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Behavioral factors on Investment Decisions in the Nepalese Stock Market

Babu Ram Panthi, Ph. D. Scholar
Associate Professor, Balkumari College, TU
email: panthibr@gmail.com

Samikshya Gurung
Balkumari College
email: samugurung0516@gmail.com

ABSTRACT

This study explores the influence of perceived behavioral factors on investment decisions in the Nepalese Stock Market (NEPSE). It assesses whether heuristic behaviors, prospect theory, market variables, and herding influence investment decisions and performance. A sample of 350 investors was selected using a random sampling technique, and data were collected through structured questionnaires. The study uses descriptive and analytical research designs to analyze the relationship between behavioral factors and investment decisions. The results show that heuristic variables, such as reliance on personal expertise and trend-following, significantly impact investment performance. However, prospect and market variables and herding behavior exhibit no significant effect on investment outcomes. The study highlights that while investors often depend on cognitive shortcuts, numerous unexplored factors influence their performance. This research offers valuable insights for policymakers, investors, and market analysts seeking to understand the behavioral drivers in emerging markets like Nepal.

Keywords: Behavioral Finance, Heuristics, Investment Decisions, Stock Market, NEPSE

Introduction

Financial markets are vital to economic functioning, yet they remain fragile due to inherent inefficiencies and complexities (Adhikari & Phuyal, 2017). Investment decisions are influenced by psychological factors such as emotions, biases, and herd behavior, which can lead to market inefficiencies. For instance, irrational exuberance during bullish periods or panic-driven selling during downturns often exacerbates market volatility (Chaudhary, 2018).

The Nepalese stock market, regulated by NEPSE and SEBON, has experienced remarkable growth in recent years, driven by digitalization and increased investor participation in the primary market across all 77 districts of Nepal. By the end of Ashar 2079 (mid-July 2022), approximately 1.46 million User IDs were issued for online transactions in the secondary market. During the review year, this number grew by about 18.63%, reaching 1.73 million. Similarly, the total number of investors in the secondary market of the stock exchange reached 3.243 million by the end of Ashadh 2080 (mid-July 2023). Among them, nearly 800,000 investors were actively engaged in transactions (SEBON, 2079/2080).

Despite these advancements, Nepal's stock market remains young and vulnerable to inefficiencies driven by economic, political, and psychological factors (Adhikari & Phuyal, 2017). Psychological biases, such as overconfidence, anchoring, and herd behavior, continue to shape investment decisions, often leading to suboptimal outcomes (Kahneman & Tversky, 1979).

Unique challenges faced by Nepalese investors include political instability, market volatility, and insufficient information. Political instability negatively impacts investor confidence and market stability, while misinformation and insider trading create confusion for investors. Many investors lack the financial literacy and analytical skills needed to evaluate company financial information, leading to poor investment choices and suboptimal portfolio performance. Behavioral biases, such as overconfidence in investment knowledge, anchoring to past price trends, herding behavior, and risk aversion, significantly influence investment decisions. These biases can lead to irrational choices that deviate from optimal investment strategies. The lack of readily available, trustworthy professional guidance compels many investors to rely on personal networks, anecdotal evidence, and informal advice for their investment decisions.

A comprehensive and meticulous analysis of the various determinants that significantly influence the investment behaviors exhibited by Nepalese investors operating within the confines of the Nepal Stock Exchange (NEPSE) is of paramount importance, particularly focusing on an array of critical demographic factors, diverse income brackets, the implications of governmental policies, prevailing cultural predispositions, as well as the unique challenges and obstacles that are encountered within the precarious and often volatile landscape of Nepal's financial market. This scholarly research endeavor seeks to fill existing gaps and voids present in the current body of academic literature by conducting an in-depth investigation into the portfolio selection behaviors that are characteristic of Nepali investors, while simultaneously elucidating the various strategies and methodologies that these investors employ to effectively navigate their investment decisions in a market that is notably characterized by a significant scarcity of sophisticated and advanced financial instruments. By adopting and implementing a mixed-methods research approach that skillfully integrates both qualitative and quantitative research techniques, this study aspires to produce valuable insights that would prove beneficial not only to policymakers and financial consultants but also to individual investors who are keen on enhancing their financial well-being, thereby ultimately fostering greater market engagement and optimizing returns for investors within the rapidly evolving and burgeoning economic framework of Nepal.

Behavioral finance investigates how psychological, social, and emotional factors influence investment decisions, often leading to deviations from traditional finance theories that assume rational decision-making. These factors can result in irrational choices and, as a consequence, affect market dynamics.

Literature Review

The Theory of Planned Behavior (TPB) delineates three fundamental determinants of behavioral intention: attitude (AT), subjective norms (SN), and perceived behavioral control (PBC), each shaped by distinct belief systems. Attitudinal beliefs govern AT, nominal beliefs sway SN, and control beliefs affect PBC, collectively influencing intentions and behaviors (Ajzen, 1991). Within the domain of investment decision-making, heuristics function as instruments for alleviating the intricacies of complex decisions amid uncertainty by reducing complexity and relying on probabilistic assessments (Waweru et al., 2008). This encompasses biases such as representativeness, availability bias, gambler's fallacy, overconfidence, and anchoring (Kahneman & Tversky, 1974). For example, representativeness bias entails investors presuming that recent trends will continue, frequently resulting in skewed decisions by overemphasizing recent experiences while disregarding long-term averages (DeBondt & Thaler, 1995; Ritter, 2003). Overconfidence, characterized by investors' tendencies to overrate their knowledge and underestimate risks, can lead to inadequately diversified portfolios (DeBondt & Thaler, 1995), whereas anchoring involves dependence on historical trends or initial values in appraising stock prices (Kahneman & Tversky, 1979). Gambler's fallacy embodies the conviction that trends will revert, prompting investors to formulate erroneous predictions based on perceived turning points (Waweru et al., 2008), and availability bias results in decision-making predicated on readily accessible information, frequently culminating in less diversified investments.

Prospect Theory provides a comprehensive understanding of the fundamental value systems and cognitive processes employed by investors, encompassing constructs such as loss aversion, regret, and mental accounting, which significantly influence decision-making frameworks based on the context of gains or losses (Kahneman & Tversky, 1979). The interplay of market dynamics, consisting of price changes, past trends, and heightened responses to news, plays a crucial role in influencing investment decisions by reshaping perceptions related to stock valuation (DeBondt & Thaler, 1995; Waweru et al., 2008). The phenomenon of herding behavior, wherein investors emulate the choices of a collective to conform with prevailing market fundamentals, significantly impacts risk-return paradigms and asset valuation (Luong & Ha, 2011; Tan et al., 2008). The perception of risk, which varies according to individual cognitions and the information at hand, may escalate in contexts characterized by inadequate data and gender disparities, thereby shaping risk-taking behaviors (Tversky & Koehler, 1994; Weber, 2004). Ultimately, investment performance is assessed in terms of portfolio returns concerning associated risks, with cognitive biases and psychological dimensions critically influencing rationality and decision-making processes (Randall et al., 1990). Collectively, these theoretical frameworks and cognitive heuristics illuminate the intricate interplay of psychological and market factors that inform investor behavior and overall performance.

Mahastanti and Hariady (2014) utilized the Theory of Planned Behavior to assess investment intentions among Indonesian women, revealing that perceived behavioral control and risk preference positively influenced intentions, while subjective norms and attitudes did not. Dangol and Manandhar (2020) analyzed the effects of heuristics on Nepalese investors' decisions, finding significant influences while overlooking other behavioral factors. Similarly, Pandey et al. (2020) determined that accounting information, advocate suggestions and personal financial needs significantly impacted investor psychology in Nepal, with additional influences from word of mouth and company goodwill, although not all behavioral aspects were addressed. Pokharel (2020) investigated market

variables on investment decisions, noting significant impacts while herding, heuristics, and prospect variables showed negligible influence, constrained by a 120-sample size and descriptive methodology. Rosdiana (2020) identified herd behavior, financial literacy, risk aversion, and risk perception as crucial determinants of investment decisions, substantiated through regression analysis. Fares and Khamis (2021) indicated that age, education, internet access, and investor-broker interaction shaped stock trading behavior in Jordan, with younger, educated investors engaging more actively and broker interaction fostering strategic trading. Septyanto et al. (2021) recognized attitude, behavioral control, religiosity, religious events, and profit maximization as key factors influencing sharia-stock investment intentions among Muslim investors in Indonesia. Rehan et al. (2021) confirmed behavioral finance theories in Pakistan, illustrating that herding, heuristics, market, and prospect variables significantly affected investment decisions and returns. Almansour et al. (2023) established that herding, disposition effect, and blue-chip bias substantially influenced risk perception, mediating investment decisions in Saudi Arabia, while overconfidence had a direct effect on decisions.

Statements of Problem

From the analysis of existing literature, the interrelations among heuristic variables, prospect theory, market variables, and herding behavior, as well as their cumulative influence on investment decisions, remain inadequately examined within the context of Nepal. The ensuing gaps highlight the research dilemma:

Heuristic biases, such as representativeness and anchoring, profoundly influence individual cognitions yet have not been subjected to thorough evaluation in the Nepalese framework. Prospect-related variables, including risk aversion and regret, are insufficiently investigated, particularly concerning their interactions with demographic factors such as age and educational attainment. Market-associated variables, including stock price fluctuations and media impact, necessitate more extensive inquiry into their psychological ramifications for investors. Herding behavior, while observable in numerous markets, has not been adequately associated with the behavioral elements that shape collective investment decisions. The prevailing research is devoid of a cohesive framework to scrutinize the interplay among these determinants and their direct ramifications on investment choices.

This research article focuses on addressing the following issues:

a. How do heuristic biases like overconfidence, representativeness, and anchoring influence behavioral factors in investment decisions?

b. What is the role of prospect variables, such as loss aversion, regret, and mental accounting, in investors' decision-making?

c. How do market dynamics, including stock price fluctuations, historical trends, and the dissemination of news, affect behavioral factors and decision-making processes?

d. How does herding behavior enhance collective psychological biases and impact investment decisions?

Objectives

The study examines the behavioral factors influencing investment decisions in the Nepalese stock market, focusing on heuristics, prospect theory, market dynamics, and herding behavior, highlighting the importance of understanding these factors for improved market efficiency. The specific objectives are:

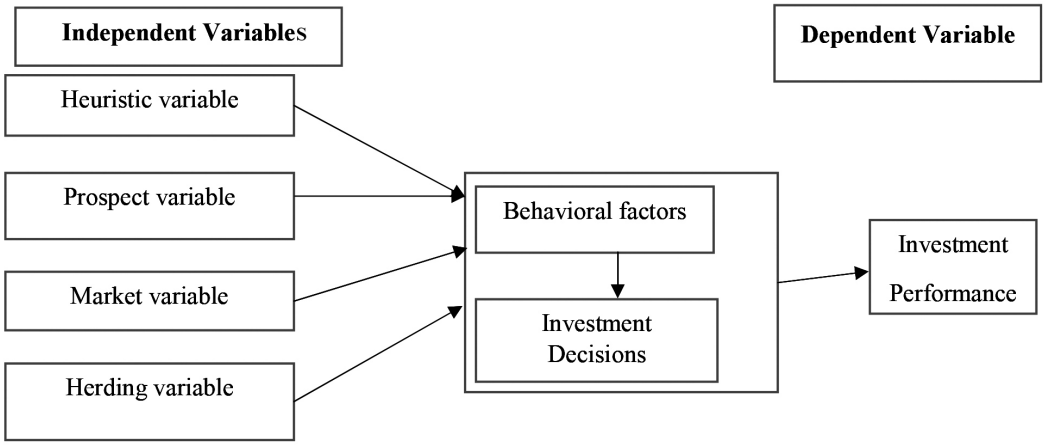
a. To analyze the influence of heuristic variables, such as overconfidence and anchoring, on investment decisions in the Nepalese stock market.

b. To examine the role of prospect variables, including loss aversion and mental accounting, in shaping investors' behavioral factors and decision-making.

c. To evaluate the impact of market dynamics and herding behavior on investment patterns and the decision-making process in the Nepalese stock market.

Research Methods

This investigation utilized a descriptive and analytical research methodology to clarify changes and examine relationships among various variables. The study population comprised stock market investors living in Bharatpur, Chitwan. After excluding nonresponses, a sample of 350 investors was selected through random sampling from four brokerage branches located in the Bharatpur and Narayangarh regions: Sani Securities, Oxford Securities, Trisul Securities, and Premier Securities. Data collection was carried out using structured questionnaires distributed to the participants. A five-point Likert scale (ranging from 1 - Strongly Disagree to 5 - Strongly Agree) was employed to assess the respondents' levels of agreement, with a variety of statistical tools used for data analysis.



Source: Luong, L. P., & Ha, D. T. (2011).

Figure 1: Conceptual Framework

Heuristics are decision-making rules used to simplify complex scenarios, particularly in uncertain situations, by reducing procedural complexity and relying on predictive probabilities. While they are effective under time constraints, as noted by Waweru et al. (2008), they can sometimes lead to biases. Prospect Theory, as opposed to Expected Utility Theory (EUT), focuses on the internal value systems of investors, highlighting their tendency to underweight probable outcomes compared to certain ones, as discussed by Filbeck, Hatfield, and Horvath (2005). This theory explains certain behaviors like risk aversion in gains and risk-seeking in losses, although EUT is often criticized for its influence on gambling and insurance behaviors. Market factors, identified by De Bondt and Thaler (1995), refer to phenomena such as extreme reactions to news or price changes, the misuse of past trends, neglect of fundamental stock analysis, and an overemphasis on popular stocks, which significantly affect investor decision-making in the stock market. Herding, as defined by Luong and Ha (2011), is the tendency of investors to follow the decisions of a group in an attempt to avoid deviations from market fundamentals, although this behavior can limit opportunities based on available information. Investment performance, on the other hand, measures the return on an investment portfolio at a given risk level, with conventional finance emphasizing rationality for optimal performance. However, behavioral finance suggests that biases, emotions, and ingrained thought patterns significantly influence investment decisions, as highlighted by Randall, Andrei, and Robert (1990).

Table No.1: Respondents Profile

Demographic Indicators	Frequency (n)	Percent
Gender – Male	256	73.14
Female	94	26.86
Marital Status – Married	281	80.29
Unmarried	69	19.71
Below 25	56	16.00
26-35 Years	104	29.71
36-45 Years	91	26.00
46-55 Years	53	15.14
Over 55 Years	46	13.14
Education - Under SEE	4	1.14
SLC	25	7.14
Plus Two	66	18.86
Bachelor	162	46.29
Master	93	26.57
Working Experience - Below 5 Years	182	52.00
5 to 10 Years	92	26.29
Above 10 Years	76	21.71
Monthly Income - Below Rs 10000	25	7.14
Rs 10001 to Rs 20000	100	28.57
Rs 20001 to Rs 30000	90	25.71
Rs 30001 to Rs 40000	44	12.57
Rs 40001 to Rs 50000	47	13.43
Above Rs 50000	48	13.71
Duration of Investment - Below 1 Year	80	22.86
1 to 3 Years	140	40.00
3 to 5 Years	55	15.71
5 to 10 Years	60	17.14
Above 10 Years	17	4.86

Source: Field Survey, 2024

Table 1 shows that out of a total of 350 individual investors situated in Bharatpur, Chitwan, the demographic assessment elucidates that a significant proportion of participants are male (73.14%), predominantly married (80.29%), and predominantly situated within the age bracket of 26–45 years (55.71%). A majority have achieved higher educational qualifications, with nearly half possessing a Bachelor's degree (46.29%), and more than half (52%) have professional experience of less than 5 years. The most common income bracket is Rs 10,001–20,000 (28.57%), whereas only a small fraction earns below Rs 10,000. In terms of investment tendencies, the majority of respondents engage in short-term investments, with 62.86% allocating funds for less than 3 years, thereby indicating a proclivity for shorter investment horizons and potentially a constrained risk tolerance.

Table 2. Coefficient of Cronbach's alpha

Variables	No. of questions	Cronbach's Alpha
Heuristic Variable	6	.798
Prospect Variable	6	.850
Market Variable	6	.826
Herding Variable	4	.832
Behavioral Factors	6	.827
Investment Decision	6	.905
Investment Performance of Individual Investors	5	.826

Note: Response to survey questionnaire

Table 2 explains the reliability of the survey instrument through the delineation of Cronbach's Alpha coefficients for each variable. The Heuristic Variable (0.798), Prospect Variable (0.850), and Market Variable (0.826) exhibit commendable internal consistency. The Herding Variable (0.832) and Behavioral Factors (0.827) likewise manifest reliable measurements. The Investment Decision demonstrates the highest level of reliability at 0.905, thereby ensuring robust consistency. Finally, Investment Performance (0.826) corroborates satisfactory reliability.

Table 3. Correlation Analysis

		HV	PV	MV	HEV	IP
HV	Pearson Correlation	1				
	Sig. (2-tailed)					
PV	Pearson Correlation	.047	1			
	Sig. (2-tailed)	.380				
MV	Pearson Correlation	-.059	-.100	1		
	Sig. (2-tailed)	.274	.061			
HEV	Pearson Correlation	.145**	.061	-.029	1	
	Sig. (2-tailed)	.006	.254	.586		
IP	Pearson Correlation	.106*	-.012	.061	-.077	1
	Sig. (2-tailed)	.047	.817	.258	.150	
**. Correlation is significant at the 0.01 level (2-tailed).						
*. Correlation is significant at the 0.05 level (2-tailed).						

Source: Calculation using SPSS

Correlation analysis between Investment Performance (IP) and four independent variables: Heuristic Variables (HV), Prospect Variables (PV), Market Variables (MV), and Herding Variables (HE). A significant positive correlation exists between IP and HV ($r = 0.106$, $p < 0.05$), indicating a slight positive influence of heuristics on investment performance. However, no significant relationships are observed between IP and PV ($r = -0.012$, $p = 0.817$), MV ($r = 0.061$, $p = 0.258$), or HE ($r = -0.077$, $p = 0.150$). HE shows a positive correlation with HV ($r = 0.145$, $p < 0.01$) and a negative correlation with certain investment decisions ($r = -0.115$, $p < 0.05$). Overall, only heuristic variables marginally affect investment performance.

Table No. 4: Model Summary

[*Impact of Investment Performance (IP) with Heuristic Variables (HV), Prospect Variables (PV), Market Variables (MV), and Herding Variables (HEV)]*

Metric	R / R^2 (Adj.)	F (Sig.)	Durbin-Watson	Coefficients (B, Sig.)	Variables (B, Sig.)
Summary	0.156 / 0.024 (0.013)	2.150 (0.074)	1.991	Const: 2.718 (0.000)	HV: 0.145 (0.022), PV: -0.007 (0.910), MV: 0.074 (0.229), HEV: -0.083 (0.086)

Table 4 shows the findings of the regression analysis of Investment Performance (IP) with the inclusion of Heuristic Variables (HV), Prospect Variables (PV), Market Variables (MV), and Herding Variables (HEV) as independent predictors. The R-value of 0.156 signifies a weak positive correlation, while the R^2 value of 0.024 denotes that the model accounts for merely 2.4% of the variation observed in IP. The F-statistic (2.150, $p = 0.074$) implies that the model lacks statistical significance. HV demonstrates a positive and statistically significant influence ($B = 0.145$, $p = 0.022$), whereas PV ($B = -0.007$, $p = 0.910$), MV ($B = 0.074$, $p = 0.229$), and HEV ($B = -0.083$, $p = 0.086$) exhibit statistically insignificant effects. The low variance inflation factor (VIF) values corroborate the absence of significant multicollinearity, thereby affirming the reliability of the model. The Durbin-Watson statistic (1.991) suggests the absence of autocorrelation within the residuals.

Findings and Discussion

This article includes a notable majority of male (73.14%) and married (80.29%) investors within the context of Nepal's stock market, with a substantial proportion being middle-aged (26-35 years), possessing at least a bachelor's degree, and generating moderate income levels (Rs 10,001-20,000). Heuristic behaviors were found to exert a statistically significant positive influence on investment performance ($r = 0.106$, $p < 0.05$), whereas Prospect Variables, Market Variables, and Herding Variables did not exhibit any noteworthy effects. The reliability of the measures was affirmed by Cronbach's Alpha, with Investment Decision exhibiting the highest degree of reliability (0.905). The regression analysis indicated that the model accounted for a mere 2.4% of the variance ($R^2 = 0.024$), with Heuristic Variables identified as the only significant predictor ($B = 0.145$, $p = 0.022$). Despite the prevalence of herding behavior, it was found to have no significant impact on investment performance.

The results are consistent with earlier studies that demonstrate heuristics have a considerable influence on investment choices (Chaudhary, 2018; Rehan et al., 2021). Nonetheless, the minimal influence of prospect variables and herding behavior stands in stark contrast to theoretical anticipations and previous research. This discrepancy may be attributed to the nascent nature of Nepal's stock market, the restricted availability of sophisticated analytical tools, and the diminished trading volume. The low R^2 value indicates that there are unassessed variables that may be affecting investment decisions. Subsequent investigations should focus on macroeconomic elements and utilize larger, more heterogeneous samples to gain a comprehensive understanding of investment behaviors in Nepal.

Conclusion and Implications

The impact of perceived behavioral factors on the decision-making processes of investors in NEPSE-listed stocks is examined in this study, with a focus on investors in Bharatpur, Chitwan, Nepal. Specific topics covered include heuristics, prospect theory, market variables, and herding behavior. By employing a sample of 350 participants, the study reveals a predominance of male, middle-aged individuals who possess advanced educational qualifications yet exhibit limited experience in investment activities (1-3 years). Heuristic tendencies, such as trend-following and reliance on personal expertise, demonstrate a modest positive correlation with investment performance, whereas other variables exhibit no statistically significant impact. The results of regression analysis indicate that behavioral factors account for merely 2.4% of the variability in investment performance, highlighting the imperative for additional investigation into investor behavior within the context of the Nepalese financial market.

This study concludes that heuristic tendencies substantially improve investment performance by directing decisions based on individual judgment and prevailing trends. Nevertheless, additional elements such as prospect theory, market dynamics, and herding behavior do not considerably impact results. This underscores the significance of heuristics while indicating that a more profound comprehension of other influential factors is essential. The results suggest that investors ought to confront cognitive biases and implement thorough market analyses to enhance decision-making processes. Managers and policymakers should incorporate behavioral insights into educational curricula and regulatory frameworks, promoting informed, data-oriented investment strategies. Subsequent studies should investigate broader behavioral and macroeconomic interrelations, offering a more comprehensive perspective on investor behavior within the stock market of Nepal.

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