irrational buying or selling as investors rush to join the bandwagon. They do so without necessarily truly grasping the value of the asset (Bikhchandani, Hirshleifer, & Welch, 1992).

✓ *Framing Effect*

The framing effect takes place when people make decisions on the basis of how information has been presented to them instead of the actual content of the information. Investors, for instance, may stand to perceive the same investment differently if it is framed as either a potential loss or a potential gain (Tversky & Kahneman, 1981).

➢ *Behavioral Finance Theories*

Theories of behavioral finance attempt to formalize the role of cognitive biases in investment decision-making. One of the major forces and the most influential theories in this domain is the Prospect Theory, developed by Kahneman and Tversky (1979). The theory states that people are not equally likely to accept potential gains and potential losses or that potential losses feel more painful than potential gains by the same amount. Such a theory explains why investors will, in the face of equivalent gains, most likely avoid losses and take the highly detrimental investment decision to either keep losing positions or risk nothing at all.

Another important one is Heuristic-Based Decision-Making; it says that people use mental shortcuts (also called heuristics) to make decisions quickly and with little cognition. Heuristics might serve in a person's favor in some conditions, thus they may act against one when such shortcuts are based on wrong assumptions or incomplete information. For example, the representativeness heuristic causes investors to approximate the likelihood of

occurrence of an event they really recognize based on Semblance, which often ignores relevant contextual factors (Tversky & Kahneman, 1974).

- *Empirical Evidence of Behavioral Biases in Investment Decisions*

Several studies have provided empirical evidence that there are behavioral biases in the investment decision-making process. For instance, Zahera and Bansal (2018) went through a systematic review of the investor bias literature and found overconfidence and loss aversion to be two of the most commonly encountered biases in investment decisions. Their review also suggested that these biases are common not only among individual but also among institutional investors, therefore challenging the assumption of rational behavior in financial markets.

Similarly, Sathya and Gayathiri (2024) attempted to assess the bearing of behavioral biases on investment decisions, concluding that biases like overconfidence and anchoring may lead to substandard investment outcomes. Their study attempts to highlight the significance of understanding these biases so as to develop more efficacious strategies for investing and improving the process of decision-making in finance.

Gabhane, Sharma, and Mukherjee (2023) study the effect of cognitive biases on investment decisions and find that such market forces due to biases such as herd behavior and overconfidence that warp investors' ability to judge risk and reward, hence intervention in market operation. The study points to the need for investors to be aware of these cognitive biases and address them in their decision making for investment purposes.

- *Behavioral Economics and Investment Strategy*

Behavioral economics has had great influence on the development of investment strategies. Some traditional methods of investing rely on the assumption that investors behave rationally, and the market is efficient. But behavioral economics argues that this cannot always be the case, as the decisions of investors are influenced by psychological forces. Such considerations have led to the development of behavioral investment strategies aimed at accommodating the cognitive biases that often influence decision-making.

Behavior strategies relate to recognizing and avoiding biases in the practice of investment. In contrast, investors may use behavioral portfolio theory (Shefrin & Statman 2000) that incorporates behavioral economic insights to build portfolio designs that are more closely aligned with their psychological preferences and tolerance for risk. By understanding how biases influence decisions, the investor could make better choices and steer clear of common predicaments such as chasing performance or selling out at wrong times.

As far as strategic investment decision-making is concerned, behavioral economics has thus emerged as a theoretical paradigm explaining why investors so often deviate from rational decision-making processes. This section further discusses the theoretical basis of behavioral economics and some empirical studies focused on cognitive biases in investment decisions. The influence of such biases on the decisions of both individual and institutional investors has, over recent years, become a burgeoning field of research, shedding new light on how behavioral factors shape financial markets.

- *The Role of Psychological Factors in Investment Decisions*

Psychological factors are key in shaping an investor's decision, which most of the time leads to the systematic errors that deviate from rational models commonly employed in finance. Behavioral economics tries to fill the gap thereof by focusing on cognitive and emotional biases affecting human decision-making.

Cognitive Dissonance is one psychological factor that influences investment behavior. A state of cognitive dissonance arises when investors feel uncomfortable holding conflicting beliefs or taking conflicting actions. For example, the investor feels uncomfortable holding onto an asset that is going down in value because their holding onto such an asset conflicts with their belief of their own investment ability. Eliminating embarrassment, they might make irrational decisions to hold onto it, even when it is far from their interests. Studies conducted by Fitzsimons, Chartrand, and Fitzsimons (2008) demonstrated that loss aversion is further perpetuated by the fact that cognitive dissonance makes investors hesitate to realize losses.

The impact of emotional factors on investor behavior is equally noticeable. According to the study of Barberis and Thaler (2003), emotional reactions of fear and greed may compel investors to generate decisions based on short-term movements in the market rather than long-term fundamentals. Emotional biases such as the disposition effect refer to an investor's tendency to sell assets that have gone up in value in order to realize gains, whereas they will hold onto assets that have gone down in value in an effort to avoid realizing losses. This bias stems from emotion-fueled reasoning to avoid regret and, in many cases, jeopardizes investor performance.

- *Investor Behavior and Market Inefficiencies*

Behavioral economics in fact questions the efficient market hypothesis (EMH), which states that all financial markets reflect whatever information is there and that investors apply rational decisions toward their investments. The EMH theorizes that investors behave rationally at all times, whereas behavioral economics suggests that market inefficiency is often on account of cognitive biases and emotional factors. Such inefficiency brings shallower anomalies at markets, like asset bubbles and crashes, that cannot be explained by traditional finance.

Shiller's work on speculative bubbles and market volatility plays a crucial role in explaining how behavior of investors may lead to market inefficiencies. Ablated parts of the acreage evaluate how herd behavior and

overstimulating reactions to perceived trends may build up market volatility and generate bubbles. These actions, coupled with a host of cognitive biases, may cause assets to be grossly priced, either over or under, when measured in terms of their actual economic value.

As mentioned, Herd Behavior is among the most discussed behavioral biases in the context of market inefficiency. Often, observers for investors tend to follow what everyone else is doing, especially when they are not sure what the proper course of action is. This group behavior gives rise to herding; hence investors tend to buy or sell according to the majority's behavior, rather than independent analysis. Greater instances of this phenomenon can be observed during financial crises, where mass panic or mass over-optimism impels an individual to make faulty decisions. Bikhchandani, Hirshleifer, and Welch (1992) documented the consequences of herd behavior in financial markets, thereby showing that such behavior may entail excessive volatility and mispricing.

- *Somebody Role into Overconfidence and Investment Decisions*

The overconfidence bias has been one of the most studied biases in the field of behavioral economics and has actually been shown to be central to investment decisions. The overconfident investor would tend to put too much faith in his judgment about the movement of prices in the markets while paying undue scant regard for the risks involved with an investment. This bias favors too much trading and risk-taking, which may be detrimental to investment performance in the longer run.

The negative influences of overconfidence in the stock market were highlighted by Barber and Odean back in 2001. Their study found that overconfident investors tend to trade more than their rational counterparts, generally lowering their returns because of transaction costs and poor judgment. In the view of the overconfident investor, superior information or skills justify greater risk-taking. This behavior is more common with retail investors, who may fall prey to the illusion of control-the belief that they can highly accurately forecast movements of the market.

With the self-attribution bias linked to overconfidence, investors would attribute their successes to skills and their failures to external factors like market conditions. The self-attribution bias thus pans out with overconfidence, as a negative distortion is cast on past performance, perpetuating that same overtrading and risk-taking in the future. Zahera and Bansal (2018) underline the need to understand overconfidence in investment decisions because the very effects of overconfidence are occasioned on portfolio management and the investment strategy.

- *Loss Aversion and Its Impact on Investor Behavior*

Loss aversion is another important idea in behavioral economics that govern investment decisions. According to Prospect Theory, much more pain is felt by individuals from the loss than pleasure from the equivalent gain (Kahneman & Tversky, 1979); hence, they resist selling off investments sunk into losses, unwilling to "realize" an actual loss. One particular implication of loss aversion is the Disposition Effect whereby investors are likely to sell winning investments while keeping losing ones in hopes that they will rise again.

The downside to loss aversion from a psychological point of view is that it tends to create an over-conservative approach to risk-taking. An investor may refuse to take risk even when profit potential copiously outweighs the risk involved. This restricts the diversification of the investment portfolio, limiting itself to a suboptimal approach from an asset-allocation point of view. Gabhane, Sharma, and Mukherjee (2023) shed light on the effects of loss aversion by stating that it acts against rational decision making and long-term considerations of investors, leading the latter to maintain suboptimal positions in their respective portfolios.

- *Cognitive Biases in Institutional Investment Decision-Making*

Though many behavioral economics studies have dwelt on individual investors, the institutional investors are also people prone to cognitive bias. In their 2024 study, Sathya and Gayathiri examined the behavioral biases in institutional investors' decision-making processes and found these strategies to be influenced by overconfidence, loss aversion, and a few others. These institutional investors are supposed to take objective and data-driven decisions; however, they seem to still possess certain psychological biases that compel them to take on risky strategies or to cling to underperforming assets.

Institutional investors are even prone to Herd Behavior when market booms or crises take hold. Since they manage huge amounts of capital, pressure mounts to meet performance benchmarks; so, institutional investors partake in herding, i.e., chasing market trends and overreacting to market sentiment. This increases the market inefficiencies and causes mispricing of assets.

- *Behavioral Economics in Strategic Investment Decision-Making*

By discerning how behavioral economics acts within investment decision-making, one can develop an effective framework for strategic investment. The conventional investment models shy away from the issues of psychological or emotional experiences that create behavior among investors. With behavioral economics coming into play, investors and financial institutions can create strategies well aligned with the psychological realities of decision-making.

Such a framework, for example, is Behavioral Portfolio Theory (Shefrin & Statman, 2000), which incorporates the premises of behavioral economics into management of portfolios. While modern portfolio theory assumes that investors try to maximize expected utility, behavioral portfolio theory posits that investors have multiple goals and that their investment decisions are

influenced by psychological factors such as the desire to avoid regret or to seek emotional comfort. By looking at these factors, investors can design portfolios that better translate into their actual preferences and risk tolerance.

III. METHODOLOGY

The present research work uses a qualitative literature-based method for a critical review of the relevant research on the behavioral economics specific issues in strategic investment decision-making. The methodology looks at synthesizing and analyzing key results from earlier studies that would allow a general image to be formed relating to cognitive biases and psychological factors influencing the investment behavior. Due to the nature of the research question, which aims at evaluating and interpreting the way behavioral economics affect investment decisions, the approach focuses mostly on performing analyses of extant literature and drawing relevant insights.

➢ *Literature Selection Criteria*

- *The included studies were selected based on the following criteria to ensure relevance and quality:*

✓ *Publication Type:*

Peer-reviewed journal articles, books, and conference papers from well-developed forums were considered to ensure that the selected studies had undergone serious academic scrutiny.

✓ *Focus on Behavioral Economics:*

The studies looking at the applications of behavioral economics in investment decision-making were selected. Hence, the research topics would include cognitive biases, heuristics, and other psychological elements affecting investor behavior.

✓ *Relevance to Strategic Investment:*

The studies must be relevant to strategic investment decisions, particularly concerning corporate finance, individual investment, and institutional decision-making.

✓ *Empirical and Theoretical:*

The empirical studies giving data, case studies, etc., and theoretical articles, comprising frameworks or models of behavioral finance, should be considered.

➢ *Data Collection Process*

The data-gathering process was treated with at select research articles published between 2014 and 2024. Relevant articles were searched for in databases such as JSTOR, Google Scholar, and ScienceDirect using the terms "behavioral economics and investment decisions," "cognitive biases in finance," "prospect theory and investment," and "behavioral finance theories." In total, 15 studies have been reviewed, emphasizing research on prominent common biases, including overconfidence, loss aversion, and anchoring, and their effects on investment results.

➢ *Analytical approach*

The analysis utilised thematic synthesis; the studies were grouped depending on common themes and psychological factors discussed. Major findings were drawn from every study and theoretical patterns were identified. Attention was paid to understanding the impact of different biases on various types of investors, from individual retail investors to huge institutional investors. Each theme was analyzed in depth to scrutinize its strategic implications for investment decision-making.

Also, a comparative dimension was utilized by juxtaposing behavioral economics findings with those of more traditional economic theories of investment, such as the EMH and MPT. This, in turn, was to bring into sharper focus the discrepancies that occur between the models of rational decision making and actual investor behavior in the real world and the clear difficulties investors face in trying to overcome their biases.

➢ *Limitations of the Methodology*

While being able to conduct a thorough review of the literature, the qualitative approach is constrained by the subjective nature of the synthesis process. The analysis depends on available peer-reviewed studies, thereby dismissing other important findings that may have come from industry reports or unpublished research. The focus in the study, however, is on behavioral economics relevant to investment decision-making, which might screen out the other factors impacting the investment strategy, such as macroeconomics or market trends.

In addition, the study mostly considers cognitive biases and does not delve into other behavioral economics aspects that also influence decisions, such as social and emotional considerations. This could be an area for future research, which may consider a wider spectrum of psychological and social elements that weigh in on investment behavior.

Table 1 Summary of Common Behavioral Biases in Investment Decisions

Behavioral Bias	Description	Impact on Investment Decisions
Overconfidence	Investors overestimate their ability to predict market outcomes.	Leads to excessive trading and taking on higher risk than rational.
Loss Aversion	Losses are felt more intensely than equivalent gains.	Causes investors to hold onto losing positions too long, avoiding selling at a loss.
Anchoring	Investors fixate on specific reference points (e.g., purchase price).	Results in decisions that ignore new market information or trends.

Herd Behavior	Investors follow the majority or trends without independent analysis.	Can contribute to market bubbles or crashes due to collective irrational behavior.
Framing Effect	Decisions are influenced by how information is presented.	Causes decisions based on how outcomes are framed, rather than on the actual risks and returns.

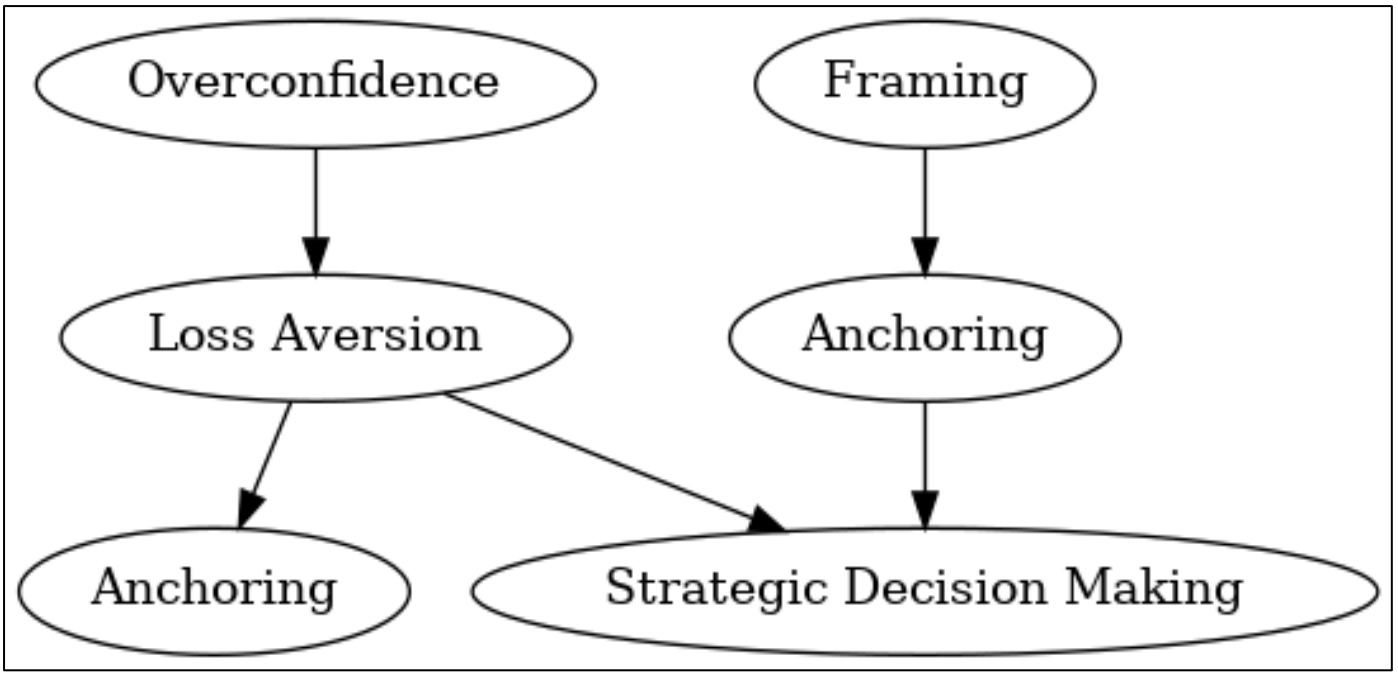

Fig 1 Behavioral Biases in Strategic Investment Decision-Making

IV. RESULTS

What follows constitutes the key results observed from the literature survey and further analysis on the behavioral economic perspective in strategic investment decision-making. Empirical findings and theoretical frameworks that studied the effect of cognitive bias on investor behavior were brought into consideration. The results are discussed with current theories concerning the main Biases-Key Biases-Turning Overconfidence to Loss Aversion, Anchoring, Herding, and Framing-as well as looking at how they affect investment decisions from individual and institutional perspectives.

- *Overconfidence Bias*

While earlier evidence confirms overconfidence as one of the factors leading to excessive trading and risk-taking, investors who consider themselves overconfident tend to overestimate their prediction power regarding market movement and trade excessively in comparison to what would be rational. According to Barber and Odean (2001), the overconfident investor has a mentality and acts as if they used superior knowledge or skill compared to other market participants, therefore, trading excessively and exposing themselves to more risk. It is primarily among retail investors that the highest occurrence of such behavior is seen: they do not necessarily know their biases, and along with those biases are the risks.

It is this overconfidence that leads to subpar investment performance as far as the investors themselves go, as well as the creation of huge volatility in markets. Overconfident investors trade excessively, thus distorting asset prices and reducing market efficiency. A study by Gabhane, Sharma, and Mukherjee in 2023 concludes that overconfidence can also be seen among institutional investors, thus arising with similar consequences, e.g., views of long-term strategies can be discarded in favor of short-term market predictions.

- *Loss Aversion and Disposition Effect*

Loss aversion, one of the major biases in investment decision-making, can make an investor experience a lot more pain from a loss than pleasure from an equivalent gain, often resulting in risk-aversion in decisions. According to Kahneman and Tversky (1979) in prospect theory, due to loss aversion, the Disposition Effect comes into play where investors are more inclined to sell assets that are winners to "lock in gains" and hesitate to sell assets that are losers in the hope that they will bounce back.

Implications are huge for portfolio managers because losing all too often means opportunity costs, as per Zahera and Bansal (2018). Loss-averse investors hold onto underperforming assets for too long and sell the outperforming one too early. This behavior hampers long-term performance and defeats efficient asset allocation.

- *Anchoring Bias*

Anchoring is a bias that arises when undecided investors attend too much weight on irrelevant or initial reference points in their valuation decisions. For example, an investor could anchor to the initial purchase price of the asset and resist the adjustment of expectations even when the market conditions change. Given that this type of bias causes investors sometimes to neglect any new information that ought to factor into their investment decisions, it leads to lost opportunities or poor timing.

Anchoring must have been witnessed all through financial decisions (Tversky and Kahneman 1974).

When investors anchor to certain price levels, they fail to take into account more relevant aspects, such as market trends, earnings reports, or macroeconomic conditions. This leads to poor investment decisions and market mispricing.

- *Herding Behavior*

The human behavior of investors to follow the crowd during market volatility is called Herd Behavior. If an investor sees a large crowd of people making a particular

investment decision, he will follow it, although the investor himself may not properly understand the decision. Bikhchandani, Hirshleifer, and Welch (1992) state that herd behavior-an even more powerful force-will make the markets enter into bubbles or go through crashes as meteoric social influence overrides sound evaluation on the basis of whom these investors make their irrational decisions.

Such biased behavior was clearly portrayed during financial crises, be it the dot-com bubble or the global financial crisis of 2008, with market participants almost unanimously overreacting to market signals and driving asset prices way overboard. According to Shiller (2000), herding tendencies cause an increase in market volatility and lead to inefficient asset prices.

- *Framing Effect*

If perception of an event by an investor is framed in one way, behavior may be different than if the same event were presented in another frame. Hereby, the cognitive bias occurs when decision-making opportunities depend on presentation whilst the underlying data are the same. An investor will act differently in a situation where an investment is told it gave a 20% "positive return" as compared to when it's told the same 20% gain was in fact a recovery from a loss.

By presenting different manners of solicitation, Tversky and Kahneman (1981) were able to show framing affects investors' choices. Consequently, both individual and institutional investor behavior are susceptible to being influenced by this effect, which causes them to act contrary to what is rational.

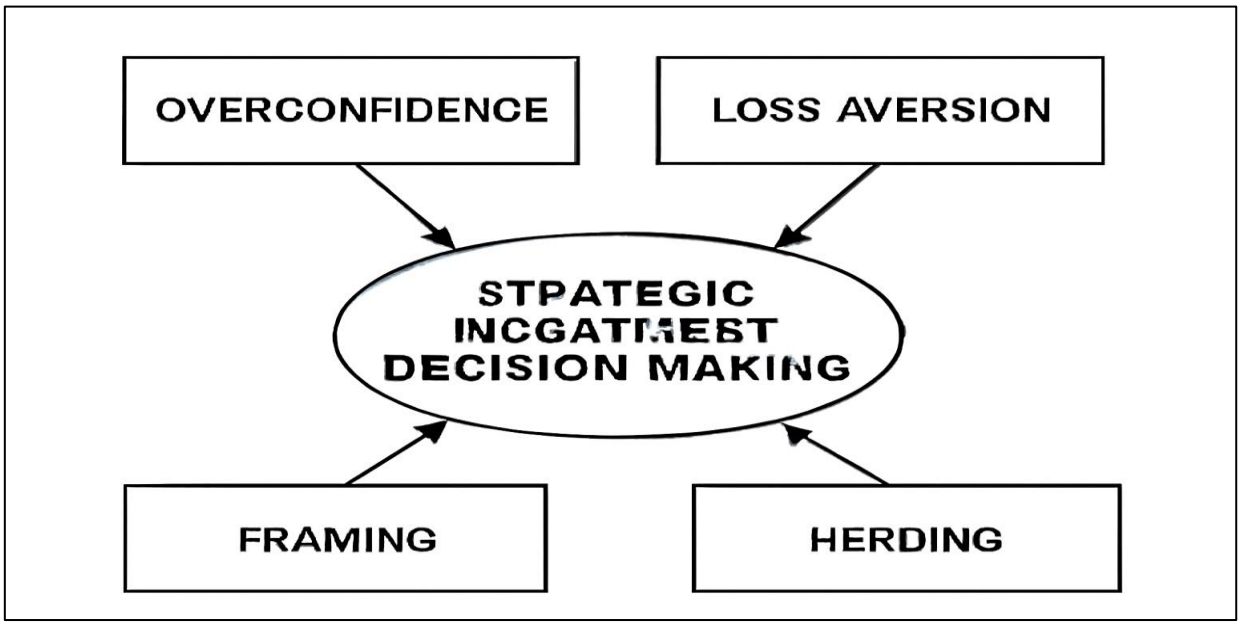

Fig 2 Behavioral Biases Impacting Strategic Investment Decision-Making

V. DISCUSSION

The findings from the literature review conclude that biases exert a far-reaching influence over investment decision-making at a strategic level. Traditional economic theories assume that there is rational decision-making; hence, behavioral economics offers a more realistic perspective on how investors make decisions in uncertain environments based on limited information. In this section, we will interpret the most relevant biases highlighted in the preceding sections and explore the implications for both individual and institutional investors.

- *Behavioral Biases Surrounding Investment Decision-Making*

The central biases discussed in this Review-Overconfidence, Loss Aversion, Anchoring, Herding, and Framing-greatly affect investors' approaches to strategic investment decisions. These cognitive biases influence individual investor choices; more importantly, they determine the larger market dynamics that institutional investors find themselves operating in.

- *Overconfidence Bias*

The implication of overconfidence in investment behavior cannot be understated. Overconfident investors, especially retail investors, tend to exaggerate their knowledge and decision-making abilities, thus taking unreasonable risks. This bias increases trading activities, engenders less portfolio diversification, and leads to market inefficiencies. The overconfidence is particularly rampant during bull markets, when any appreciation in asset prices induces investors to perceive themselves capable of foreseeing all moves into the future. Such a situation changes for the worse when the market undergoes a paradigm shift, as does the overconfidence. Indeed, these

investors take excessive risks but return less because they cannot see when the market and in fact the circular logic of their predictions are incorrect.

- *Loss Aversion and the Disposition Effect*

Loss aversion is probably one of the most powerful behavioral biases in investment decision making. Investors fear losses more than they value gains, and this trepidation may result in bizarre decisions. The Disposition Effect occurs when investors sell winners too soon, and in contrast, loss aversion makes investors hold onto losers too long. It amounts to an impediment to portfolio rebalancing so that portfolios become less than efficiently risk-return combinations. Zahera and Bansal (2018) confirmed that loss aversion is not just an individual trait but affects even institutional investors who refuse to cut their losses on assets performing badly for fear of realizing that loss. That behavior magnifies market inefficiencies because investors shy away from underperforming assets.

- *Anchoring*

Anchoring bias has a big influence on investment decisions, for it causes investors to weigh heavily upon the original reference that comes to mind, such as an initial purchase price of an asset. Therefore, there will not be any adjustment of expectations in accordance with changed market conditions. Anchoring would be tested most when information about past performance is communicated to investors to be used as a reference for future decisions. For example, an investor who bought in at $50 would anchor his expectations at that price and hold the stock even if its future prospects have gone downhill. Tversky and Kahneman (1974) also showed that anchoring leads to systematic errors in judgment in that investors do not adjust their mental models in light of new information and thus compromise investment decisions.

- *Herding Behavior*

Herding is another phenomenon of daily occurrence, more so during phases of market turmoil. In bull or bear markets, investors tend to follow the crowd simply because they think the majority must have made the right call. Yet such market behavior only increases market trends contributing to the forming of speculative bubbles or crashes. Bikhchandani et al. (1992) indicated that herd behavior could induce inefficiencies in markets where, through collective action, asset prices stray far from their fundamental values. Even institutional actors are not immune to herding. Quite the opposite; judging by the fact that their performance is benchmarked against market indices, they could be more susceptible to herding. The fear of looking bad in comparison with peers would incline them to go along with seemingly rational strategies, even when not fully grounded on analytical reasoning.

- *Framing Effect*

The framing effect occurs when investment choices are influenced by how information is presented. When confronted with identical information, investors may respond differently depending on whether it is cast in view of gains or losses. For example, one investment alternative may be treated differently because it is presented as a "70% chance of success" against a "30% chance of failure," even though the probabilities are exactly the same. Tversky and Kahneman (1981) showed that decision-making could be altered by framing through changing the perception of risks and rewards by investors. The framing effect brings significant ramifications for financial advisors and investment firms since investment products and risks can be framed to sway investor choice.

- *Implications for Investment Strategies*

Behavioral biases present considerable implications in investment decisions. Modern investment theories, like Modern Portfolio Theory (MPT), hold that investors behave rationally on the basis of a given set of information and that markets are efficient. The studies considered in this review, however, suggest that behavioral deviations bring about systematic errors in decision-making; hence, inefficiencies exist in individual and institutional investing alike. Investors neglecting these factors are prone to poor decision-making, which eventually leads to wealth erosion over time.

Due to changes in investor psychology, an investor must develop strategies to counter these effects. One way is through behavioral portfolio theory whereby an investor is assumed to be pursuing many objectives-inducing avoiding regret, emotional security, and financial success. Given these psychological considerations, portfolios can be designed in a way that is more consistent with investors' actual preferences and risk tolerance.

Particularly, they need to be aware of biases such as overconfidence and herding in their decision processes. Institutional investors may have more resources and information at their disposal than individual investors, but they are equally prone to cognitive biases. By instituting a structured decision-making process, incorporating diversification practices, and applying behavioral finance principles, institutional investors may avoid common errors and rationally make investment decisions.

- *Limitations and further research*

This review provided some decent conclusions into behavioral economics and investment decisions. There are many limitations to the approach taken in the literature review. Considering that it is based on existing literature, the review may never really do justice to the messy reality of actual investment decisions. Future studies could also engage in empirical work to study how behavioral biases affect investment outcomes in the real world, especially under diverse market situations.

Second, most of the review focused on the behavior of individual and institutional investors, but corporate decision-making can also get affected by behavioral biases. Future studies could analyze how corporate managers and boards of directors might be affected by overconfidence and loss aversion when making strategic decisions for corporate investments.

Finally, while it is important to note that biases must be duly noted, it is equally imperative to explore the

possible ways of overcoming these biases. In later studies, one can look into behavioral interventions, like nudges and decision aids, which help investors make more rational choices.

VI. CONCLUSION

This critical review sheds light on the important position behavioral economics holds in strategic investment decision-making. By exploring the cognitive biases affecting the behavior of investors, the study offers a comprehensive insight into the psychological factors triggering a drift away from rational decision-making. Investors are basically making decisions under the influence of the main biases of overconfidence, loss aversion, anchoring, herd behavior, and framing. Investors would then make investments that are far from optimal, and that would aggravate the inefficiencies of the market.

The findings discussed in this article challenge the traditional theories that are founded on concepts of rationality. They propose that psychology has a huge effect on investment strategies. Overconfidence causes investors to take excessive risks and trade more frequently than the rational models suggest. Due to loss aversion, investors tend to hold onto losing investments for too long, while anchoring biases deter them from adjusting their expectations to new information. Herding behavior exploits market trends, while the framing effect colors risk perception and reward valuation, culminating in impacted investment outcomes.

In improving investment strategies, it is vital to recognize these biases and how they influence decision-making. Behavioral finance provides useful insights into ways investors can reduce the influence of biases in their decision-making process. Behavioral portfolio theory, by including psychological assumptions into the investment strategy, enables practitioners to construct more efficient and personalized portfolios. Institutional investors should also be wary of biases that influence their decisions regarding performance benchmarking or market trend following.

Though this review has underscored the role biases play in investment decision-making, future research is necessary for the empirical testing of these results, especially across different market conditions. To enhance practical approaches to handling investment bias and solutions, it would prove beneficial to further explore behavioral interventions such as nudging or decision aids. Behavioral economics, therefore, provides a hopeful avenue in the understanding and enhancement of strategic investment decision-making.

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