

Creating Investment Strategies Using Behavioural Finance

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ABSTRACT

This paper is concerned with discussing some general principals of behavioral finance, including- financial cognitive dissonance, the theory of regret, overconfidence, and prospect theory. These principals are contrasted with those of traditional finance and the assumptions undertaken in traditional finance. This paper is intended to help those who invest (or trade) in stocks, derivatives, government bonds, and mutual funds by providing some important strategies to avoid psychological mistakes and errors in their investments. Individual investment preferences and the different factors of behavioral finance which influence investment decisions are also discussed here.

Keywords: *Behavioural Finance, Traditional Finance Theories, Behavioural Biases, Investment Decision Making, Investor Biases*

Throughout history- financial commentators, scholars, and analysts have observed the impact of human psychology on financial decision making and the outcomes. Over the last two decades, the term "behavioral finance" has become widespread scientific and financial communities. Several investment companies are currently applying behavioral finance studies to provide financial services (Baltussen, 2009).

Over the past 20 years, the field of behavioral finance has been rapidly growing and it uses insights from and knowledge of psychology to understand how human behavior influences the decisions of individual and professional investors, markets. Some decisions are simple, daily choices, such as how hard we are going to study for the next test, or what brand of t-shirt we are going to buy, but other decisions significantly impact our financial stability, such as whether to buy a particular stock or not.

The application of the insights of behavioral finance contrasts with that of the traditional finance paradigm, which assumes that economic agents are rational in order to comprehend financial decisions. The traditional finance paradigm implies that people act in a totally unbiased manner in order to make decisions that maximize their self-interest, but this concept involves unrealistic assumptions about human behavior and the functioning of financial markets. Plenty of other evidence indicates that markets generally do not behave in the textbook fashion. Compared with a rational model, markets seem to have too much

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volume and too much volatility (Thaler & Richard H.,1999). Some people have preferences that differ from rational factors, and their ability to process information and solve complex problems is limited in addition to social considerations and constraints (Baltussen, 2009) Therefore, classical finance theories may give an inaccurate description of financial behavior. In fact, many studies confirm this proposition in the overall behavior of financial markets, investors, and managers (Baltussen, 2009).

This paper is concerned with the practical implications of psychological biases that investors face while making investment decisions. Major themes of behavioural finance are used to explain these biases to help investors make logically-sound investment decisions. Section titled 'Research Objectives' elaborates on the intent of this paper, and the section titled 'Research Methodology' explains how the purpose of this research paper is achieved.

Research Objectives

The purpose of this paper is to study and discuss some general principals and past studies of behavioral finance, including- financial cognitive dissonance, the theory of regret, overconfidence, and prospect theory. This paper is intended to help those who invest (or trade) in stocks, derivatives, government bonds, and mutual funds by providing some important strategies to avoid psychological mistakes and errors in their investment decisions.

For investors, these strategies act as 'rules of thumb' and provide them a place to start as they are urged to keep track of their investments.

RESEARCH METHODOLOGY

In the context of behavioural finance, this paper has covered four topics: overconfidence, cognitive dissonance, regret theory, and prospect theory. These four subjects serve as an overview of the numerous themes that have begun to emerge in the discipline during the past several years. As behavioural finance scholars eventually do study and put ideas into practise, or as other approaches become outmoded or are rejected, the validity of all of these themes will be put to the test throughout time.

On the basis of these theories and themes of behavioral finance, Investment strategies have been devised and listed in order to help stock and bond investors overcome and regulate their psychological barriers.

In traditional finance, theorists assume that the common investor makes perfectly rational decisions, applies unlimited processing power to any available information, and holds preferences well-described by standard utility theory.

In short, the traditional economist assumes people to be **Homo Economicus**- a hypothetical person who behaves in exact accordance with their rational self-interests.

Table 1. Traditional Financial Theories (Source: Kapoor & Prosad, 2017)

Author	Year	Finding
John Stuart Mill	1844	Introduced the concept of Economic Man or <i>homo-economicus</i>
Bernoulli	1738, 1954	
Von Neumann and Morgenstern	1944	
Harry Markowitz	1952	Markowitz Portfolio Theory
Treynor, Sharpe and Lintner	1962,1964, 1965	
Jan Mossin	1966	
Eugene Fama	1970	Efficient Market Hypothesis

One of the main themes of standard finance is the **Modern Portfolio Theory (MPT)** -also known as ‘Markowitz Portfolio Theory’, which proposes a practical method for selecting investments in order to maximize their overall returns within an acceptable level of risk. This theory was developed by Harry Markowitz (an American economist) and was published in the Journal of Finance in 1952; according to this theory an individual can create an ‘efficient portfolio’ by studying a stock or portfolio’s expected return, it’s standard deviation, and it’s correlation with the other stocks or mutual funds held within the portfolio. An efficient portfolio consists of a group of stocks or bonds that has a maximum expected return given the amount of risk assumed, or on the contrary, consists of least possible risk for a given expected return value. Markowitz argues that any investment’s given risk and return characteristics should be evaluated by how it affects the overall portfolio’s risk & return and not be viewed alone. Considering a stock’s historical data’s variance and correlation, a single investment's performance is less important than how it impacts the entire portfolio. Although the MPT is criticized for its negligence towards downside risk. To understand this, consider two portfolios that have the same level of variance and returns, so they will be considered equally desirable under modern portfolio theory. But one portfolio may have that variance because of frequent small losses and the other one could have that variance because of rare but spectacular declines. Most investors prefer frequent small losses, which are easier to endure.

Another popular theme of standard finance is the **Efficient Market Hypothesis (EMH)** according to which markets are are efficient, leaving no room to make excess profits by investing since everything is already fairly and accurately priced. This implies that there is little hope of beating the market, although you can match market returns through passive index investing. According to the efficient market hypothesis, stocks always trade at their respective fair value on stock-exchanges, making it impossible for investors to purchase undervalued stocks or to sell stocks for inflated prices. Therefore, it should be impossible to outperform the market through expert stock selection or market timing, and thus, the only way an investor can obtain higher returns is by purchasing riskier investments. This premise is supported by the fact that the S&P 500 beats the overall market by approximately 60% to 80%.

Some notable aspects of the EMH are as follows and must be kept in mind. Stock analysis provides no benefits in an efficient market because prices already reflect all available information; but this is not intended to say that the investors should avoid stocks or other assets. It might not be possible to consistently generate abnormal profits but the return must be warranted based on the risk associated with the investments. Also, the benefits to

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diversification of portfolio do not disappear in efficient markets nor do the benefits from tax planning; thus, the financial advisors play an important role in efficient markets as well and the EMH is not an evidence against their work.

Although these theories are successful and have well defined established premises, since 2002- when Daniel Kahneman was awarded The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel for having integrated insights from psychological research into economic science- *Behavioral Finance* as a science has become especially popular and a better alternative to traditional or standard finance.

BEHAVIOURAL FINANCE

When studying behavioral finance, traditional finance still remains a centre piece -the reason why we discussed traditional finance first; however, psychology and sociology are integral parts of behavioral finance. Psychologists and sociologists have been studying how human behavior affects their decision, including investment decisions. Behavioral finance uses models in which some agents are not totally rational, either because of personal preferences or because of mistaken beliefs. (Jay R. Ritter, 2003)

Scientists in these disciplines focus on how decision makers make their decisions. Traditional finance theory is normative because it indicates how investors should make decisions; on the other hand, the behavioral science approach tries to understand how the investors make the observed decisions, why their decisions might not appear to be rational every time, and why they have unintended outcomes.

Table 2: Behavioral Finance Theories (Source: Kapoor & Prosad, 2017)

Author	Year	Finding
Herbert Simon	1955	Models of bounded rationality
Festinger, Riecken and Schachter	1956	Theory of cognitive dissonance
Tversky and Kahneman	1973, 1974	Introduced heuristic biases: availability, representativeness, anchoring and adjustment
Kahneman and Tversky	1979	The prospect theory, introduced loss aversion bias
Tversky and Kahneman	1981	Introduced Framing Bias
Richard Thaler	1985	Introduced mental accounting bias
De Bondt and Thaler	1985	Theory of overreaction in stock markets
Barberis, Shleifer and Vishny	1998	Investor sentiment model for under-reaction and overreaction of stock prices
Meir Statman	1999	Behavioural asset pricing theory and behavioural portfolio theory
Andrei Shleifer	2000	Linkage of behavioural finance with efficient market hypothesis to find that stock markets are inefficient
Barberis, Huang and Santos	2001	Incorporation of prospect theory in asset prices.
Grinblatt and Keloharju	2001	Role of behavioural factors in determining trading behaviour
Hubert Fromlet	2001	Importance of behavioural finance. Emphasis on departure from ' <i>homo economicus</i> ' or

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		traditional paradigm to more realistic paradigm Survey of Behavioral Finance
Barberis and Thaler	2003	Effect of behavioural biases on stock prices.
Coval and Shumway	2006	The price reversal for biased investors is quicker than unbiased investors
Avanidhar Subrahmanyam	2008	Normative implications of behavioural finance on individual investors and CEOs.
Richard Thaler	2008	Impact of mental accounting on consumer choice behaviour
Robert Bloomfield	2010	Compares the behavioural and traditional finance approach in explaining market inefficiencies
Parag Parikh	2011	Practical implications of behavioural finance and investor sentiments in value investing

The basic foundation of behavioral finance is an area based on an interdisciplinary approach, which includes scholars from social sciences and business schools. (Ricciardi et al., 2000). It is important to understand the ‘**Market Paradox**’ which occurs in order for the markets to be efficient; investors must believe that the markets are inefficient.

If this condition is not fulfilled and investors readily believe the markets to be efficient, there would be no point in engaging in active share trading and thus, markets would not react quickly and efficiently to new information.

Once the markets are assumed to be inefficient by most investors, a number of patterns and scenarios come into being. One of them is the momentum effect- a period of rising share prices may result in a general feeling of optimism that prices will continue to rise and an increased willingness to invest in companies that show prospects for (short term) growth.

Behavioral finance has also been used to study and explain various stock market anomalies, such as the January effect; speculative market bubbles, such as the .com bubble of 1999; and market crashes, such as that of 1987 and 2008. It also attempts to explain how and why emotions and cognitive biases create anomalies in stock market for investors.

It must be noted that a thorough understanding of this science can be lucrative, as an emerging belief is that people systematically make mental errors in the financial decision making. Being able to recognize these mistakes in oneself (while making investments) and in others (finding a mis-priced security) can be a very useful skill for investors as well as for those working in financial services; superior investment returns could be made by buying and selling underpriced securities.

Four major themes of behavioral finance are- Financial cognitive dissonance, Prospect Theory and Loss Aversion, Regret Theory, and Over confidence Bias.

Financial Cognitive Dissonance

To understand Cognitive Dissonance, consider the following hypothetical scenario- Jerry, an avid environmentalist, is president of the environmental club at school, goes to climate change marches, and his family owns an electric car. One day, Jerry decides to attend a seminar on the negative environmental effects of certain animal products which contribute

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significantly to climate change. To his dismay, Jerry realizes that he uses many of those products on a regular bi-weekly basis. That means that he is a part of the problem that he has been trying to solve. However, Jerry isn't willing to stop eating meat and he knows that his family won't be willing to stop either. To get rid of the pit in his stomach and resolve the identity crisis he is having, Jerry quickly concludes that the speaker must not know what they are talking about. Additionally, he reminds himself that even if animal products aren't great for the environment, he has done so many other things that are good for the environment and that it must even out. Jerry's mind is put at ease.

Cognitive dissonance is most likely at work here. To resolve the inconsistency revealed by this new information on certain animal products, Jerry rejects and rationalizes the speech so that his identity as an environmentalist isn't painfully compromised.

This theory may apply to investors or traders in the stock market who attempt to rationalize contradictory behaviors, so that they seem to follow naturally from personal values and viewpoints. The research study of Goetzmann and Peles (1997) examines the role of cognitive dissonance in Mutual Fund investors, arguing that some individual investors experience dissonance during the mutual fund investment process- specifically, the decisions to buy, sell, or hold. Another research has shown that investor dollars are more quickly allocated to leading funds (mutual funds with strong performance gains) than outflows from lagging funds (mutual funds with poor investment returns). Essentially, the investors in the under-performing funds are reluctant to admit they made a "bad investment decision." Although, the proper course of action would be to sell the under-performer more quickly, investors choose to hold on to these bad investments. By doing so, they do not have to admit to the fact that they made an investment mistake.

Prospect Theory or the Loss Aversion Theory

Prospect theory was originally developed by Daniel Kahneman and Amos Tversky and was originally published in 1979 in *Econometrica*. The theory assumes that losses and gains are valued differently, and thus individuals make decisions on the basis of perceived gains instead of perceived losses. This theory is also known as the Loss-Aversion theory, and the general concept is that if two choices are presented before an individual, both choices being equal, with one presented in terms of potential gains and the other presented in terms of possible losses, the former option will be chosen.

An example of Prospect theory at work would be Purchasing insurance policies when historic data is unavailable. One could buy a dog or a cat and get trapped into the dilemma of whether or not to buy a health insurance for his/her new pet. In most cases, a family health record won't be available for the pet; so the likelihood of the pet having an issue as an unknown: there was no way to predict whether something could pop up and be a major expense. One could save the insurance money and hope that his/her pet remains perfectly healthy, but if a health issue were to appear he/she would possibly need to spend exorbitant amounts of money for treatment.

People generally tend to overweight small probabilities to guard against losses. Even when the likelihood of a costly event is minuscule, we would rather agree to a small, sure loss-insurance payment in the example above- than risk a large expense. We perceive the likelihood of a greater loss occurring to be more than it actually is. All of us would like to believe that we are logical decision makers. Many research papers often talk about how users weigh the expected utility of different alternatives to determine what action to take

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and/or where to go next. However, when it comes to making decisions such as make a donation, whether to purchase something, or to pick a level of a service, people are highly prone to cognitive biases, and often do not make the logical choice.

Consider the following investment selection:

Choice A- Sure profit of \$15000

Choice B- A 90% possibility of gaining \$18,000, with 10% chance of gaining nothing.

Question: Which option would give one the best chance to maximize his/her profits?

Most people act risk averse when confronted with an expectation of a financial gain and thus, pick Choice A, which is a sure gain of \$15,000.

But this is in fact the less attractive alternative because the investors' overall performance on the cumulative basis would be greater in Choice B than that in Choice A.

The payoff associated with Choice A is calculated by: $(\$15,000 * 100\%) = \$15,000$.

The payoff associated with Choice B is greater i.e., \$16,200.

The payoff is calculated by: $(\$18,000 * 90\%) + (\$0 * 10\%) = \$16,200$.

Now consider this scenario-

Choice A: Loss of \$900 for sure.

Choice B: 90% chance of losing \$1000, with 10% chance of losing nothing.

Most people would pick the second option i.e., 90% chance of losing \$1000 and thus engage in a risk seeking behavior in the hope to avoid the loss entirely.

Expected value for choice A is calculated by: $(-\$900 * 100\%) = -\900

Expected value for choice B is calculated by: $(-\$900 * 90\%) + (\$0 * 10\%) = -\$900$

Regret Theory

Regret theory, as studied in behavioral finance, is a concept stating that investors will feel regret if a wrong decision is made and thus will consider this anticipated regret when making investment decisions. Fear of regret can play a significant role in discouraging someone from taking an action. This can impact an investor's rational behavior, thus, impairing their ability to make investment decisions that would benefit them as opposed to harm them. On the other hand, it can also encourage investors to make investments that have a higher risk and thus, can lead to losses. During extended bull markets, regret theory causes some investors to continue investing heavily and ignoring the signs of an impending crash.

It is very important to understand that this impact can be significantly controlled if the investor has an understanding and an awareness of the regret theory. They need to look at how regret as affected their investment decisions in the past and study their train of thought when making an investment decision.

For Example- An investor, having missed a large trending move in the past, now only trades momentum stocks to try to catch the next big upward move. This investor must realize that he tends to regret missed opportunities and consider that before his investments.

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This theory is closely related to the fear of missing out (FOMO). Many investors, even the most conservative ones, would ignore warning signs during an extended bull market because of this fear. The result could be disappointing as such an investment is made with an ignorance of the warning signs and without enough analysis.

Investors may also avoid selling stocks that have declined in value in order to avoid the regret of having made a bad investment choice and the discomfort of reporting a loss.

Overconfidence Bias

Thinking that you're better than average may fuel risky decisions. In investing, overconfidence bias often leads people to overestimate their understanding of the financial markets or specific investments and to disregard data & expert advice. This bias often results in ill-advised attempts to time the market or build concentrations in risky investments that the investors consider a sure thing.

People tend to be overconfident about their abilities and skills. Not so surprisingly, young entrepreneurs are especially likely to be overconfident. The overconfidence bias manifests itself in a number of ways. (Jay R. Ritter, 2003)

Evidence suggests that even financial experts with powerful tools at their disposal can have difficulty outpacing the market on a regular basis, but the overconfidence bias tricks the brain into believing that it is possible to beat the market *on a consistent basis* by making risky bets (investments). It should be no surprise that for an average investor, overconfidence can potentially be a pathway to poor portfolio performance. Beyond that, clients' overconfidence may also lead them to overestimate their level of risk tolerance, resulting in investment strategies that don't truly align with their needs or financial objectives. Most market analysts consider themselves to be above average in their analytical skills; However, it is obviously statistically impossible for *most analysts* to be *above the average analyst*.

As human-investors, people have the inherent ability to forget the lessons learnt from our past errors. The failure to learn from our past errors further adds to our overconfidence dilemma. The biggest danger of an overconfidence bias is that it makes one prone to making mistakes in investing. Much of these mistakes stem from an illusion of knowledge. Overconfidence tends to make us less than appropriately cautious while making our investment decisions.

RESULTS: DEVELOPING EFFICIENT INVESTMENT STRATEGIES

On the basis of the information gathered in the previous section, this section discusses several important factors and variables to be kept in mind while developing any kind of investment strategy. Please note that many of these points are applicable for making investment decisions not only in financial markets but also in day-to-day life and in financial problems faced by people in today's world.

The goal is to counteract your investor biases and make decisions using a rational mind-set by refining your decision-making process. The investment decisions shall be made in an unemotional way, and they must solely be based on the information available and with respect to your long term and short-term financial goals.

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Having a long-term viewpoint is often helpful to avoid assuming that current performance is an indicative of future performance. However, one needs to keep in mind that current market trends are not the same as the past trends they may resemble. For example- factors that led to stock-market crashes include elements unique to each.

Loss aversion, as discussed earlier, is beneficial when it keeps you from taking too much risk, but not when it keeps you from undertaking profitable opportunities. Using reliable information to best assess the scope and probability of loss is a way to see the loss in context.

Automating the investment strategy is one's best protection against his/her behavioral impulses. Such an automation might be done to have a plan based on an objective analysis of goals, risk tolerance, and constraints, taking your entire portfolio into account. Having a well-defined plan in place helps one counteract investor biases.

If you want to become a better investor, you will need to become less human when deciding where to put your money. That sounds harsh, but it'll benefit you to take control of your own biases and know how your faulty thinking has hurt you in the past.

Following your investment policy or plan, you are able to determine the capital and asset allocations that can produce your desired return objective and risk tolerance within your defined constraints. Your asset allocation should be diversified; this is a good idea suitable for most investment strategy is.

When investing in stocks- focusing on a specific investment strategy over a long-term. Doing so is the best way to avoid mental errors while taking investment buy/sell decisions.

One must ask himself whether he has all of the data needed to make the right investment choices. Getting to know everything about a stock before buying or selling it is not an easy task.

Keeping detailed records of why you purchased or sold a particular stock can reveal data that can be helpful. Also, time to time, asking yourself questions such as- "Do I always think I am right?" , "Do I take credit for investment wins or blame outside factors for my losses?" , and "Have I ever sold stock in anger/ego, or bought a stock based on a simple gut feeling?" Investors should decide upon a fixed-specific criteria for making an investment decision (buy, sell, or hold). This could be achieved by including a checklist of financial fundamentals- of the company whose stock is being considered to be bought or sold.

Lastly, investors should be beware of prevalent fraudulent schemes. Bubbles often attract not only fraudulent schemers but also investors and speculators. A loss of market efficiency and signs of greater investor irrationality attract con-men to the financial markets. It's easier to convince a "mark" of the credibility and viability of a fraudulent scheme when there is general prosperity, rising asset values, and lower perceived risks.

For example- During the post-World War I expansion and the stock bubble of 1920s, Charles Ponzi created the first Ponzi scheme, which was a variation of the classic pyramid scheme. The pyramid scheme creates "revenue" from new members' deposits rather than from real earnings in the market place. The originator gets a number of people to invest, each of whom recruits more people, and so on. However, the money from each group of

investors, rather than being invested, is used to pay “returns” to the previous group of investors. The scheme gets uncovered when there are not enough “returns” to go around. Thus, the originator and the early investors may make a lot of money, while later investors lose most of their money.

DISCUSSIONS

Standard finance has been the preeminent theory in the academic world for the past 50 years. However, academics and financial experts are currently looking into behavioural finance as an alternative theory for financial decision making. The goal of behavioural finance is to increase public understanding of the psychological and emotional aspects that influence persons and entities that invest in the financial markets. The multidisciplinary research that forms the basis of this burgeoning subject is becoming more and more appreciated by behavioural finance academics and investment specialists. We think that a wide range of individual investors, investor groups, and entire organisations engage in the stock market activities discussed in this research. Behavioral Finance examines how actual investors are affected by their psychological biases and reduces the strict rationality requirement prevalent in conventional financial theories. They can make poor decisions as a result of these biases, which are transferred into their behaviour. These choices are referred to as market anomalies. Such anomalies must be avoided because they have a detrimental impact on both the financial health of the individual and the overall economy.

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Conflict of Interest

The author declared no conflict of interest.

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