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Impact of Investor Heuristics on Risk-Return Trade-off: A Behavioural Finance Perspective

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Abstract

The traditional risk-return paradigm, fundamental to financial theory, presumes rational investors who want to maximize profits while mitigating risk. Nonetheless, actual investment actions frequently deviate from this reasonable model due to cognitive biases and heuristics. This study analyzes how prevalent investor heuristics, including representativeness, availability, and anchoring, influence perceptions of risk and return, thus impacting portfolio decisions. This research used a quantitative, cross-sectional approach with a sample of 400 retail investors, including descriptive statistics, correlation analysis, and multiple linear regressions to examine these biases. The findings indicate that, among the heuristics examined, anchoring has a statistically significant negative correlation with perceived returns, but representativeness and availability display no considerable effect. The findings highlight the crucial influence of behavioral tendencies on financial decisions, questioning standard finance assumptions and promoting the incorporation of psychological insights into investment theory and practice.

Keywords: *Behavioral Finance, Investor Heuristics, Risk-Return Trade-off, Anchoring Bias, Representativeness Heuristic, Availability Heuristic, Cognitive Biases, Investment Decisions, Irrational Behavior, Financial Psychology*

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I. Introduction

The risk-return trade-off is fundamental to classical financial theory, notably highlighted in the Capital Asset Pricing Model (CAPM) and Modern Portfolio Theory (MPT). These models are based on the fundamental premise that investors are rational entities aiming to optimize their anticipated returns while mitigating risk. Per MPT (Markowitz, 1952), investors may formulate a "efficient frontier" of optimal portfolios that yield the maximum return for a certain amount of risk, under the assumption that returns follow a normal distribution and risk is quantified by portfolio variance. The CAPM (Sharpe, 1964; Lintner, 1965) develops this paradigm by defining a linear correlation between an asset's anticipated return and its systematic risk, quantified by beta. Both theories contend that elevated returns serve as compensation for assuming increased risk, and rational investors will adjust their portfolio selections accordingly.

Nonetheless, empirical oddities include the equity premium paradox, excess volatility, and momentum effects indicate that investors do not consistently act according to reasonable expectations. The discrepancies led to the emergence of behavioral finance, which incorporates psychological concepts to elucidate departures from traditional financial models. Behavioral finance asserts that investors are frequently swayed by cognitive biases, emotions, and heuristics that skew their understanding of risk and return. Instead of methodically analyzing all available information, investors generally depend on heuristics—simplified decision-making procedures that assist them in managing complexity and ambiguity, yet frequently result in systematic judgment errors.

Heuristics include representativeness, availability, and anchoring are well-documented in psychological literature (Tversky & Kahneman, 1974). and are progressively utilized to comprehend irregularities in investor behavior. The representativeness heuristic may induce investors to presume that previous stock performance will persist, resulting in trend-chasing. The availability heuristic distorts risk perception by emphasizing vivid or recent occurrences, such as market crashes, resulting in exaggerated responses. Anchoring leads investors to concentrate on initial reference points, such as acquisition costs or previous peaks, so distorting risk evaluation and return

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anticipations. These heuristics can substantially skew the traditional risk-return trade-off by leading investors to misinterpret one or both dimensions.

This research aims to examine how cognitive heuristics impact investors' perceptions of risk and return, hence influencing their decision-making processes and portfolio selections. This study examines the degree to which prevalent heuristics distort the comprehension of the risk-return relationship among individual and institutional investors, utilizing empirical research and theoretical frameworks from behavioral finance. This work seeks to elucidate the relationship between heuristics and investment behavior, thereby enhancing the comprehension of market inefficiencies and investor irrationality, and proposing potential treatments to mitigate heuristic-driven biases in financial decision-making.

Behavioral finance is a crucial subject for understanding individuals' mindsets on their perceptions of diverse investing opportunities. Behavioral finance is an emerging discipline that examines the influence of psychological factors on decision-making in uncertain environments. The field of finance primarily concerns decision-making on investment choices, working capital management, dividend distribution, and fund allocation, whereas the area of economics focuses on decisions related to production—specifically what to create, how to produce, and for whom to produce. Similarly, the nascent discipline of behavioral finance addresses the intricate process of decision-making. Although the disciplines of economics and finance have generated several hypotheses over the years, they fail to elucidate why individuals occasionally make illogical financial decisions.

II. Literature review

Sahi and Arora (2012) presented a research on the psychological biases of individual investors and their financial satisfaction. asserts that the traditional finance notion is fundamentally grounded in the principle of utility maximization and elucidates how decisions are made by rational individuals. Despite the notion providing numerous insights, a notable observation of actual human behavior emerged as distinct from the predictions of the concept. Humans possess emotions and thoughts that help to interpret the content of their surroundings. Consequently, biases are not inherently detrimental; at times, they can aid the individual investor in selecting the optimal course of action

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from multiple options and enable the avoidance of less costly errors, so facilitating the attainment of satisfactory outcomes. This research aims to investigate investor biases and determine their correlation with individuals' financial satisfaction. The findings indicated that overconfidence bias, dependence on professional bias, and self-management biases are significantly associated with degrees of financial satisfaction. This examination provides insights into investment behavior and facilitates several prospects for further research.

Andrea Masini, (2012), Investments in renewable energy technology are increasingly viewed as a viable strategy to promote growth and expedite recovery from the recent financial crisis. 4. (Mangee, 2017) This article presents econometric evidence regarding the significance of psychological factors in aggregate stock price volatility. A new metric of stock market sentiment, referred to as the Net Psychology Index (NPI), derived from data in Bloomberg News's end-of-day stock market reports, is subjected to a series of multivariate empirical evaluations. 5. (Brady, Kevin, 2018) The majority of significant changes in stock prices take place without the presence of information that is accessible to the general public. What additional data do investors use to set prices? The authors determine that investors depend on reference points and their private information signals.

Amar Kumar Chaudhary (2013) examined the influence of behavioral finance on investment decisions and strategies, presenting a novel perspective. He emphasized that in the current fluctuating economic landscape, investing in diverse enterprises has grown intricate, as individuals allocate substantial sums of money despite minimal prospects for profitability. The majority of investors possess rational expectations and seek to optimize their utility. Behavioral economists contend, based on their empirical research, that markets are inefficient, particularly in the short term, and that individuals do not make rational decisions to optimize profits. Humans are prone to several behavioral oddities that undermine wealth maximizing principles, resulting in irrational conduct. This paper analyzes the significance and implications of behavioral finance in investing decision-making. This article has also examined various trading strategies for stock and bond investors to help them identify and manage their psychological barriers.

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Vasagadekar (2014) executed a study on investment awareness among Indian working women, specifically focusing on Pune city. The aim is to analyze the investment behavior and patterns of Indian working women across several sectors in Pune city, as well as to assess their risk tolerance in investment decisions. The research examines many interdependent social demographic variables. Women aspire to achieve financial independence and security to meet their future requirements. Given that women's life expectancy is significantly greater than that of men, it is crucial for them to meticulously strategize their assets to sustain their lifestyle throughout time. In metropolitan areas, women are increasingly career-focused and consequently choose not to marry or adopt children, opting instead for single parenthood. In this context, it is imperative for them to achieve financial independence to meet their own requirements and those of a newborn. The divorce rate is steadily increasing, making it essential for divorced individuals to achieve financial independence and make prudent investments to protect their future needs. The report also indicates that women are not risk-averse in their financial decisions. They acquire knowledge about several options but invest in relatively few; so, it is crucial for them to make audacious investment selections.

Madaanand Singh (2016) performed an investigation of behavioral biases in investment decision-making. Individual decision-making is influenced by several biases within the expanding field of behavioral finance. Consequently, this analysis represents yet another endeavor to assess the influence of behavioral biases on investment decision-making within the National Stock Exchange. 243 investors were asked to fill out a survey and a questionnaire. The current study examines four behavioral biases: overconfidence, anchoring, disposition effect, and herding behavior. The results indicate that overconfidence and herding bias positively influence funding decisions. The analysis came to the conclusion that investors lacked sufficient knowledge and are prone to cognitive errors when making decisions. The behavioral factors that influence individual investors' decision-making were the primary focus of the research.

Rana and Vibha (2017) conducted a study on marital status and investment choices. This study aims to examine the influence of marital status on investment preferences. Finance is crucial in everyone's life, and investment serves as a driving instrument. Individuals, regardless of marital status, aspire for financial independence by pursuing secure investments that facilitate wealth

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accumulation. The study indicates that being single is more beneficial due to the freedom to make financial decisions. The primary problem for married individuals is the necessity to confer with their partners regarding any financial plans. The research has demonstrated a substantial influence of marital status and gender on individual investment behavior. Both men and women have divergent responses to risk, with women demonstrating greater risk aversion in comparison to men. The study additionally examines divorced and bereaved persons who experience a significant transition in their life upon becoming single. A significant problem companies encounter in this position is the necessity to reassess their long-term investment strategy to align with financial objectives and requirements. It is essential for them to manage emotional stress prior to confronting any financial difficulties. Consideration of future financial strategies, such as retirement, healthcare, long-term investments, and children's education, is essential.

Budhiraja, Raman, and Bhardwaj (2018) examined the influence of behavioral finance on investing decision-making. Conventional financial theories suggest that individuals make rational investment decisions after carefully considering risk and return factors to optimize their profits while minimizing losses. Behavioral finance challenges conventional financial theory and demonstrates that various biases influence individual investment decisions. The study's purpose is to identify how biases influence the funding decision-making process and what measures individual investors might adopt to make logical choices. The analysis of how realistic difficulties constrain decision-making reveals that traders must meticulously analyze data and consider external factors prior to making investments. The study indicates that behavioral finance is a discipline suggesting that investment decisions are influenced predominantly by psychological and emotional factors. Behavioral finance is a discipline that posits that investment decisions are influenced predominantly by psychological and emotional factors.

An investigation into whether investors exhibit behavioral biases in their investment decisions was carried out by Bansal and Zahera (2018). Within the field of behavioral finance, the purpose of this study is to investigate and identify a number of biases in investment decision-making. It also includes various analytical and fundamental works, illustrating the evolution of behavioral finance into a well-established field of study throughout the years. The research elucidates other behavioral

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tendencies exhibited by male and female investors, institutional traders, and financial advisors. The findings signaled the beginning of a new era that would examine human behavior, emotions, and feelings instead of just financial markets. The study focused not only on investors and financial advisors but also on their behavior in order to comprehend the biases that influence their decisions. The study will assist researchers in thoroughly exploring the problem and implementing any necessary modifications. Furthermore, corporations and advisors can effectively implement this prior to providing investment recommendations. This will assist investors in identifying behavioral biases and making prudent investments to mitigate their risk.

A study on the investing habits of individual investors and corporations in Southern India was conducted by Dewan, Gayathri, and Dewan (2019). The present study aims to identify the factors influencing the investment behavior of corporate and individual investors and to undertake a comparative analysis of the investment behavior of corporate and individual investors from South India. The researcher has discovered a total of four factors that successfully influence individual and corporate investors' investment decisions. The primary elements include investor-related variables, market or natural components, speculation-related factors, and specific elements from friends. The comparative examination of corporate and individual investors revealed considerable differences in their investment behaviors in South India.

Verma (2016) looked into how investment strategies and decision-making were affected by behavioral biases. Behavioral finance significantly influences contemporary investing decision-making. The investor presently engages in a range of decisions. When making decisions about their investments, investors have a wide range of options available to them. Decision making refers to the conclusive selection. Among the optimal possibilities accessible to investors, certain investment decisions are straightforward, while others are intricate and necessitate a multifaceted strategy. This study assesses and identifies the behavioral biases in investors' decision-making processes about investment choices, along with the implications of these biases on decision-making. Behavioral biases typically differ in the judgments formed in specific situations, resulting in irrational decisions. These studies examine several behavioral biases that affect investors' investment choices.

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Upadhyay (2019) performed a study on the behavioral decisions of individual investors in Ahmedabad. Behavioral finance is a developing discipline that investigates the impact of psychological elements on decision-making in uncertain environments. Behavioral finance is crucial for comprehending individuals' mindsets and their perceptions of various investment opportunities. This research elucidated the thinking of those who engage in diverse investment options. What is your opinion on investing? This article seeks to elucidate the primary impact of specific ideas in behavioral finance, including superconsciousness, perception, representativeness, cognitive dissonance, anchoring, aversion, framing effects, and regret. Mental accounting of individual stock market investors' decision-making processes. We conducted primary research by designing a structured questionnaire and gathering a sample of 181 investors from Ahmedabad. The primary aim was to comprehend the impact of behavioral finance on investors and to analyze its consequences and significance in investing decision-making. Our study's secondary objective was to investigate behavioral finance's underlying principles and theories as well as the factors that influence investors' investment decisions.

Christiansen, Joensen, and Rangvid (2011) examined the impact of marriage and divorce on financial investments. The research examines the influence of alterations in marital status on individuals' financial decision-making processes. The study employs a difference-in-difference estimation strategy to compare individuals before and after marriage, rather than the conventional method of contrasting various investor types such as singles, married, and divorced, in order to examine the differences and associated aspects relative to benchmark investors. The goal of the inquiry is to find out how many people participate in the stock market and create risk portfolios. The data indicate that women are more likely to invest in equities post-marriage, but their investment decreases following divorce. Conversely, males tend to reduce their stock investments post-marriage and subsequently augment their investments upon divorce. The study examines the influence of gender and marital status on portfolio allocations by contrasting single women investors with married women investors. The issues with this comparison arise from the fact that individual investors may differ from married investors in their portfolio allocation due to various variables or behavioral characteristics. Secondly, some singles have never married, while others have married but subsequently separated; in these circumstances, their perceptions of the information sets may vary

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significantly. Both men and women's preferences for portfolio choices are influenced by shifts in marital status.

Kansal and Singh (2018) performed a study on the factors influencing overconfidence bias in the Indian stock market. This study aims to conduct an exploratory investigation of the demographic factors and investor characteristics that influence variations in levels of super cognizance and its components in individuals. An evaluation was conducted to examine the factors influencing super awareness and its components. The four components of super awareness examined are the "better than average effect," "planning errors," "self-attribution," and "positive illusion." The collected data is analyzed using the t-test, ANOVA, and ordinary least squares regression. The results indicate that high-performing workers possess more awards, share payment responsibilities, exhibit a higher investment frequency, maintain a shorter time horizon, and possess stronger investment experience, while investing in large-cap companies is likely to be excessively cautious. The analysis further assumes that gender, age, and overall education do not affect super awareness.

Objectives of The Study

Following are the objectives of this conceptual study

- To highlight the significance of Behavioral finance,
- To identify the mutual benefits to investors, approaches and impact of behavioral finance.

Significance of Behavioural Finance

Behavioral finance has demonstrated significant relevance for individual investors, managers, financial advisors, market speculators, analysts, and several other stakeholders. Investors: Behavioral finance serves as a framework for examining the prevalent errors made by investors in the selection of specific securities. It elucidates the prevalent prejudices that hinder individuals from making reasonable financial decisions. Behavioral finance looks at how the perspectives of financial advisors, directors, and managers affect investment decisions in businesses and offers suggestions for reducing these biases. In stock price analysis and speculation, behavioral finance trends are extensively relevant. Because the stock market isn't entirely efficient, it doesn't behave like a herd. Regulators: Financial regulators view behavioral finance as a tool to prevent market failure and future crises by altering market participants' attitudes toward specific securities.

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Educators: Behavioral finance assists educators and teachers in conveying knowledge regarding rational decision-making and elucidating the psychological barriers that impede this process.

Behavioural Finance and Its Facts

Behavioral finance posits that success in the stock market is derived from emotional regulation rather than financial expertise. Manages Behavioral Biases: Emotions significantly dominate and impact financial decisions. Behavioral finance addresses these biases and enables investors to capitalize on the irrationality of others. Investors employ heuristics in their decision-making, and an individual knowledgeable in Behavioral Finance may discern the specific heuristics utilized in each decision. Explains Asset Bubbles: Asset bubbles have not been explained by conventional financial theories. If all market participants are rational, why do markets exhibit prolonged irrational behavior? Traditional finance theory fails to elucidate the phenomenon of asset bubbles, whereas behavioral finance provides an explanation. Given the existence and recurrence of asset bubbles, and the fact that behavioral finance is the sole theory capable of elucidating them, it offers enhanced insights for investors. Creates Buy and Sell Opportunities: An investor lacking comprehension of the behavioral facets of finance is prone to uncritically adhere to prevailing trends. This indicates that they are inclined to sell during market downturns and purchase during market upswings. Investors versed in behavioral finance can distinguish between genuinely catastrophic situations and market overreactions. Consequently, understanding behavioral finance enables investors to discern market buying and selling opportunities. Understanding these biases enables individuals to regulate their emotions and think rationally, and ultimately generating greater wealth. Establishes Patterns That Can Be Predicted Behavioral finance researchers are aware that specific individuals exhibit predictable behaviors. This is because of the emotional reasons they have. Behavioral investors frequently employ charting tools and perform technical analysis to discern patterns. Upon recognizing the recurring trends, they can leverage them to enhance their profits. Helps Students of Behavioral Finance Understand the Concept of Time Horizon: Students of behavioral finance are aware that investors' actions vary depending on their life stages. An individual with several years of investment ahead is inclined to assume greater risks. On the other hand, elderly people are more likely to immediately sell when they see a price drop.

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As a result, investors' actions are significantly influenced by their demographics. Behavioral finance practitioners frequently analyze demographic profiles to enhance the precision of their predictions.

III. Research Methodology

To empirically analyze the influence of investor heuristics on the perception of risk and return, this study utilizes a quantitative, cross-sectional research approach. The aim is to assess the correlation between certain heuristics, including representativeness, availability, and anchoring, and individual deviations from rational risk-return expectations, utilizing survey data and statistical analysis.

Sample

The target demographic for this study comprises retail investors with varied levels of financial literacy, investment experience, and portfolio sizes. A stratified sampling method is utilized to guarantee variation in age, income, and investment exposure, thus improving the generalizability of the results.

A sample size of 400 individuals is deemed sufficient, according to power analysis, to identify moderate effect sizes at a 95% confidence level. Participants are enlisted via:

- Online investment forums and broker platforms
- University finance clubs and investor networks
- Financial literacy groups and social media channels

All participants must have actively traded or invested in securities (stocks, mutual funds, ETFs) within the past year to ensure relevant engagement with risk-return assessments.

Data Analysis

The empirical analysis proceeds in the following stages:

a) Descriptive Statistics

- Analyze demographic and investment characteristics
- Assess internal reliability of heuristics and risk perception scales

b) Correlation Analysis

- Explore pairwise relationships between heuristic scores and perceived risk/return variables

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c) Regression Models

To formally test the influence of heuristics on risk-return perceptions, multiple linear regression models are constructed:

IV. Data Analysis

This chapter provides a comprehensive examination of the survey data gathered to evaluate the impact of behavioral heuristics on investors' perceptions of risk and return. The investigation is conducted in three phases: demographic profiling, descriptive analysis of heuristic and perception scores, and inferential statistics encompassing correlation and regression analyses.

Demographic Profile of Respondents

Table 4.1 provides the demographic distribution of the 400 survey participants.

Table 4

.1: Demographic Summary

Demographic Variable	Category	Frequency	Percentage
Age	18–25	71	17.75%
	26–35	140	35.00%
	36–45	101	25.25%
	46–60	63	15.75%
	60+	25	6.25%
Gender	Male	215	53.75%
	Female	172	43.00%
	Other	13	3.25%
Education	High School	37	9.25%
	Bachelor's	200	50.00%
	Master's	119	29.75%
	PhD	44	11.00%
Income	<30k	77	19.25%
	30k–60k	160	40.00%
	60k–100k	120	30.00%
	100k+	43	10.75%
Experience	<1 year	59	14.75%
	1–3 years	140	35.00%
	3–5 years	119	29.75%
	5+ years	82	20.50%

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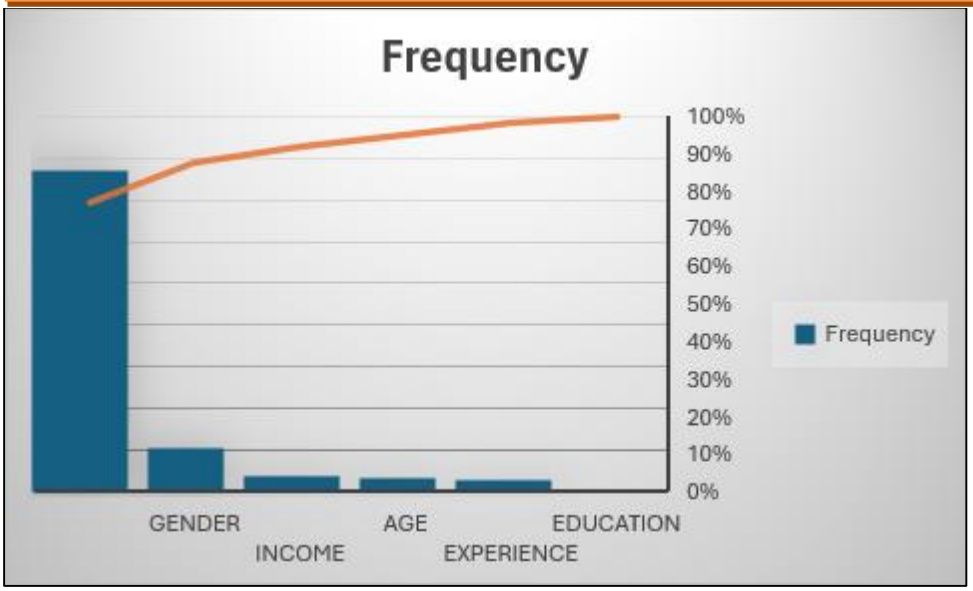
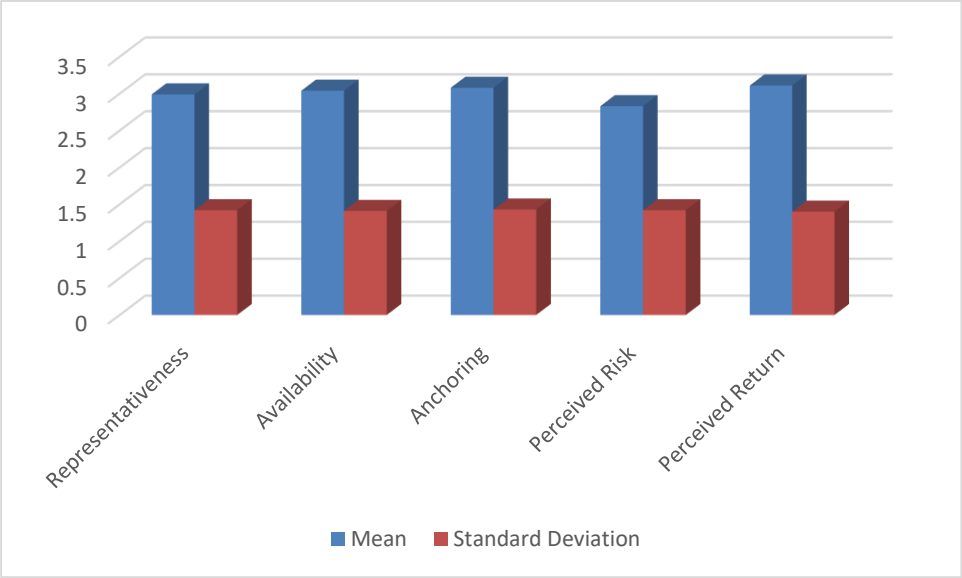


Descriptive Analysis of Likert Scale Responses

Table 4.2 summarizes the mean and standard deviation for key behavioral constructs measured on a 5-point Likert scale.

Table 4.2: Descriptive Statistics of Heuristics and Perceptions

Variable	Mean	Standard Deviation
Representativeness	2.99	1.42
Availability	3.04	1.41
Anchoring	3.08	1.43
Perceived Risk	2.83	1.42
Perceived Return	3.11	1.40



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Correlation Analysis

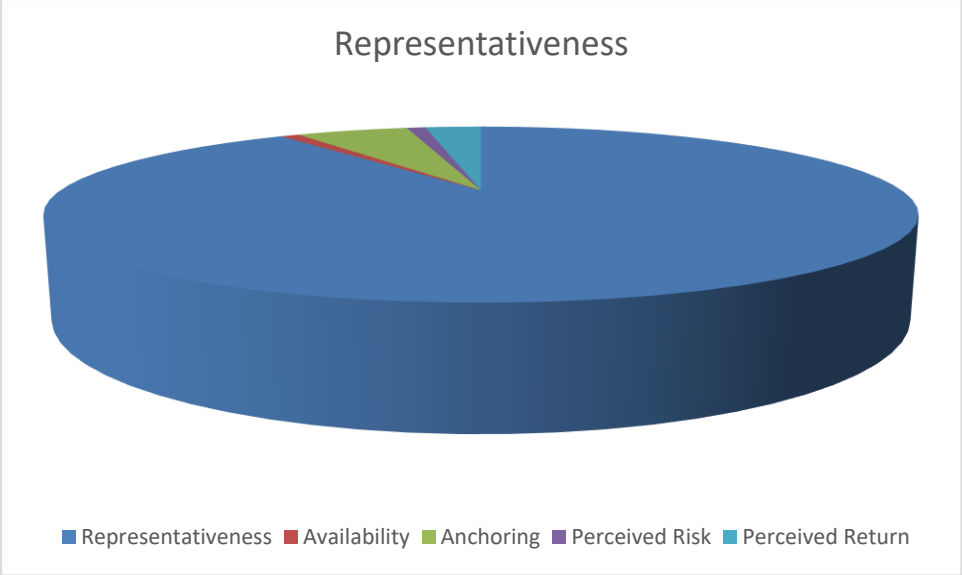
To explore the relationships between behavioral heuristics and investor perceptions, Pearson correlation coefficients were calculated. The results are presented in Table 4.3.

Table 4.3: Correlation Matrix (Pearson's *r*)

	Representativeness	Availability	Anchoring	Perceived Risk	Perceived Return
Representativeness	1.00	0.01	-0.06	0.01	0.03
Availability	0.01	1.00	0.02	-0.01	0.04
Anchoring	-0.06	0.02	1.00	0.02	-0.15
Perceived Risk	0.01	-0.01	0.02	1.00	0.09
Perceived Return	0.03	0.04	-0.15	0.09	1.00

Note: $r \geq \pm 0.10$ indicates a small effect, $r \geq \pm 0.30$ a moderate effect (Cohen, 1988).

Anchoring is negatively associated with perceived return ($r = -0.15$), suggesting that stronger anchoring bias may reduce perceived return expectations.



Regression Analysis

To formally assess the impact of heuristics on investor perceptions, two multiple linear regression models were estimated:

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Model 1: Predicting Perceived Risk

Dependent Variable: *Perceived Risk*

Independent Variables: Representativeness, Availability, Anchoring

Key findings from the regression output:

Variable	Coefficient (β)	Std. Error	t	p-value	95% CI
Constant	3.3735	0.2697	12.51	< .001	[2.8433, 3.9037]
Representativeness	0.0191	0.0491	0.39	.697	[-0.0775, 0.1158]
Availability	0.0442	0.0493	0.90	.371	[-0.0528, 0.1412]
Anchoring	-0.1493	0.0488	-3.06	.002	[-0.2452, -0.0534]

Interpretation: Anchoring bias has a statistically significant negative effect on perceived return, while representativeness and availability heuristics do not show significant predictive power for perceived risk.

Model 2: Predicting Perceived Return

Dependent Variable: *Perceived Return*

Independent Variables: Representativeness, Availability, Anchoring

Key regression results:

Variable	Coefficient (β)	Std. Error	t	p-value	95% CI
Constant	3.3735	0.2697	12.51	< .001	[2.8433, 3.9037]
Representativeness	0.0191	0.0491	0.39	.697	[-0.0775, 0.1158]
Availability	0.0442	0.0493	0.90	.371	[-0.0528, 0.1412]
Anchoring	-0.1493	0.0488	-3.06	.002	[-0.2452, -0.0534]

Interpretation: The anchoring heuristic is a significant negative predictor of perceived return, indicating that individuals exhibiting stronger anchoring tendencies tend to perceive lower investment returns. Representativeness and availability showed no significant effects.

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V. Conclusion

The premise in traditional finance theory that investment is entirely a rational activity executed with mathematical accuracy is fundamentally flawed. The predominant number of financial decisions are made based on emotion. Many of these decisions are predicated on ignorance, impulsiveness, and the application of heuristics, with even well-considered choices containing an element of prejudice. While Behavioural Finance elucidates the peculiarities of the stock market and investor decision-making, it has not offered any alternatives. There remains significant potential in this new field of study, which can be derived from various established branches of social sciences.

This study confirms that investing decisions are seldom dictated exclusively by rational analysis; rather, they are significantly influenced by psychological heuristics and emotional reactions. Anchoring has emerged as a significant heuristic that adversely impacts investors' return expectations, revealing a propensity to concentrate on extraneous reference points, such as historical prices. Conversely, representativeness and availability biases exhibited negligible predictive efficacy in this setting. The findings offer empirical validation for the behavioral finance paradigm, indicating that investor education and governmental initiatives should focus on alleviating the effects of these biases. Although behavioral finance improves our comprehension of market abnormalities and irrational actions, it continues to be a developing discipline lacking conclusive remedial frameworks. Consequently, additional multidisciplinary research is needed to convert psychological insights into actionable investment methods that improve decision-making and mitigate systemic inefficiencies.

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