An Analysis of the Indian Retail Investing Paradox

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Abstract:
This paper examines behavioural finance and Investment Decisions, explaining why Indian investors often make irrational decisions in spite of widely available information. It discusses common biases such as overconfidence, herding and loss aversion and uses recent evidence in the Indian context to show how these shape investor behaviour. People generally sell in panic when the market falls, buy whatever stock their neighbour, friends or analysts are talking about, and hold on to loss-making shares far longer than they should. This paper looks at behavioural finance, the branch of finance that considers human psychology very seriously, and tries to explain why Indian investors, despite currently having more information at their fingertips than ever before, keep on making the same avoidable mistakes. This paper also explains what recent Indian data tells us about investor behaviour, and what, if anything, can be done about it.

Keywords: Behavioural finance, investor psychology, biases, herding, overconfidence, financial literacy, India.

Introduction
During a market fall, you will find the retail investors selling in a hurry near the bottom, after which the market recovers within a few months. Ask those same investors during a bull run, and they will tell you, quite confidently, that the market will only go up, and they are buying at a higher price. Both beliefs are particularly irrational, yet both are extremely common. Traditional economics has long assumed that people make decisions like calculating machines, work out the best possible outcome every single time and take rational decisions. Anyone who manages money, teaches commerce, or simply has a demat account of their own knows this picture is incomplete.

Behavioural finance grew out of this gap between theory and reality. Rather than assuming investors are rational, it starts from the more honest position that investors are "normal", meaning they are emotional, occasionally lazy in their thinking, easily swayed by the opinions of others, and prone to a fairly predictable set of mental shortcuts. This is a particularly useful lens for India at the moment. The last few years have seen a genuine explosion in retail participation, helped along by cheap smartphone data, easy-to-open demat accounts, SIP mandates that run quietly in the background, and no shortage of finance "influencers" on Instagram and YouTube offering tips. More people investing should, in theory, mean more informed decision-making. What we actually see is something researchers have started calling the

Indian retail investing paradox: participation has grown far faster than performance. This paper tries to unpack why, using behavioural finance as the framework and recent Indian data as the evidence.

Objectives of the Study

- To understand the errors and biases that behavioural finance identifies in investor decision-making.
- To examine how these biases play out among Indian investors specifically, using recent survey and market data.
- To weigh the advantages and limitations of behavioural finance as a way of understanding markets.

Traditional Finance versus Behavioural Finance

Traditional financial theory rests on a few comfortable assumptions: markets and investors are rational, people only care about maximising their returns, investors have complete self-control, and nobody gets confused while processing information. If all of this were actually true, share prices would move smoothly in line with company fundamentals and very little else. Every crash, every bubble, every sudden rally that has nothing to do with a company's balance sheet would be a bit of a mystery.

Behavioural finance disagrees with almost every part of that picture. It argues that investors are “normal” rather than rational: they have limited self-control, they are shaped by their own biases, and they regularly make cognitive errors that lead them astray. None of this makes investors foolish; it simply makes them human. The trouble is that markets do not reward being human. They reward discipline, patience and clear thinking, which is precisely what our biases tend to work against. Anyone who lived through the sharp fall and equally sharp recovery of Indian markets during the COVID-19 pandemic will recognise this immediately. Fundamentals alone cannot explain why the same set of companies was priced the way they were in March 2020 and then priced so differently a few months later. Sentiment, fear and herd behaviour explain a great deal more.

Behavioural Biases and Retail Investor Decision-Making in India's Equity Derivatives Market

The honest answer, going by recent data, is not particularly. SEBI's own investor survey, along with trading data from the NSE, showed that in FY2023, close to 89 per cent of individuals trading in equity and index derivatives ended the year with a net loss. That is not a small or unlucky minority; it is nearly nine out of every ten traders (see Chart 1). The regulator has pointed to overconfidence, excessive speculation and poorly diversified, concentrated positions as the main reasons behind this, which sits neatly with what behavioural finance has been saying for years: people trade too much because they believe they know more than they actually do, and they underestimate just how much of their past success was down to a rising market rather than their own skill.

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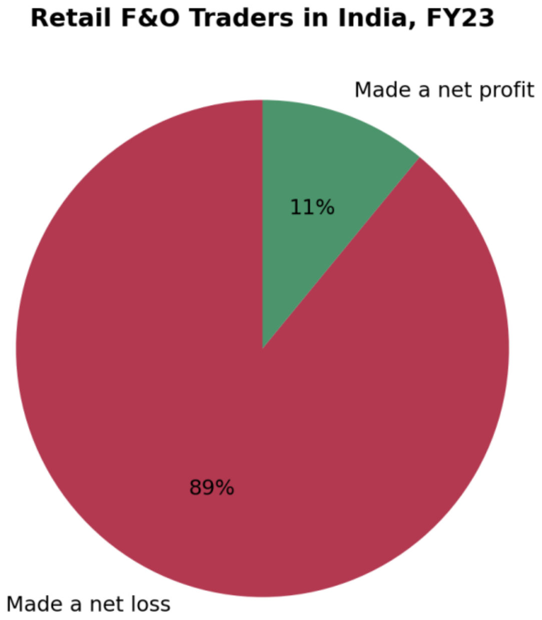

Chart 1: Share of retail F&O traders in India who made a net profit or loss, FY2023 (Source: SEBI/NSE)

This is a fairly sobering statistic for anyone who assumes markets are dominated by careful, well-informed decision-making. It also explains why regulators have been tightening rules around derivatives trading for retail participants and pushing harder on investor education and disclosure, an area where India still has some catching up to do compared with more mature markets.

The Role of Financial Literacy in Mitigating Behavioural Biases Among Indian Retail Investors

Part of the reason biases run so freely is that a significant portion of the population has not had the opportunity to develop strong financial literacy. According to the National Centre for Financial Education, only about a third of urban Indians meet the minimum benchmark for financial literacy, and the figure drops further to around a quarter in rural India (see Chart 2). There is also a noticeable gap between men and women on this front, which the same surveys have flagged repeatedly, and which deserves a study of its own.

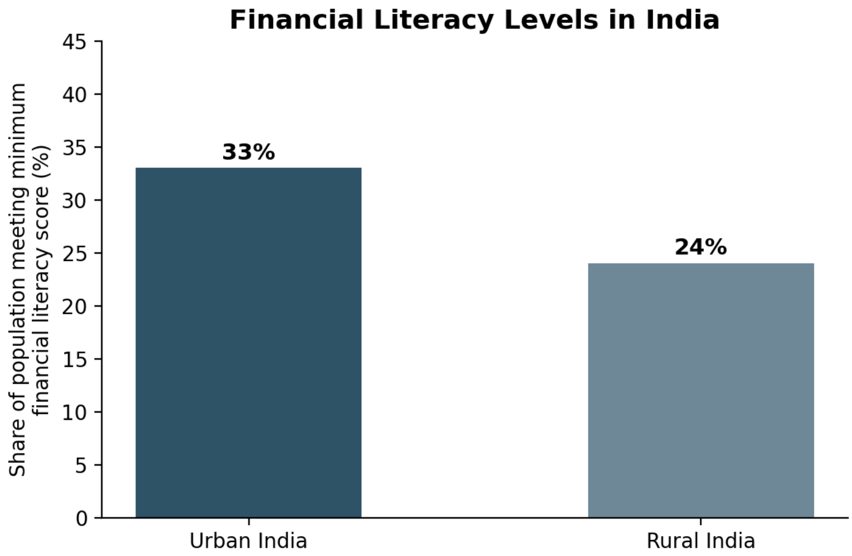

Chart 2: Financial literacy levels across urban and rural India (Source: NCFE Financial Literacy and Inclusion Survey)

This matters because financial literacy acts as something of a buffer against behavioural biases. Investors who understand concepts like compounding, diversification and risk tend to be somewhat better placed to notice when they are about to make an emotional decision rather than a considered one. Recent studies of recent Indian market investors suggest that more experienced, money-smart investors were less susceptible to behavioural biases such as anchoring and overconfidence, as newer investors opening their first trading account, say in the past one to two years, to make good the initial lure from social media or a friend, of rapid wealth creation.

Behavioural Biases in Investment Decision-Making: Evidence from Indian Retail Investors

Behavioural finance divides the underlying causes for making bad decisions into four general groups, and it's worth reviewing these before we dive into specific biases.

Self-deception: This basically means thinking we know more about something than we do. At face value, this isn't a big problem, but it results in investors ignoring vital information that we all require simply because we feel we've already figured it out. Anyone who feels they've "read the market" perfectly and knows exactly when to get in and get out is a classic victim of self-deception.

Heuristic simplification is a mental shortcut problem. Faced with more information than anyone can reasonably process, the brain takes shortcuts, or rules of thumb, rather than working through everything properly. This is a perfectly useful survival skill in daily life and a rather less useful one when picking stocks or mutual funds.

Emotion refers to decisions made based on mood rather than logic. Perhaps you are having a bad day at the office or you receive a text message indicating that there has been an emergency with your family and you impulsively sell your stocks because your adrenaline is running high, or if on the contrary you are thrilled because you recently came into some money you are liable to invest carelessly in a risky asset which would under scrutiny fail to hold its ground.

Social influence includes the herd instinct. This is the tendency to follow what others are doing instead of developing an independent viewpoint.. WhatsApp groups forwarding “hot tips”, and finance influencers on YouTube and Instagram promising the next multibagger have, if anything, made this bucket considerably bigger in recent years. It is worth noting that regulators have started paying closer attention to this space precisely because of how easily it feeds into herding behaviour among first-time investors.

Within these four buckets sit the specific biases that researchers keep coming back to. Overconfidence tops nearly every list of biases studied among Indian investors. Investors who have had a lucky run, particularly during a rising market, start believing their success is down to skill rather than a broad market rally, and this leads to more frequent trading and less diversification, both of which tend to hurt returns over time. Herding follows close behind, visible in the way money floods into whichever small-cap or mid-cap fund happens to be fashionable that quarter, or the way IPOs get oversubscribed purely on hype rather than on a careful reading of the offer document. Loss aversion shows up as investors holding on to losing stocks for far too long simply to avoid "booking" a loss on paper, while happily selling their winning positions early to lock in a gain, which is more or less the opposite of what a disciplined investment strategy would suggest. Anchoring is the tendency to fixate on a particular price, the price we originally bought at, say, and judge everything else against that number rather than against current fundamentals or future prospects.

The disposition effect, representativeness bias, framing bias, confirmation bias and hindsight bias round out the picture, each showing up repeatedly across the recent Indian studies reviewed for this paper (see Chart 3). Confirmation bias, for instance, explains why investors tend to seek out news and opinions that support a stock they already own while conveniently ignoring warning signs. Hindsight bias explains why, after a stock does well, almost everyone claims they "always knew" it would.

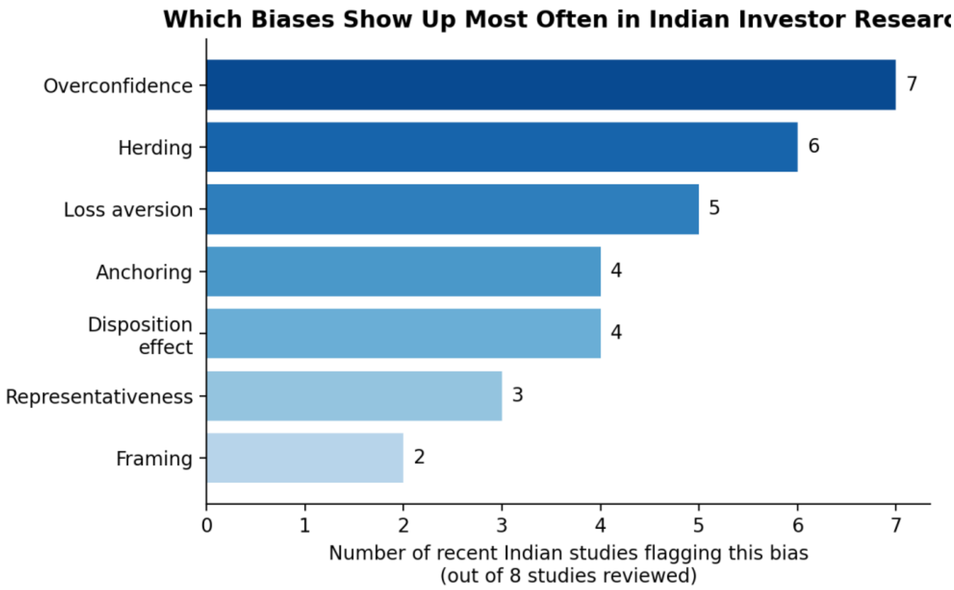

Chart 3: Number of recent Indian investor studies (out of 8 reviewed) flagging each bias as significant

Strategies for Mitigating Behavioural Biases in Investment Decision-Making

There is no magic cure, but behavioural finance provides some useful suggestions that focus on slowing down rather than complicated strategies.

The first suggestion is to focus on the process and ignore the outcome. There are two general modes of decision-making, reflexive and reflective. Reflexive is the fast and automatic mode, while reflective is the more thorough and slower mode. Because of reliance on reflexive decision-making, many investors make bad calls, especially during times of rapid market movement, where there is a lot of volatility. Building a habit of reflective decision-making, such as writing down why you are buying something before you buy it, or waiting twenty-four hours before acting on a tip, can slow things down enough to catch an emotional decision before it is acted upon.

The second suggestion is to prepare, plan, and pre-commit. Before making the actual trade, you should set loss limits and decide when to sell, as well as the percentage of your portfolio you will allocate to a specific stock or sector. This takes the decision-making from an emotionally charged situation and moves it to a more rational setting. Systematic Investment Plans (SIPs) are, in essence, an automatic way to achieve this. As you commit to investing every month regardless of the market situation, SIPs eliminate the space for emotionally charged trade decisions.

The Relevance of Behavioural Finance in Explaining Investor Behaviour and Market Dynamics

Behavioural finance has earned its place in the conversation for good reason. For one, it explains something traditional finance never really could: why so many highly qualified professionals, doctors and engineers often end up performing worse in the market than relatively unskilled investors who simply stay patient and let their money compound quietly in the background. It is not intelligence that drives returns in the stock market; it is temperament, and behavioural finance takes temperament seriously in a way older theories never did.

It also does a far better job of explaining real-world phenomena such as asset bubbles. Traditional theory, built on the assumption of rational markets, struggles to explain why prices sometimes detach entirely from fundamentals for months or even years at a stretch. Behavioural finance has no such trouble; herd behaviour combined with overconfidence explains bubbles rather neatly, without needing to assume that everyone involved was somehow acting the whole time rationally.

There are benefits from a practical point of view as well. Understanding these biases enables investors to identify buying and selling opportunities others miss because those investors are not responding to the buying and selling behaviour of the majority. This could be the case when the majority is selling because the market is crashing or buying in an overvalued market. Behavioural finance is a lot more helpful in understanding how money is moving through the market because it understands that investors behave differently at different stages of life, as opposed to a totally rational model. For example, younger investors are more willing to take greater risks. Older investors become more defensive and risk-averse when the market begins to decline.

Limitations of Behavioural Finance in Explaining Investment Decision-Making

None of this makes behavioural finance a complete answer, and it would be dishonest to present it as one. Its biggest weakness is that it is very good at describing what goes wrong but not particularly good at telling investors what to do instead. Pointing out a bias is not the same thing as fixing it, and knowing that you are prone to overconfidence does not, by itself, make you any less overconfident the next time markets are rising.

There is also a slightly uncomfortable side effect worth mentioning: reading too much about biases can leave investors second-guessing every single decision, which does little for their confidence and can occasionally lead to a kind of decision paralysis that is arguably just as harmful as overconfidence. Some of the conclusions drawn by behavioural researchers can appear contradictory, too. Investors are sometimes described as risk-averse in one study and overconfident in the next, and reconciling the two is not always straightforward, even for someone who studies this area closely.

Most of the biases discussed apply to individual investors rather than institutions, which limits how useful the framework is for understanding, say, mutual fund houses, insurance companies or foreign institutional investors, who operate under very different pressures and incentives. The framework also tends to overlook how social status and peer pressure shape financial decisions, something that matters a great deal in a country as socially interconnected as India, where financial decisions, whether it is buying gold before a wedding or choosing a particular insurance policy, are rarely made in isolation from family and community expectations.

Conclusion

Traditional finance gave us elegant models, but elegant models built on the assumption of a perfectly rational investor were never going to survive contact with real markets. Behavioural finance fills that gap by taking human nature seriously: our overconfidence, our tendency to follow the crowd, our discomfort with locking in a loss. The Indian data examined in this paper, from the very high proportion of derivative traders losing money in FY2023 to the still-modest levels of financial literacy across the country, suggests these biases are not a minor footnote but a fairly central part of how our markets actually function on a day-to-day basis.

None of this means investors are doomed to keep repeating the same mistakes forever. Awareness helps, financial literacy helps more, and a bit of discipline built into the process itself, deciding things calmly and in advance rather than in the heat of a falling or rising market, goes a long way towards better outcomes. Behavioural finance will not replace traditional financial theory, nor should it try to. But taken together, the two give a far more honest picture of how money actually gets managed, or mismanaged, than either could on its own, and that honesty is probably the single most useful thing this field has to offer both to policymakers and to the ordinary investor sitting at home with a trading app open on their phone.

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