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The Influence of Psychological Factors on Financial Markets from the Perspective of Behavioral Finance

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Abstract: This article discusses the impact of psychological factors on financial markets from the perspective of behavioral finance. Traditional financial theory assumes that market participants are rational and able to make optimal decisions, but in reality, market participants' decisions are often influenced by various psychological factors, leading to irrational behavior and price fluctuations in the market. The article explores the theoretical foundations of behavioral finance, including psychological account theory, prospect theory, social evidence theory, information asymmetry theory, and choice difficulty theory. It also examines the influence of psychological factors on financial markets, including emotional and cognitive influences, social and information dissemination, and the analytical methods used in behavioral finance research. The article concludes that the use of behavioral finance can provide investors and regulators with deeper understanding and insight to help them make more informed investment decisions and develop more effective regulatory policies. However, the future development of behavioral finance requires more empirical studies, multi-perspective studies, and multi-disciplinary cross-sectional studies to further expand the understanding of the impact of psychological factors on financial markets.
Keywords: Behavioral Finance; Psychological Factors; Financial Markets; Theoretical Foundations; Analytical methods

1. Introduction

Behavioral finance is a supplement and modification of traditional financial theory, which emphasizes the influence of psychological factors in human behavior on financial markets [1]. Traditional financial theory assumes that market participants are rational and able to make optimal decisions, but in reality, market participants' decisions are often influenced by various psychological factors, leading to irrational behavior and price fluctuations in the market. The impact of psychological factors on financial markets has received extensive research and attention. For example, investors' emotions and confidence can affect market volatility; overconfidence and risk aversion can lead investors to make wrong decisions, etc. Therefore, studying the impact of psychological factors on financial markets can help us better understand the operation mechanism of financial markets, predict market trends and fluctuations, improve investors' investment decisions, provide a scientific basis for policy makers, and promote the stability and development of financial markets.

2. Theoretical foundations of behavioral finance

2.1 Origin and Development

Behavioral finance emerged to fill the gaps in traditional finance in explaining market phenomena and predicting market changes. Traditional finance usually assumes in theory that investors are rational, fully informed and self-interested. However, this assumption does not hold true in actual markets, as investors are often influenced by psychological factors that lead to uncertainty and instability in market behavior [2].

The origin of behavioral finance can be traced back to the 1970s, when some psychologists began to study the psychological mechanisms of human behavior and decision making, and their research results enlightened economists' knowledge and understanding of investor behavior. Second, empirical research in behavioral finance began in the mid-1980s, when researchers began to use empirical

data to conduct statistical analysis and empirical studies of investor behavior and market phenomena, such as research on stock market reactions, investor sentiment and cognitive biases. Again, as the empirical research in behavioral finance deepened, researchers began to establish the theoretical framework and hypotheses of behavioral finance, such as psychological account theory, prospect theory, and social evidence theory, which form the theoretical foundation of behavioral finance. Finally, to date, behavioral finance has been increasingly applied to a wide range of fields, including financial markets, corporate finance, asset pricing, risk management, etc. At the same time, behavioral finance is also evolving, such as research on the dynamic evolution of investor behavior and the impact of multiple cognitive biases. In short, behavioral finance is an evolving discipline, and its emergence and development provide new perspectives and approaches to better understand financial markets and investor behavior [3].

2.2 Theoretical Framework

Behavioral finance theory is based on psychological account theory, prospect theory, social evidence theory, information asymmetry theory, and choice difficulty theory. Psychological account theory suggests that people tend to allocate their assets into different accounts and make different investment decisions depending on the accounts. For example, people may separate stock accounts from savings accounts and adopt different risk preferences and investment strategies for the assets in different accounts. Prospect theory suggests that people have different attitudes toward losses and gains. Specifically, people tend to be more concerned about losses and react differently to the same amount of gains and losses. Social evidence theory suggests that people refer to the behaviors and opinions of others when making decisions, thus influencing their own decisions [4]. Information asymmetry theory suggests that market participants have different information, which leads to incomplete and asymmetric information in the market. Choice difficulty theory suggests that people tend to feel difficulty and uncertainty when faced with multiple choices, which leads to lagging and irrational decisions.

3. The Influence of Psychological Factors on Financial Markets

3.1 Emotional and Cognitive Influences

From the perspective of behavioral finance, investors' market behavior is largely influenced by their own emotions and perceptions, which are ultimately reflected in the financial markets [5]. Investors tend to look for information that matches their own views and ignore information that does not match their own views, which can lead to biased judgments of the market. Most investors are more sensitive to losses and less sensitive to gains, which can lead investors to be overly cautious in the face of risk and too risky in the face of opportunity. Some investors also overestimate their ability and knowledge, leading them to overlook some important risk factors in their investment decisions. There is also a herding effect among investors, where investors blindly follow the mainstream opinions of the market and ignore their own judgment and analysis, leading them to follow the trend in the market, resulting in investment risks.

3.2 Impact of Social and Information Dissemination

Social influence and information dissemination on the market are very important factors. Social influence can include political, economic, cultural, and environmental factors, which can have an impact on the market and thus influence investors' decisions. For example, political stability and economic growth can increase investor confidence and thus contribute to the rise of the stock market; conversely, political unrest and economic recession may lead to investor panic and thus cause the stock market to fall [6].

Information dissemination is also an important factor affecting the market. With the development of information technology, the speed and scope of information dissemination has been dramatically increased. Channels such as news, social media, and financial blogs can quickly deliver market information and analysis, which can influence investors' decisions. For example, a piece of good news can trigger investors' enthusiasm to buy and thus push the stock market higher; conversely, a piece of bad news may trigger investors' panic and thus cause the stock market to fall.

4. Analytical Methods of Behavioral Finance

The common methods used in behavioral finance research include empirical analysis, statistical analysis, experimental studies, and questionnaires. Among them, empirical analysis and statistical analysis are the most commonly used methods, and the data can be analyzed by regression analysis, event study, panel data, etc. Data sources include company financial reports, stock market trading data,

economic indicators, questionnaires, etc. Among them, company financial reports are the most commonly used data sources in behavioral finance research, including financial statements, financial indicators, accounting information, etc. Behavioral finance research focuses on issues such as investor behavior and market efficiency. Research shows that investors often have behaviors such as cognitive bias and emotional influence, which lead to market overreaction and price anomalies. Meanwhile, market efficiency is also affected by investor behavior, and the market suffers from information asymmetry, institutional investor dominance, and other problems. In conclusion, the various analytical methods of behavioral finance have a promising application in financial markets. It can help investors, financial institutions, regulators and other parties to better understand market behavior, develop more scientific investment, risk management and regulatory strategies, and promote the healthy development of financial markets.

5. Conclusion and Outlook

In summary, emotional and cognitive biases can have a great impact on investment decisions, and investors should try to avoid these biases in order to make more objective and rational investment decisions. The use of behavioral finance is the best way to correctly and rationally analyze the impact of psychological factors on financial markets. Behavioral finance mainly revolves around the impact of human behavior and psychological factors on financial decisions and market behavior. These theories and assumptions provide new perspectives and methods to better understand market phenomena and predict market changes. Proper use of behavioral finance methods can provide investors and regulators with deeper understanding and insight to help them make more informed investment decisions and develop more effective regulatory policies. However, there are still many shortcomings in behavioral finance theory, and its future development requires more empirical studies, multi-perspective studies and multi-disciplinary cross-sectional studies to further expand the understanding of the impact of psychological factors on financial markets.

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