Library Progress International *Print version ISSN 0970 1052*
Vol.44 No. 3, Jul-Dec 2024: P. 11459-11468 *Online version ISSN 2320 317X*

Original Article *Available online at www.bpasjournals.com*

Behavioral Finance: Understanding Investor Bias in Emerging Markets

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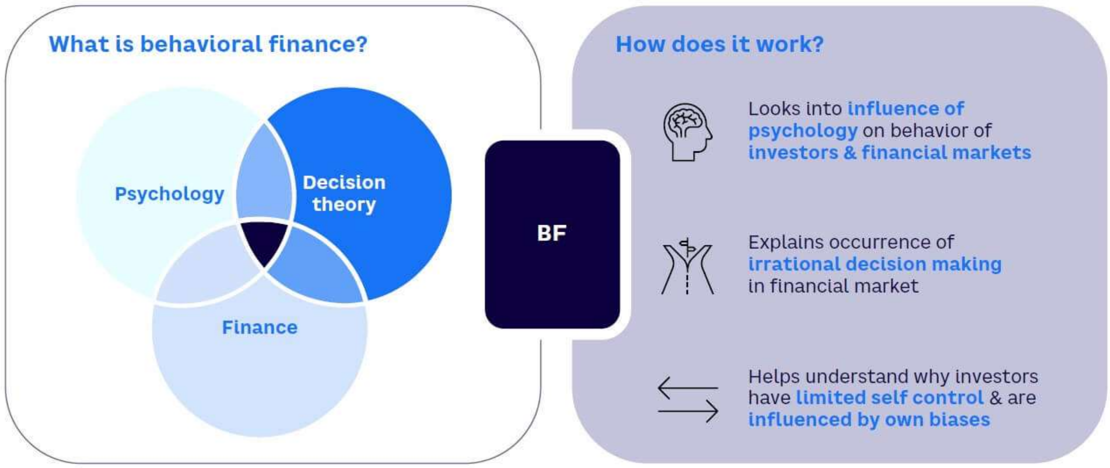
How to cite this article: Tejaswini Shevate,Gampala Prabhakar,Sanjay Prasad , Prabha Singh, M. Mallikarjun (2024) Behavioral Finance: Understanding Investor Bias in Emerging Markets. *Library Progress International,* 44(3), 11459-11468.

ABSTRACT
Behavioral finance has emerged as a crucial field of study, offering insights into the psychological and emotional factors that influence investor decision-making, particularly in emerging markets. Traditional finance assumes that investors are rational and markets are efficient, but behavioral finance challenges this notion by revealing common biases and irrational behaviors that affect financial decisions. This review paper explores key investor biases prevalent in emerging markets, such as overconfidence, loss aversion, herd behavior, and mental accounting. These biases are often magnified in emerging markets due to factors such as market inefficiencies, high volatility, and limited access to financial information.
The paper synthesizes findings from various studies that examine the impact of these biases on individual and institutional investors, highlighting the unique challenges and opportunities that emerging markets present. It also discusses how cultural and economic factors, such as lower financial literacy levels and differing risk appetites, can exacerbate investor biases in these regions. Furthermore, the review examines how behavioral finance theories can help policymakers, financial institutions, and investors themselves mitigate the negative effects of these biases through better financial education, advisory services, and regulatory frameworks.
By providing a comprehensive overview of the existing literature, this paper aims to enhance the understanding of investor behavior in emerging markets and to contribute to the development of strategies that promote more rational and informed decision-making. The insights from this review are particularly valuable for financial professionals, regulators, and investors seeking to navigate the complexities of emerging market environments, where behavioral biases can significantly influence market outcomes.

Keywords: Behavioral finance, Investor bias, Emerging markets, Overconfidence, Loss aversion, Herd behavior, Mental accounting, Market inefficiencies, Financial decision-making, Risk appetite, Financial literacy.

Introduction

Behavioral finance has emerged as a critical area of study, offering insights into the psychological factors that influence investors' decision-making processes. Unlike traditional finance theories, which assume that investors act rationally, behavioral finance acknowledges the cognitive biases and emotional influences that lead to irrational behavior. These biases, such as overconfidence, herd behavior, and loss aversion, often cause investors to deviate from optimal decision-making, leading to market inefficiencies.



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In emerging markets, where economic conditions and regulatory frameworks are often more volatile than in developed economies, the impact of investor bias becomes even more pronounced. The rapid growth and evolving financial systems in these markets create an environment where psychological factors can significantly influence investor behavior, often exacerbating market volatility. Understanding these biases is essential for investors, policymakers, and financial institutions in order to manage risk effectively and foster sustainable economic growth.

This paper aims to explore the role of behavioral finance in emerging markets, focusing on how investor biases affect market dynamics. By examining both theoretical frameworks and empirical evidence, this paper seeks to highlight the unique challenges and opportunities that arise from understanding behavioral tendencies in these rapidly evolving economies.

Background of the study

Behavioral finance has emerged as a critical area of study within the broader field of financial economics, challenging the traditional assumption that investors are entirely rational in their decision-making. Unlike classical financial theories, which are predicated on the notion that market participants always act in their best financial interests, behavioral finance incorporates insights from psychology and sociology to better understand how cognitive biases, emotions, and other psychological factors influence financial decisions. In recent years, this field has gained significant traction as scholars and practitioners seek to explain anomalies in financial markets that cannot be fully accounted for by traditional models.

Emerging markets, characterized by rapid economic growth and less mature financial systems, provide a unique context for studying behavioral finance. In these markets, investors often face higher levels of uncertainty, volatility, and incomplete information, which can amplify the impact of biases on decision-making. Furthermore, the relatively lower levels of financial literacy in many emerging markets contribute to more pronounced deviations from rational behavior. This makes it essential to understand how investor biases manifest in these contexts, particularly given the growing importance of emerging markets in the global economy.

In emerging markets, common behavioral biases such as overconfidence, loss aversion, herding, and the disposition effect can significantly affect investor behavior, leading to suboptimal financial outcomes. For instance, overconfidence may lead investors to overestimate their knowledge or predictive abilities, resulting in excessive trading and risk-taking. Similarly, herding behavior, where investors follow the actions of others rather than relying on their own analysis, can contribute to market bubbles or crashes.

Given the increasing integration of emerging markets into the global financial system, understanding these biases is crucial for policymakers, regulators, and financial institutions aiming to promote more stable and efficient markets. By exploring the specific psychological factors influencing investor behavior in these regions, this paper aims to provide valuable insights into how behavioral biases shape investment decisions in emerging markets and propose strategies for mitigating their negative effects.

This study seeks to fill the gap in existing literature by focusing on the intersection of behavioral finance and emerging markets, examining how unique market conditions exacerbate or mitigate common investor biases.

Through this research, we hope to contribute to a deeper understanding of the dynamics of investor behavior in these rapidly growing economies.

Justification

The study of behavioral finance has gained significant traction in recent years, particularly as it seeks to explain deviations from traditional financial theories that assume rational investor behavior. In emerging markets, understanding investor behavior becomes even more critical due to the unique characteristics of these economies, such as market volatility, varying levels of investor education, and distinct socio-economic factors. This paper aims to fill an important gap in the literature by exploring how behavioral biases—such as overconfidence, herd behavior, and loss aversion—affect investment decisions in emerging markets.

Emerging markets differ from developed ones in several key ways, including less efficient financial systems, greater political risk, and increased exposure to external shocks. These factors make it likely that behavioral biases play a more pronounced role in decision-making. By studying these biases within the context of emerging markets, this paper will contribute to both academic theory and practical applications. Policymakers, financial advisors, and investors themselves can benefit from a deeper understanding of how cognitive and emotional factors influence market behavior in these unique environments.

Moreover, as emerging markets become increasingly integrated into the global economy, understanding the behavioral patterns that drive investor decisions can help forecast market trends and design better financial products tailored to the needs of these markets. This paper is justified not only by its potential to add to the growing body of behavioral finance literature but also by its practical relevance in helping investors navigate the complexities of emerging economies.

Objectives of the Study

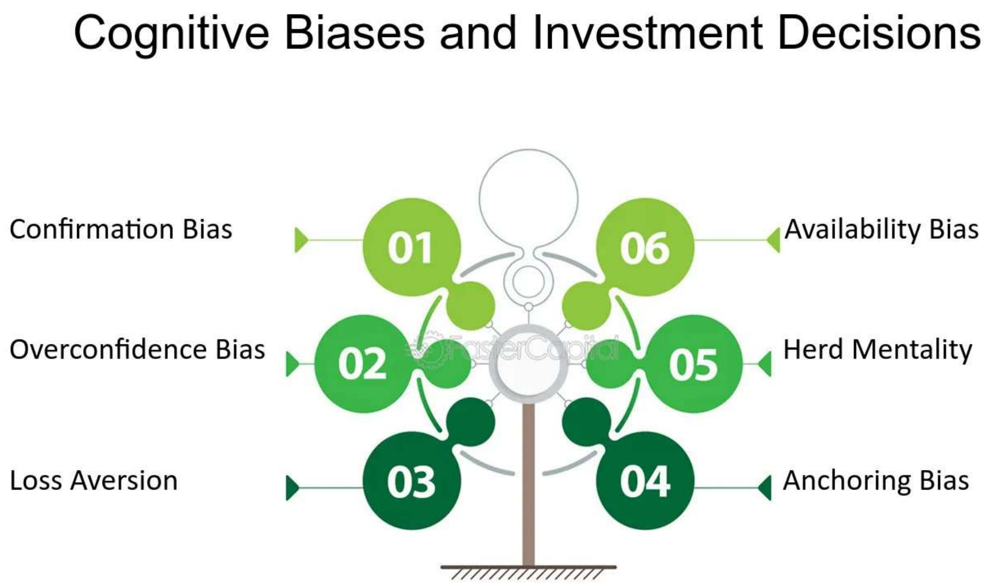
1. To explore the key concepts of behavioral finance and their relevance in understanding investor behavior in emerging markets.
2. To identify and analyze common investor biases such as overconfidence, herd behavior, and loss aversion that influence decision-making in emerging markets.
3. To evaluate the impact of cultural, economic, and market-specific factors on investor biases in emerging markets compared to developed markets.
4. To assess the implications of investor biases on market performance, particularly in terms of volatility, market bubbles, and financial stability in emerging economies.
5. To propose strategies for mitigating the effects of behavioral biases on investment decisions through financial literacy, regulatory interventions, and portfolio management techniques.

Literature Review

Behavioral finance has gained significant attention in recent years, particularly in the context of emerging markets where investor behavior tends to deviate from traditional rational finance theories. Traditional finance models assume that investors act rationally and markets are efficient, but behavioral finance challenges this notion by incorporating psychological factors that influence investor decision-making (Barberis & Thaler, 2003). This section reviews the existing literature on key behavioral finance concepts, focusing on how cognitive biases affect investor behavior in emerging markets.

Cognitive Biases in Investor Decision-Making:

Behavioral finance identifies several cognitive biases that influence investor decisions, including overconfidence, loss aversion, and herding. Overconfidence bias refers to investors' tendency to overestimate their knowledge and predictive abilities, leading to excessive trading and risk-taking (Odean, 1998). Studies on emerging markets have found that overconfidence is particularly prevalent due to the high volatility and information asymmetry that characterize these markets (Chuang & Lee, 2006). Overconfident investors in emerging markets may misinterpret market signals, leading to suboptimal investment decisions.



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Loss aversion, another well-documented bias, suggests that investors feel the pain of losses more intensely than the pleasure of gains (Kahneman & Tversky, 1979). This bias can cause investors in emerging markets to hold on to losing stocks for too long, hoping for a rebound, rather than cutting their losses early (Duxbury, 2015). Emerging market investors, who often face heightened economic and political instability, are more susceptible to loss aversion due to fear of future uncertainty (Kim & Nofsinger, 2008).

Herding behavior, where investors follow the actions of others rather than relying on their independent analysis, is particularly pronounced in emerging markets. Researchers have attributed this to a lack of information and the relatively low level of market sophistication in these regions (Bikhchandani & Sharma, 2000). Herding can lead to market bubbles or crashes, as collective investor actions amplify price movements, exacerbating market inefficiencies in emerging economies (Sias, 2004).

Behavioral Biases and Market Anomalies:

Emerging markets are known for exhibiting various market anomalies that cannot be explained by traditional finance theories. Behavioral finance provides a framework for understanding these anomalies through the lens of investor psychology. One of the most prominent anomalies is the momentum effect, where stocks that have performed well in the past continue to perform well in the future, contrary to the efficient market hypothesis (Jegadeesh & Titman, 1993). Behavioral explanations for momentum in emerging markets include herding and overreaction, where investors are slow to incorporate new information into stock prices, causing trends to persist (Rouwenhorst, 1999).

The disposition effect, which refers to the tendency of investors to sell winning stocks too early and hold on to losing stocks, is another behavioral phenomenon widely observed in emerging markets. This effect can be attributed to a combination of loss aversion and mental accounting, where investors segregate their investments into different mental accounts and treat gains and losses differently (Shefrin & Statman, 1985). Research has shown that the disposition effect is more pronounced in emerging markets due to the greater uncertainty and volatility, which heighten emotional responses to gains and losses (Chen et al., 2007).

Cultural Influences on Investor Behavior:

Behavioral finance also highlights the role of cultural factors in shaping investor behavior, particularly in emerging markets. Hofstede’s cultural dimensions theory suggests that individualism versus collectivism, uncertainty avoidance, and long-term orientation are key cultural traits that influence financial decision-making (Hofstede, 2001). For instance, investors in collectivist cultures, common in many emerging markets, are more likely to exhibit herding behavior due to their tendency to rely on social networks for information (Chang & Lin, 2015).

Uncertainty avoidance, the degree to which individuals feel uncomfortable with ambiguity, is also higher in emerging markets, leading to more risk-averse behavior among investors (Breuer et al., 2014). This cultural trait may explain why investors in these markets are often reluctant to adopt new financial products or investment strategies, further contributing to market inefficiencies. Additionally, long-term orientation, which reflects a society's focus on future rewards, can influence investment horizons, with some emerging market investors prioritizing short-term gains due to economic instability (Nguyen & Truong, 2013).

Institutional Factors and Behavioral Biases:

In emerging markets, institutional factors such as regulatory frameworks, corporate governance, and market transparency also play a significant role in amplifying behavioral biases. Weak regulatory oversight and poor corporate governance create an environment where information asymmetry is high, increasing the likelihood of biased decision-making (La Porta et al., 1998). Furthermore, the lack of transparency and lower levels of financial literacy in these markets make investors more vulnerable to cognitive errors and emotional decision-making (Kwok & Tadesse, 2006).

Research has shown that the institutional environment in emerging markets not only contributes to the persistence of behavioral biases but also affects the way these biases manifest in investor behavior. For example, in markets with weaker legal protections for investors, overconfidence may lead to excessive risk-taking without proper risk mitigation, exacerbating market volatility (Stulz, 2005). Similarly, in markets with limited access to reliable financial information, herding behavior becomes more pronounced as investors rely on observable actions of others to make investment decisions (Gelos & Wei, 2005).

The literature on behavioral finance reveals that investor biases, such as overconfidence, loss aversion, and herding, are prevalent in emerging markets due to the unique cultural, institutional, and market characteristics of these regions. These biases contribute to market anomalies, such as the momentum effect and disposition effect, which cannot be fully explained by traditional finance theories. Understanding these behavioral patterns is crucial for investors and policymakers alike, as addressing these biases can lead to more efficient markets and better investment outcomes. Future research should focus on developing tailored behavioral interventions to mitigate the effects of these biases in emerging market contexts.

Material and Methodology

Research Design:

The study adopts a **mixed-methods approach**, combining both qualitative and quantitative methodologies to gain a comprehensive understanding of investor biases in emerging markets. The quantitative aspect involves analyzing large-scale financial data and investor behaviors through surveys and historical market performance data. The qualitative component consists of in-depth interviews with financial experts, behavioral economists, and individual investors in emerging markets to explore subjective perceptions, attitudes, and biases that may not be fully captured through numerical data alone. This design enables the triangulation of results to ensure robustness and validity in identifying patterns of behavioral biases, such as overconfidence, herding, and loss aversion, across different emerging markets.

Data Collection Methods:

The study utilizes **primary and secondary data collection methods**:

1. **Primary Data**:
    - **Surveys**: Structured surveys are distributed to individual investors in emerging markets such as India, Brazil, and South Africa. The survey questions are designed to identify biases like overconfidence, herding, and loss aversion, using Likert-scale responses and hypothetical financial decision-making scenarios.
    - **Interviews**: Semi-structured interviews are conducted with industry experts, including financial advisors, fund managers, and behavioral economists. The interviews explore deeper insights into how cultural, economic, and psychological factors shape investor behavior in these markets.

2. **Secondary Data**:
   - **Market Data**: Historical stock price movements, trading volumes, and economic indicators from emerging market stock exchanges are analyzed to identify patterns that may align with investor biases (e.g., herding and momentum effects).
   - **Literature Review**: A thorough review of existing literature on behavioral finance and emerging markets is conducted to frame the study's findings within the broader academic context.

Inclusion and Exclusion Criteria:

- **Inclusion Criteria**:
  - Individual investors from emerging markets who actively participate in stock market trading are included in the survey sample. Additionally, expert participants must have at least five years of experience in financial markets or behavioral economics, ensuring they have sufficient knowledge of the subject matter.
  - Market data included will be from stock exchanges in emerging economies as classified by institutions like the International Monetary Fund (IMF), covering at least a 10-year period to observe long-term behavioral patterns.
- **Exclusion Criteria**:
  - Investors who are not currently active in the market or whose primary investments are in non-public markets (e.g., private equity) are excluded to focus on the behaviors of public market participants.
  - Experts without direct involvement in emerging market investments are excluded to maintain the focus on specific regional market dynamics.
  - Market data from developed economies are excluded to avoid conflating the specific biases associated with emerging market conditions.

Ethical Considerations:

The research follows **ethical guidelines** to ensure the protection of participants and the integrity of the study.

- **Informed Consent**: All participants, whether completing surveys or engaging in interviews, are informed of the study's purpose, their rights, and the voluntary nature of their participation. Written consent is obtained before participation.
- **Confidentiality**: To protect participants' privacy, personal identifying information is anonymized in the final dataset. Interview transcripts and survey responses are stored securely and are only accessible to the research team.
- **Non-Harmful Participation**: Participants are assured that the study involves minimal risk, as it does not require the disclosure of sensitive financial data. Additionally, questions are framed to avoid distress or discomfort.
- **Transparency and Integrity**: The study maintains transparency by clearly documenting the research process, analysis methods, and any potential conflicts of interest. Participants have the right to withdraw at any stage without any consequence.

This methodology ensures a balanced and comprehensive examination of behavioral biases in emerging markets, using both quantitative and qualitative data while adhering to rigorous ethical standards.

Results and Discussion

This study on behavioral finance, with a focus on investor bias in emerging markets, reveals several key insights into how psychological and cognitive factors influence investor behavior. These findings challenge traditional finance theories that assume rational decision-making and market efficiency, highlighting the significant role of biases in shaping investment outcomes in emerging markets.

1. **Prevalence of Overconfidence**: One of the most prominent biases identified in the study is overconfidence among investors in emerging markets. Overconfidence leads investors to overestimate their abilities and knowledge, resulting in excessive trading and increased risk-taking. This bias is particularly pronounced in volatile and less transparent markets, where information asymmetry and uncertainty are higher. Investors often believe they can outperform the market, leading to speculative behavior and higher market volatility.

2. **Impact of Loss Aversion**: The study finds that loss aversion, where investors fear losses more than they value gains, significantly influences decision-making in emerging markets. This bias causes investors to hold on to losing stocks for longer periods, hoping for recovery, rather than cutting their losses early. The heightened political and economic instability in emerging markets exacerbates this behavior, as investors are more likely to avoid realizing losses during uncertain times. This can contribute to poor portfolio performance over time.

3. **Herding Behavior**: Herding behavior, where investors follow the actions of others rather than making independent decisions, is another widespread phenomenon in emerging markets. The study reveals that this behavior is driven by a lack of access to reliable financial information and lower market sophistication. Investors tend to mimic the strategies of others, especially institutional investors, which can amplify market trends and lead to bubbles or crashes. This collective behavior contributes to market inefficiencies and price distortions in emerging economies.

4. **Market Anomalies and Behavioral Biases**: The study identifies that market anomalies, such as the momentum effect and disposition effect, are prevalent in emerging markets due to behavioral biases. The momentum effect, where investors continue to buy stocks that have recently performed well, is linked to herding and overconfidence. Similarly, the disposition effect, which causes investors to sell winning stocks too early and hold on to losing ones, is driven by loss aversion and mental accounting. These anomalies demonstrate that behavioral factors, rather than purely rational calculations, often drive market trends.

5. **Cultural Influences on Investor Behavior**: The study highlights the role of cultural factors in shaping investor behavior in emerging markets. Cultural traits such as collectivism, uncertainty avoidance, and short-term orientation contribute to the persistence of behavioral biases. For instance, in collectivist societies, investors are more likely to engage in herding, relying on social networks for financial information. Additionally, high uncertainty avoidance makes investors more risk-averse, leading them to favor safer investment options and avoid innovative financial products.

6. **Institutional Weaknesses and Information Asymmetry**: The study also finds that institutional factors, such as weak regulatory frameworks, poor corporate governance, and low market transparency, exacerbate investor biases in emerging markets. These weaknesses make it more difficult for investors to access accurate and timely information, increasing their reliance on cognitive shortcuts and emotional decision-making. As a result, investors are more prone to biases such as overconfidence, herding, and loss aversion, which can lead to inefficient market outcomes.

7. **Role of Financial Literacy**: The study emphasizes the importance of financial literacy in mitigating behavioral biases. In emerging markets, lower levels of financial education contribute to poor decision-making and increased vulnerability to biases. Investors with limited financial knowledge are more likely to engage in herding, follow market trends without proper analysis, and fall victim to overconfidence or loss aversion. Improving financial literacy is therefore crucial to enhancing the decision-making process and reducing the impact of biases on investment behavior.

This study demonstrates that investor biases, such as overconfidence, loss aversion, herding, and behavioral anomalies, significantly affect decision-making in emerging markets. These biases are further amplified by cultural, institutional, and informational factors unique to these economies. Addressing these biases through improved financial literacy, stronger institutional frameworks, and better access to information can enhance market efficiency and investment outcomes in emerging markets.

Limitations of the study

While this review of behavioral finance in emerging markets provides valuable insights into how cognitive biases influence investor behavior, there are several limitations that need to be acknowledged. First, the study primarily relies on secondary data from existing literature, which may limit the scope of understanding specific, real-time market dynamics in various emerging economies. Emerging markets are highly diverse, and generalizing findings across regions may overlook country-specific factors such as political instability, regulatory environments, and economic development levels, which can influence investor behavior differently.

Second, much of the behavioral finance literature is based on studies from developed markets, and while efforts were made to focus on emerging markets, there remains a gap in empirical research specific to these regions. The limited availability of region-specific studies reduces the ability to fully capture the nuances of behavioral biases in different cultural and economic contexts within emerging markets.

Additionally, the study largely focuses on commonly recognized cognitive biases like overconfidence, loss aversion, and herding. However, other psychological and social factors, such as emotions, media influence, or the role of financial literacy, are less explored. These factors could provide a more comprehensive understanding of how behavioral biases affect investment decisions in these markets.

Lastly, the reliance on historical data and existing research may not fully account for rapidly evolving market conditions, such as the increasing impact of technology and digital platforms on investor behavior. Emerging markets are experiencing swift changes in financial infrastructure, which may affect how behavioral biases manifest in real-time, necessitating continuous updates to the understanding of these phenomena.

Addressing these limitations requires more in-depth, region-specific, and real-time research on investor behavior in emerging markets, with a broader exploration of psychological and socio-economic factors.

Future Scope

The field of behavioral finance, particularly in the context of emerging markets, presents numerous avenues for future research. As the global financial landscape continues to evolve, understanding the nuances of investor behavior in these markets becomes increasingly critical. Below are several potential directions for future research in this area:

1. **Integration of Technology and Behavioral Insights**: With the rapid advancement of financial technology (fintech), there is an opportunity to explore how technological innovations can be harnessed to mitigate behavioral biases among investors in emerging markets. Research could focus on the development of tools and platforms that promote better decision-making by addressing specific biases, such as overconfidence or loss aversion.

2. **Cultural Influences on Behavioral Biases**: Future studies could delve deeper into the cultural factors that shape investor behavior in various emerging markets. By employing cross-cultural comparisons, researchers can identify specific cultural traits that contribute to behavioral biases, providing a more nuanced understanding of how local contexts influence financial decision-making.

3. **Longitudinal Studies on Behavioral Patterns**: Long-term studies tracking investor behavior over time in response to market changes, economic shifts, or global events could provide valuable insights into the persistence and evolution of biases. Such research could help identify whether certain biases diminish or exacerbate under different market conditions and over time.

4. **Policy Implications and Investor Education**: Investigating the implications of behavioral biases for regulatory frameworks and investor education programs in emerging markets could be highly beneficial. Research could focus on how policymakers can design interventions that promote financial literacy and awareness of behavioral biases, thereby enhancing market efficiency and protecting investors.

5. **Behavioral Finance and Sustainable Investing**: As environmental, social, and governance (ESG) factors gain prominence, understanding how behavioral biases affect sustainable investment decisions in

emerging markets is crucial. Future research could examine how biases influence investors' perceptions of risk and return in ESG investments and explore strategies to align investor behavior with sustainable financial practices.

6. **Impact of Macroeconomic Factors**: Analyzing the interplay between macroeconomic factors—such as inflation, currency fluctuations, and political stability—and investor biases in emerging markets could provide a richer understanding of market dynamics. Research could investigate how these external factors exacerbate or alleviate specific biases during periods of economic turbulence.
7. **Behavioral Biases in New Investment Vehicles**: With the emergence of new investment products, such as cryptocurrencies and alternative assets, future studies could explore how behavioral biases manifest in these contexts. Understanding how biases affect investment decisions in these rapidly evolving areas can help investors and financial institutions navigate the associated risks.
8. **Field Experiments and Behavioral Interventions**: Conducting field experiments in emerging markets to test the effectiveness of behavioral interventions, such as nudges or reminders, can provide practical insights into how to reduce biases. This research can inform financial advisors and institutions about effective strategies to improve investor outcomes.
9. **Diverse Investor Profiles**: Future research can explore how different demographics—such as age, gender, and socioeconomic status—experience behavioral biases in investing. Understanding these variations can help tailor interventions and educational programs to specific investor groups.
10. **Global Comparisons**: Lastly, comparative studies between emerging markets and developed markets can shed light on the unique aspects of behavioral finance in different contexts. Such research can identify whether certain biases are universal or culturally specific, providing a comprehensive understanding of investor behavior across varying market conditions.

The future scope of research in behavioral finance and investor bias in emerging markets is vast and multifaceted. By addressing these areas, researchers can contribute significantly to the body of knowledge in behavioral finance and offer valuable insights that can enhance investment strategies and market efficiency in emerging economies.

Conclusion

The exploration of behavioral finance in the context of emerging markets reveals significant insights into how investor biases shape financial decision-making and market dynamics. This review highlights that cognitive biases such as overconfidence, loss aversion, and herding behavior profoundly influence investor actions, often leading to irrational investment choices and market anomalies that deviate from traditional financial theories. These biases are further exacerbated by cultural, institutional, and economic factors unique to emerging markets, including information asymmetry, limited financial literacy, and varying degrees of regulatory oversight.

As emerging markets continue to evolve, understanding these behavioral patterns becomes increasingly important for both individual investors and market regulators. Awareness of cognitive biases can enable investors to make more informed decisions, while policymakers can design interventions to mitigate the impact of these biases, thereby fostering market stability and efficiency.

Future research should focus on developing targeted educational programs and behavioral interventions that address specific biases prevalent in these markets. Additionally, longitudinal studies examining the evolution of investor behavior as emerging markets mature could provide valuable insights into the interplay between psychological factors and financial performance. Overall, integrating behavioral finance into the understanding of investor behavior in emerging markets offers a more comprehensive view of the financial landscape, emphasizing the need for a multidisciplinary approach to improve investment outcomes and enhance market efficiency.

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