Consumption and Investment Decisions from Behavioral Finance Perspective

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Abstract. This review paper examines the role of behavioral finance in understanding irrational consumption and investment decisions, which traditional financial theories often fail to explain. By integrating psychological principles with economic models, behavioral finance reveals how cognitive biases—such as loss aversion, overconfidence, and mental accounting — systematically influence financial behavior. The study synthesizes key findings from experimental and empirical research, demonstrating that investors frequently deviate from rationality due to emotional and social factors. For instance, loss aversion leads to risk-averse behavior in gains but risk-seeking in losses, while overconfidence results in excessive trading and under-diversification. In consumption, present bias and framing effects often drive impulsive spending and poor savings habits. The paper also discusses practical implications, including improved financial product design, policy interventions like automatic enrollment in pension plans, and personalized financial advice to mitigate biases. By bridging psychology and finance, this research enhances theoretical frameworks and offers actionable strategies to promote rational decision-making, ultimately contributing to more efficient markets and better individual financial outcomes.

1 Introduction

Traditional finance is based on the rational man assumption, which holds that investors and consumers are able to weigh the pros and cons in the decision-making process in a completely rational manner and pursue utility maximization. However, in the real world, this assumption faces many challenges. Traditional finance has difficulty explaining many anomalies in consumption and investment decisions, such as impulse buying behavior of consumers and overtrading of investors [1, 2]. With the in-depth study of these phenomena, behavioral finance has emerged. It integrates multidisciplinary knowledge of finance, psychology, sociology and other disciplines, and provides a new perspective for understanding consumption and investment decisions from the perspective of actual human behavior and psychology, and occupies an increasingly important position in economic research.

Behavioral finance is of great significance in understanding consumption and investment decisions. It reveals the psychological and behavioral deviations of consumers and investors

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in the actual decision-making process, which helps to grasp their decision-making mechanisms more accurately. At the same time, behavioral finance improves the financial theoretical system and makes up for the shortcomings of traditional financial theory. In terms of market practice, it provides powerful theoretical guidance for financial institutions to design products and develop marketing strategies, for governments to formulate policies and strengthen market regulation, and for individuals to make financial planning and investment decisions [3, 4].

This article adopts the literature review method to extensively collect and sort out the domestic and international research literature on behavioral finance in the field of consumption and investment decision-making. The article firstly elaborates the theoretical foundation of behavioral finance, then deeply analyzes the specific influence of behavioral finance on consumption decision and investment decision, then discusses its achievements in practical application, then points out the controversies and challenges faced by behavioral finance, and finally looks forward to its future development trend [2, 5].

2 The impact of behavioral finance on consumption decisions and investment decisions

2.1 Analysis of irrational investor behavior

Psychological factors such as psychological account, loss aversion and endowment effect significantly affect consumer decision making. In terms of psychological accounts, consumers often allocate funds from different sources into different accounts for management, which affects consumption choices. For example, consumers may use their salary income for daily expenses, while they regard unexpected wealth such as winning a lottery as additional funds and prefer to use them for non-essential consumption [6]. Loss aversion refers to the fact that consumers are highly sensitive to losses and change their consumption decisions to avoid losses. For example, a consumer who purchases a good and then realizes that the price has decreased will feel a sense of loss and may avoid spending with that merchant in the future [2]. The endowment effect causes consumers to assess the value of an item after they own it higher than when they do not own it. If a consumer owns a limited edition of a good, he or she will value it more due to the endowment effect and will be reluctant to sell it easily, affecting his or her consumption and disposal decisions.

2.2 Irrational behavior in consumption decision making

Consumers' common irrational behaviors include overconsumption and impulsive consumption. Overconsumption refers to the consumption that exceeds one's affordability and actual needs. Some consumers are influenced by the social comparison psychology, buy a large number of luxury goods, resulting in debt, which is behind the overconfidence and herd mentality, overestimation of their own economic capacity and consumption rationality, blindly follow the consumption behavior of others [7]. Impulsive consumption is when consumers buy goods on the spur of the moment, without fully considering the actual needs and cost-effective. For example, when shopping mall promotions, consumers are attracted by preferential information, and impulsively buy many goods that are not urgently needed, which is the result of limited rationality and heuristic principle, and consumers rely on intuitive judgment, ignoring in-depth thinking [8].

2.3 Influence of behavioral finance on consumer decision making models

Traditional consumer decision-making models are based on the rational man assumption that consumers seek to maximize utility. However, behavioral finance finds that consumers are not completely rational. Behavioral finance amends the traditional model by introducing psychological factors, such as considering psychological accounts and incorporating consumers' different attitudes toward different sources of funds into the model, so that the model can better explain the differences in consumers' propensity to consume different funds [4]. At the same time, loss aversion and endowment effect also change the way of assessing the value of goods in the model, which is more in line with the actual decision-making process of consumers. These amendments make the consumer decision-making model closer to reality, can more accurately predict consumer behavior, for enterprises in marketing, product pricing and other aspects to provide more targeted strategy recommendations [7].

2.4 Analysis of irrational investor behavior

Overconfident investors tend to overestimate the accuracy of their own judgment, underestimate the risk, and thus make overly aggressive investment decisions, such as frequent trading, expecting to obtain higher returns, but may be due to the increase in transaction costs and misjudgment and lead to losses [3, 8]. The herd effect makes investors blindly follow the behavior of others, ignoring their own information and analysis, flocking to buy in the bull market, panic selling in the bear market, resulting in a lack of independence of investment decisions [9]. Disposition effect is manifested in the tendency of investors to sell profitable stocks prematurely and hold losing stocks for a long period of time, which violates the principle of rational investment and affects the optimization of investment portfolios [8].

2.5 Impact of irrational behavior on market efficiency

Irrational behavior of investors can trigger market volatility. For example, overreaction or underreaction leads to a significant deviation of stock prices from their intrinsic value in the short term, which makes market information transmission distorted and reduces market efficiency [6]. The collective behavior triggered by the herd effect further amplifies market volatility, causes irrational rise and fall of asset prices, destroys the price discovery function of the market, interferes with the effective allocation of resources, and then affects the efficiency and stability of the entire market [10].

2.6 Behavioral finance guidance on investment strategy

Reverse investment strategies based on behavioral finance take advantage of market overreaction to buy stocks that have performed poorly in the past and sell stocks that have performed well in the past in order to obtain long-term extraordinary returns [11]. Momentum trading strategies, on the other hand, address the momentum effect by pre-setting stock return and volume filtering criteria and buying or selling stocks when the conditions are met. In addition, cost averaging and time diversification strategies, which help investors avoid the larger risks that may be associated with one-time investments, provide investors with investment ideas that are more in line with market realities and help optimize investment decisions [12].

3 Practical applications of behavioral finance

3.1 Results of behavioral finance in practical applications

3.1.1 Product design and marketing strategies of financial institutions

With the help of behavioral finance, financial institutions gain in-depth insight into the psychological characteristics of consumers and investors to design financial products and formulate marketing strategies. For example, some financial institutions take advantage of consumers' loss aversion to launch financial products with capital preservation to attract risk-averse consumers to buy [1]. In terms of marketing, by creating a sense of urgency, such as limited-time promotions, they trigger consumers' impulse consumption psychology and promote product sales. At the same time, in response to the overconfident psychology of investors, complex but seemingly high-return investment products are designed to attract investors to invest their money [6].

3.1.2 Government policymaking and market regulation

Based on the principles of behavioral finance, the government formulates relevant policies to strengthen financial market regulation and guide rational consumption and investment. On the one hand, through publicity and education, it improves the financial literacy of consumers and investors and helps them recognize their irrational behaviors. On the other hand, the information disclosure system in the financial market should be improved to reduce information asymmetry and the possibility of investors making irrational decisions due to insufficient information. In addition, in response to the behavior of financial institutions taking advantage of consumer psychology to carry out excessive marketing, the government strengthens supervision, standardizes the market order, and protects the rights and interests of consumers and investors [13].

3.1.3 Personal finance and investment planning

Individuals can use behavioral finance knowledge for financial planning to avoid irrational decisions. For example, recognizing the impact of psychological accounts, rationally dividing the use of funds to avoid irrational consumption due to the confusion of different psychological accounts. In terms of investment, overcome overconfidence and the herd effect, and formulate scientific investment strategies based on one's own risk tolerance and investment objectives. At the same time, the use of behavioral finance in the reverse investment strategy and other concepts, when the market sentiment is overly pessimistic or optimistic, to make the opposite investment decision, in order to obtain better investment returns [9, 10].

3.2 Controversies and challenges facing behavioral finance

3.2.1 Problem of universal applicability of theoretical models

Behavioral finance theoretical models have applicability problems in different market environments and different cultural backgrounds. Different market environments have unique operating mechanisms and participant structures, for example, emerging markets and mature markets have significant differences in regulatory systems, investor composition, etc., which makes it difficult to directly promote the applicability of behavioral finance theoretical models constructed on the basis of specific market environments [8]. At the same time, the cultural background has a profound impact on individual values, cognitive and behavioral patterns, and there are significant differences in the attitudes and decision-making preferences of investors in different cultures, which in turn affects the validity of the theoretical model [14].

3.2.2 Limitations of empirical research

Existing empirical studies are deficient in data acquisition, financial data are often affected by a variety of complex factors, it is difficult to accurately strip out the role of a single behavioral financial factors. And the timeliness and completeness of the data also limit the in-depth study of dynamic behavior [2]. In terms of research methodology, most empirical studies are based on traditional statistical methods, which have limited ability to portray complex behavioral patterns and non-linear relationships, making it difficult to comprehensively reveal the mechanism of the psychological and behavioral factors of concern to behavioral finance on consumption and investment decisions [10].

3.2.3 Integration difficulties with other disciplines

Behavioral finance encounters difficulties in the process of integration with psychology, sociology and other disciplines. The research paradigms and theoretical frameworks of psychology and sociology differ from finance, making it difficult to unify conceptual definitions and measurement standards. For example, the measurement of cognitive bias in psychology may need to be adjusted in finance application scenarios, but the adjustment process faces many challenges [4]. The solution lies in strengthening inter-disciplinary exchanges and cooperation, establishing unified research frameworks and norms, and cultivating interdisciplinary research talents to promote the deep integration of behavioral finance with other disciplines [7].

3.3 Trends in behavioral finance

3.3.1 Combination with emerging technologies

With the rapid development of science and technology, emerging technologies such as big data and artificial intelligence have brought new opportunities for behavioral finance. Big data can provide massive consumer and investor behavior data, so that behavioral finance research can get rid of the limitations of traditional sample data and analyze consumer and investment decision-making behavior more accurately. Artificial intelligence can mine the potential patterns in the data through machine learning algorithms, predict the behavioral trends of consumers and investors, and help behavioral finance make greater breakthroughs in the study of consumption and investment decision-making [3].

3.3.2 Expansion of interdisciplinary research

Behavioral finance itself integrates multidisciplinary knowledge of finance, psychology, sociology and other disciplines. In the future, its interdisciplinary research will be further expanded to deeply intersect with neuroscience, cognitive science and other disciplines. For example, neuroscience can reveal the neural mechanisms of consumer and investor decision-making, providing a more microscopic theoretical basis for behavioral finance, thus expanding the research field and deepening the understanding of human consumption and investment decision-making behavior [4, 7].

3.3.3 Deepening influence on policy making and market practice

Behavioral finance will have a more far-reaching impact on government policy making, financial institutions practice and individual consumption and investment behavior in the future. Based on the principles of behavioral finance, the government can formulate more targeted policies to guide rational consumption and investment. Financial institutions can better design products and marketing strategies to meet the needs of consumers and investors. Individuals can also use behavioral finance knowledge to avoid irrational decision-making and achieve better consumption and investment planning [15].

4 Conclusion

4.1 Summary of research results

Behavioral finance reveals the widespread psychological biases and cognitive limitations in consumption and investment decisions by introducing the theoretical frameworks of psychology, sociology and behavior. In the field of consumer decision-making, overconfidence, herd mentality, and heuristic bias significantly affect consumers' purchase choices and consumption timing. In addition, heuristic bias, as a shortcut in information processing, can improve the efficiency of decision making, but it is also prone to lead to systematic errors. In terms of investment decisions, emotional factors such as greed, fear, and regret avoidance have a profound impact on asset allocation and trading strategies. Studies have shown that investors often miss market opportunities due to fear or overtrade due to greed, which in turn undermines long-term returns. Behavioral finance not only identifies these key influences, but also provides a new perspective for understanding real-world consumption and investment behaviors by constructing decision-making models based on psychological biases. This interdisciplinary research approach makes up for the shortcomings of traditional finance that relies only on the rational man assumption and injects new vitality into decision-making research.

4.2 Additions and modifications to traditional financial theory

Traditional finance is centered on the "rational man" assumption that investors are able to make optimal decisions in an efficient market. However, this assumption faces many challenges in real life situations. The rise of behavioral finance is a direct response to the limitations of traditional finance theory. First, behavioral finance suggests that the actual decision-making process of investors is not completely rational, but is influenced by a variety of psychological biases. Second, behavioral finance emphasizes that markets are not always efficient and that irrational behavior of investors may cause market prices to deviate from their fundamental values, thus triggering market anomalies such as overreaction and disposition effects. These findings not only enrich the connotation of financial theory, but also provide a more precise tool for explaining financial phenomena in reality. By combining psychology and finance, behavioral finance has injected new vitality into traditional financial theories, making them closer to reality, and also promoting the diversified development of financial research.

4.3 Practical implications

For consumers, understanding their psychological biases can help improve the quality of decision making. For investors, behavioral finance provides a variety of investment strategies to deal with psychological biases. In addition, financial institutions can design products and services that are more in line with customers' psychological needs by combining behavioral finance theories. At the same time, financial institutions can also use the research results of behavioral finance to optimize the internal risk management mechanism and enhance the scientific nature of investment decisions. In short, behavioral finance not only provides individual decision makers with tools for rational thinking, but also creates more opportunities for value growth for financial market participants.

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