The Journal of Economic Concerns | Volume 16, Number 1-2, 2025
ISSN Print : 2091-0541 | ISSN Online : 2705-4802 | Published by NECS, NEPAL
 DOI: https://doi.org/10.3126/tjec.v16i1-2.90185

Effect of Behavioral Anomalies in Investment Decisions of Investors in Nepalese Capital Market

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Abstract

The study examines the effect of behavioral anomalies on the investment decisions of Nepalese capital market investors using a closed-end questionnaire as primary data collection method. By analyzing a sample of 504 respondents, the research investigates the influence of six behavioral anomalies: overconfidence, representativeness, herding, anchoring, loss aversion and confirmation. The study has used both descriptive and casual comparative research designs. The findings reveal that investors are not rational, and there is a significant impact of different behavioral anomalies, particularly overconfidence, representativeness, herding, and anchoring on the investment decisions of investors in Nepal. These results suggest that behavioral anomalies can significantly affect the investment decisions of Nepalese investors and may have negative consequences for their investment outcomes. The study recommends that investors be aware of these anomalies and take measures to reduce the impact on decision-making.

Keywords: *Behavioral Anomalies, Investment Decisions, Capital Market, Overconfidence, Herding, Loss-Aversion*

1. Introduction

Traditional finance theories, especially the *Efficient Market Hypothesis (EMH)*, suggest that financial markets are rational, with investors making decisions based on available information and aiming to maximizing risk (Fama, 1970). This theory assumes that investors act rationally and market prices reflect all relevant information. However, the understanding of investor behavior has evolved from the *Classical Economic Theory*, which assumes rationality in economic agents, to *Modern Financial Behavior Theory*, which incorporates psychological factors and acknowledges that decision-making is often influenced by biases and emotions. According to Kahneman and Tversky (1979) and Shiller (2000) investors are often influenced by cognitive biases and emotional factors that lead to irrational decision-making, which results in market anomalies that cannot be explained by *Classical Economic Theory*. As a result, the significance of acknowledging investor irrationality has gained recognition in efforts to better understand individual investor behavior.

Behavioral anomalies, such as overconfidence, loss aversion, anchoring, and herd behavior, are now recognized as key factors that shape investor decisions and contribute to market inefficiencies (Barberis & Thaler, 2003). The use of behavioral bias could encourage investors to better decisions and help individuals to overcome individual investment behavior (Thaler & Benartzi, 2004). In emerging markets, behavioral anomalies were even more pronounced due to a combination of lower market liquidity, higher volatility, and greater influence of social and cultural factors (Statman, 2014).

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Several studies explored the role of behavioral biases in investment decisions in other emerging markets, such as those conducted by Islam et al. (2018) in Bangladesh, Abideen et al. (2023) in Pakistan, Padmavathy (2024) in India, Ige and Adebayo (2024) in South Africa.

Investor rationality has become a contentious issue, especially as traditional finance theories often fail to explain the anomalies observed in the stock market (Prosad et al., 2015). Werah (2006) identified that investors behavior at the Nairobi Securities Exchange (NSE) is often characterized by irrational tendencies, driven by behavioral anomalies such as herd behavior, regret aversion, overconfidence and anchoring. This indicates disconnect between rational decision-making and actual investor practices. Mbaluka (2008) further emphasized the significant impact of behavioral factors on individual investment decision-making process at NSE, highlighting the persistent challenges faced by investors in maintaining objectivity. Aduda and Muimi (2011) confirmed the prevalence of investor overreaction and under reaction at the NSE. Similarly, Baker and Wurgler (2007) demonstrated how investor sentiment influences stock prices and trading volumes, underscoring the susceptibility of markets to psychological biases such as overconfidence, representativeness, and conservatism. Thirikwa and Olweny (2015) added that market performance only modestly impacts the deviation of individual stock returns, with market capitalization and book- to- market value having limited influence. These finding collectively point to the problem of irrationality and behavioral biases as critical challenges in the context of investment decisions at the NSE. In Vietnam's stock market, heuristic biases, prospect factors, market trends, and herding behaviors significantly affect investment decision-making and performance, with the prospect factor having the strongest influence, followed by heuristic and herding behaviors (Cao et al., 2021). In the context of the South Asian studies Praveen and Siddiqui (2018) explained a positive effect of anchoring and a negative effect of overconfidence on investment. Madaan and Singh (2019) and Kulal (2022) declared that overconfidence and herding bias have significant positive impact on investment decision in India. Shah et al. (2018) expressed that investment decision is negatively influenced by overconfidence, representativeness, availability and anchoring in Pakistan and that financial literacy moderates the relationships between the overconfidence and investment decisions. Likewise, Krishnapriya (2023) investigated the impact of behavioral factors on investor decision-making, finding that investors in Kerala were primarily influenced by overconfidence bias, herd bias, availability of bias, mental accounting and regret aversion. Their study highlighted that, there is a significant relation between investment decisions and behavioral biases of respondents.

In the Nepalese context, Gyawali and Neupane (2021) explained that herding, overconfidence and loss aversion has significant relationship but other psychological factors such as anchoring, mental accounting and regret aversion have no significant relationship with individual investor investment decision in NEPSE. Moreover, both cognitive and emotion bias have significant relationship with individual investment decision in NEPSE. According to Dhakal and Lamsal (2023), overconfidence, herding, representativeness, anchoring, and confirmation biases have a significant relationship between the investment decisions of investors in Nepal.

Overall, Madaan and Singh (2019), Gyawali and Neupane (2021), Kulal (2022), Krishnapriya (2023), Dhakal and Lamsal (2023), Ige and Adebaya (2024) investigated overconfidence, herding, anchoring, and representativeness had significant influence of behavioral anomalies in investment decisions of investors in Nepalese capital market whereas, Shah et al. (2018) found insignificant influence of overconfidence, representativeness, and anchoring in investment decision. Similarly, Kulal (2022) and Parveen and Siddique (2018) had negative influence of overconfidence on investment decision.

In this backdrop, the main aim of this study is to fill the research gap by examining how behavioral anomalies impact investment decision of individual investors in the Nepalese capital market. Furthermore, this paper aims to contribute to a more holistic understanding of investment behavior that influence investors' investment decisions.

2. Literature Review

Traditional Finance

Traditional finance theories are built on the premise of investor rationality, market efficiency, and profit maximization. These frameworks assume that individuals make emphasized the significance of these assumptions by introducing the concept of "homo economics or economic man". A foundational principle of traditional finance is Expected Utility Theory, introduced by Von Neumann and Morgenstern (1944), which provides a mathematical basis for rational decision-making under uncertainty. Another critical pillar is the Modern Portfolio Theory, introduced by Harry Markowitz in 1952. This theory emphasized the importance of diversification and optimal portfolio construction. It was further advanced by Sharpe (1964) through the Capital Asset Pricing Model (CAPM), and later refined by Black (1972) which known as the Black CAPM or zero-beta CAPM.

Behavioral Finance

Behavioral finance emerged as critique of traditional finance, integrating insights from psychology to explain why and how investors deviate from rationality. It posits that human behavior, influenced by cognitive biases and emotional factors, often leads to irrational decision-making, which can result in market inefficiencies (Kahneman & Tversky, 1979). Behavioral finance, according to Nofsinger (2017), examines how individuals act in a financial context. It is the examination of the impact of psychology on businesses, financial markets, and financial decisions.

Cognitive Dissonance

Festinger et al. (1956) defined cognitive dissonance. They proposed that cognitive dissonance occurs when two concurrently held cognitions are inconsistent. Furthermore, cognitive dissonance creates an unpleasant feeling in people, so they try to reduce or avoid it by changing their beliefs/convictions. Many researchers investigate the psychological cycles that are a component of cognitive psychology in terms of decision making under abnormal conditions. Raiffa (1968) contributed significantly to the development of this body of literature. Moreover, the researcher examines "decisions under three approaches that give unique insight of individuals thought pattern and these approaches are normative approach, descriptive approach, and prescriptive approach".

Prospect Theory

Choices amid uncertain prospects reveal a number of significant factors that go counter to the core assumptions of utility theory. People, in particular, tend to place less value on outcomes that are just likely than those that can be determined with certainty. People choose risk-aversely when definite benefits are at stake and choose risk seeking when certain losses are at stake. Additionally, when the same option is given in several ways, people tend to ignore qualities that are shared by all of the potential candidates, leading to inconsistent choices. A novel theory where decision weights are used in place of probability and value is attributed to losses and gain as opposed to ultimate assets. According to Kahneman and Tversky (1979), the value function is generally convex for losses, concave for gains, and sharper for losses than gains. Prospect theory examines a variety of mental conditions that might influence a person's decision-making process.

Empirical Review

Gurung et al. (2024) examined the behavioral biases influencing investment decisions among Nepalese investors within the rapidly evolving context of Nepal's stock market. The researchers analyzed specific biases such as overconfidence, representative, anchoring, regret aversion, and herding. The findings revealed that overconfidence, anchoring, and regret aversion significantly influence investment, underscoring their prevalence among Nepalese investors. However, the study noted that representative bias and herding behavior had minimal or no significant impact on investment decisions in this market context.

Dhakal and Lamsal (2023) investigated the influence of cognitive biases on the investment decisions of Nepalese stock market investors. The study examined cognitive biases: overconfidence bias, herding bias, loss-aversion bias, and confirmation bias. The study suggests that cognitive biases can significantly affect the investment decisions of Nepalese investors and may have negative consequences for their investment outcomes. The research concluded that cognitive biases are prevalent among Nepalese stock market investors and have a significant impact on their investment decisions.

Dhungana et al. (2022) studied effect of five cognitive biases on investment decision taking investor of Pokhara valley of Nepal using convenience method of sampling, distributing questionnaire to 196 individual investor taking margin of error of 7%. The study found that, overconfidence bias, availability bias, herding bias significantly affect investment decision however anchoring and regret aversion bias appear to have no significant effect on investment decision.

Gyawali and Neupane (2021) investigated the influence of psychological factors on individual investors' decision-making in the Nepalese Stock Exchange (NEPSE). The researchers employed a quantitative research design, utilizing a self-administered questionnaire to collect data from 347 investors in Butwal, Nepal. The questionnaire assessed various psychological factors, including anchoring, herding, mental accounting, overconfidence, regret aversion, and loss aversion. The data was analyzed using multiple regression analysis. The study found that overconfidence, herding, and loss aversion significantly impact individual investors' investment decisions in NEPSE. However, anchoring, mental accounting, and regret aversion were not found to have a significant impact.

Mumtaz and Ahmad (2020) examined how behavioral finance factors impact the investment decisions of investors in the Karachi Stock Exchange (KSE) in Pakistani stock market. It focused on three key factors: overconfidence bias, representativeness bias, and availability bias. Among them, all three dependent variables had a significant impact on investment decision-making.

3. Methodology

This study has used a combination of descriptive research design and causal comparative research design to analyze the behavioral characteristics of individual investors and explore the relationship among major variables influencing their investment decisions. The primary goal of this research is to explore the presence and influence of behavioral biases on the investment decisions of individual investors. This mixed-method approach ensures a comprehensive understanding of the psychological factors shaping investment behavior.

The study focuses on individual investors in the Nepalese stock market who possess a minimum of two years trading experience, ensuring that participants adequately understand stock market fundamental, trading patterns, and market volatility. Due to the unavailability of specific population data from relevant authorities, the study employs a non-probability sampling method, specifically using convenience sampling techniques. The data are collected through a structured questionnaire from stock investors of Nepal. A total of 600 questionnaires were distributed through online and physical platform, and 504 responses were received (84% response rate). This study has used the descriptive statistics to assess the position of fundamental variables and inferential statistics to analyze the effect of independent variables (overconfidence, representativeness, herding, anchoring, loss aversion and confirmation) on dependent variable (investment decision).

Reliability Analysis

This study employed the Cronbach's alpha test to assess the internal consistency of the model variables. According to Cooper et al. (2006), evaluating internal consistency is essential to determine the extent to which constructs demonstrate high reliability. Furthermore, Tavakol and Dennick (2011) suggested that a Cronbach's alpha value of at least 0.70 is required to indicate acceptable internal consistency, thereby supporting the overall reliability of the model.

Table 1: Reliability Statistics

Variables	Cronbach's alpha	Decision
Investment Decision	0.745	Acceptable
Overconfidence	0.808	Good
Representativeness	0.897	Good
Herding	0.883	Good
Anchoring	0.802	Good
Loss Aversion	0.885	Good
Confirmation	0.876	Good

According to the established results, every variable has strong internal consistency since every alpha value is above 0.70.

4. Result

Statistical technique like correlation analysis, and regression analysis, were applied to examine the relationship between independent variable (behavioral anomalies) and dependent variable (investment decisions).

4.1. Descriptive Statistics

Table 2: Descriptive Statistics

Variables	Minimum	Maximum	Mean	Std. Deviation
Overconfidence	1	4.40	2.7143	0.88151
Representativeness	1	4.60	3.0286	0.98972
Herding	1	5	2.6317	1.05345
Anchoring	1	5	3.0984	0.96169
Loss Aversion	1	5	3.3492	1.08602
Confirmation	1	5	3.3365	1.02444

Source: Field Survey, 2025

In Table 2, in relation to the overconfidence, the average has 2.71 with standard deviation of 0.88. For representativeness, the average has 3.03 with standard deviation of 0.99. With respect to herding, the average has 2.63 with a standard deviation of 1.05. For anchoring bias, the average has 3.10 and a standard deviation of 0.96. Regarding loss aversion, the average has 3.35 with a standard deviation of 1.09. Finally, with respect to confirmation, the average has 3.34, along with a standard deviation of 1.02.

4.2 Correlation Analysis

Table 3: Correlation Analysis

Variables	ID	C	LA	A	H	R	OC
ID	1						
C	.448**	1					
LA	.452**	.675**	1				
A	.559**	.541**	.458**	1			
H	.546**	.444**	.602**	.459**	1		
R	.548**	.475**	.648**	.691**	.546**	1	
OC	.666**	.506**	.284**	.543**	.487**	.418**	1

Source: Field Survey 2025

Note: **Correlation is significant at the 0.01 level (two-tailed).

Table 3 shows the correlations between various factors. Here, 504 investors are surveyed, and the correlation between the independent and dependent variables is determined. The investment decision

is dependent variable and the independent variables are confidence, loss aversion, anchoring, herding, representativeness, and overconfidence.

Table 4: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
.749[a]	.560	.555	.62430

a. Predictors: (Constant), Confirmation, Herding, Overconfidence, Representativeness, Anchoring, and Loss Aversion

Table 4 shows that value of R square is 0.560. It suggests that the independent variables (confirmation, herding, overconfidence, representativeness, anchoring, and loss aversion) explain a 56% and other variables explain 44% of the variance in investment decision in the model. The goodness of fit in the case is indicated by the adjusted R of 0.555.

Table 5: ANOVA

	Sum of Squares	Df	Mean Square	F	Sig.
Regression	246.960	6	42.160	105.606	0.000
Residual	193.706	497	0.390		
Total	440.665	503			

Source: Field Survey, 2025 and SPSS-25

Table 5 shows that the regression model has a sum of squares of 246.960 with 6 degrees of freedom, and the residual has a sum of squares of 193.706 with 497 degrees of freedom. The mean square for the regression is 42.160, while the residual mean square is 0.390. The F-statistic value is 105.606, with a significance level (Sig.) of 0.000. This very low significance value indicates that the overall regression model is statistically significant.

Table 6: Status of Regression Coefficients

	Unstandardized Coefficients		**Standardized Coefficients**		
Variables	B	Std. Error	Beta	t	Sig.
Constant	0.671	0.116		5.811	0.000
Overconfidence	0.477	0.043	0.449	11.056	0.000
Representativeness	0.145	0.047	0.153	3.091	0.002
Herding	0.125	0.037	0.140	3.361	0.001
Anchoring	0.094	0.045	0.097	2.093	0.037
Loss Aversion	0.075	0.046	0.087	1.628	0.104
Confirmation	0.014	0.043	0.015	0.319	0.750

Table 6 provides the positive relationship between each independent and dependent variable except for the loss aversion and confirmation. The relationship between each independent and dependent variable other than loss aversion and confirmation is statistically significant with p-values less than 0.05. In contrast, loss aversion and confirmation bias have p-values of 0.104 and 0.750

respectively. Even though they have a small positive value in the unstandardized coefficients table, they are not statistically significant because their p values are too high. There is no strong evidence that the effects are different from zero. Thus, their effect could be due to random variation rather than a real influence on the investment decision.

5. Discussion

It is found that overconfidence has a highly significant positive effect on investment decision. This finding is aligned with previous literature (Mumtaz & Ahmad, 2020; Dhungana et al., 2022; Yasmin & Ferdaous, 2023). This suggests a similar outcome of the overconfidence impact on investment decision. However, the result of this study is not parallel with the findings of Tabassum et al. (2021) and Kengatharan (2014). This findings showed that overconfidence has an insignificant impact on investors' decision-making behavior. Furthermore, the analysis revealed that representativeness has a positive and significant impact on investment decision making about investment on Nepalese capital market, consistent with previous paper (Molla, 2018; Yasmin & Ferdaous, 2023). This implies that representativeness factor affects the investment decision of the investors.

In addition, the finding of the analysis revealed a positive and significant effect of herding on investment decision about Nepal Stock Exchange. This suggests that investors follow the crowd, which can drive market bubbles or crashes. Regarding the relationship with the anchoring bias, it has revealed a positive and significant influence on an individual investor's investment decisions, indicating investors rely too heavily on initial information or past reference points, even when new data is available. This finding is similar to the finding of Dhakal and Lamsal (2023). They concluded that herding and anchoring these biases have significant relationship between the investment decisions of investors in Nepal. Moreover, Dhungana et al. (2022) and Gurung et al. (2024) also found that herding bias has a statistically significant effect on investment decision of Nepalese investors. However, the effect of anchoring bias on investment decision is statistically insignificant. This contradicts the research by Islam et al. (2018), which found that the anchoring has huge impact on investment decision.

Loss aversion has insignificant, as suggested by the p-value, which is greater than 0.05. The finding of this study is similar to the findings of Dhakal and Lamsal (2023) as well. They concluded that the effect of loss aversion has insignificant. However, the result of this study is not parallel with the finding of Gyawali and Neupane (2021) and Kartini and Nahda (2021). The finding of the loss aversion has significant relationship with individual investor investment decision. Kartini and Nahda (2021) indicated that most of investors in Yogyakarta tend to be affected by loss aversion in making investment decision.

Confirmation also has an insignificant effect on the investment decisions of the respondents. However, a study on confirmation bias has been limited in Nepal. The study by Armansyah (2022) suggested that confirmation has a significant impact on investment decision of Indonesian investors. Dhakal and Lamsal (2023) also found a significance positive effect on the investment decisions. Loss aversion and confirmation biases do not play a significant role in influencing the investment decisions of respondent because of cultural or contextual factors, such as financial literacy or limited

access to reliable information. Alternatively, their impact might be indirect or interrelated with other psychological traits not captured in this model.

The results showed that overconfidence, representativeness, herding, and anchoring had significant positive effect on investment decision. This finding is consistent with prior research paper that has highlighted the significance of these behavioral anomalies on investment decisions (Molla, 2018; Mumtaz & Ahmad, 2020; Gyawali & Neupane, 2021; Dhakal & Lamsal, 2023; Kartini & Nahda, 2021; Dhungana et al., 2022, Armansyah, 2022; Yasmin & Ferdaous, 2023). For example, Molla (2018) and Mumtaz and Ahmad (2020) found that overconfidence and representatives are significant predictors of investment decision, while Ige and Adebayo (2024) and Abideen et al. (2023) showed that herding and anchoring play a crucial role in making individual investors' investment decision.

6. Conclusion

Based on the results of the research that has been done, it can be concluded that variables overconfidence, representativeness, herding, anchoring each have a significant effect on investment decision on the capital market in Nepal, while the loss aversion and confirmation variables have no effect on investment decisions. Investors are irrational while deciding on investment in capital market. Thus, it is considerable study for individual investors to make proper financial planning first, rather believing on rumors or airy news it will better to make analysis of related organization by them and take investment decisions more rationally.

This study points to several important directions for future research and practice for investors, financial professionals, and policymakers. Investors that are recognizing the role of psychological factors in influencing investment decisions is crucial for investor education. Educational initiatives can emphasize the potential drawbacks of impulsive investment decisions driven by overconfidence, herding behavior, representativeness, and anchoring. Informed investors are better equipped to make rational investment choices. Financial advisors can integrate behavioral insights into investment strategies. Regulatory authorities can consider the implications of psychological biases on market stability. Measures could include implementing disclosure requirements that address these biases and ensuring investors are aware of their potential impact on investment decisions.

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