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## Behavioural Finance and ESG Investments

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### ABSTRACT

This research explores how behavioural finance influences investor choices in relation to Environmental, Social, and Governance (ESG) investments. Unlike traditional finance, which is grounded in the assumption of rational decision-making, the inclusion of ESG principles in investment decisions has gained significant prominence in the modern corporate environment. The study investigates the relationship between ESG performance and investment behaviour, with a particular focus on the impact of ESG ratings on earnings-oriented and environmentally focused investments. It also examines the potential trade-offs that organizations may face and the broader implications for corporate decision-making. The results of the study offer practical insights for corporate leaders seeking to design sustainable investment strategies. By prioritizing capital projects and earnings-driven investments that integrate strong ESG practices, firms can simultaneously pursue financial returns and reinforce their commitment to sustainability, thereby strengthening long-term resilience and stakeholder confidence. Ultimately, the findings highlight the challenges of harmonizing profitability with environmental and social responsibilities, underscoring the importance of adopting a balanced approach that unites financial objectives with ESG values.

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## Introduction

Over the past few decades, the discipline of finance has undergone a paradigm shift as scholars and practitioners increasingly acknowledge the shortcomings of traditional economic theories in fully explaining market behaviour. Behavioural finance, an interdisciplinary domain combining psychology and economics, has emerged as a valuable framework to better understand investor behaviour and decision-making (Jinesh Jain et al., 2021). At the same time, Environmental, Social, and Governance (ESG) investing has transitioned from a niche approach to a widely adopted strategy in global financial markets. Contemporary investors now consider not only financial performance but also the ethical, social, and environmental impact of their investment choices.

In practice, ESG-based decision-making often deviates from purely rational models. The environmental dimension evaluates a company's impact on the natural environment, encompassing factors such as carbon emissions, resource utilization, waste management, renewable energy adoption, pollution control, and ecological sustainability. The social dimension focuses on a company's relationships with society, including labour practices, employee welfare, diversity and inclusion, community engagement, human rights, and product responsibility. Governance reflects the strength of corporate leadership, internal controls, transparency, shareholder rights, compliance with laws, and ethical standards.

Against this backdrop, the present study integrates insights from behavioural finance and sustainable finance to examine the determinants of Socially Responsible Investment (SRI). With particular emphasis on the Indian market, it investigates how behavioural biases influence investment decisions in the context of ESG-focused strategies.

## Behavioural Finance

Behavioural finance is an interdisciplinary field that combines insights from psychology and economics to explain how human emotions and cognitive biases influence financial decisions. Unlike traditional finance theory, which assumes that individuals act rationally and base their choices on complete information to maximize wealth or utility, behavioural finance acknowledges that decision-making is often shaped by psychological tendencies, emotional reactions, and social pressures.

These developments highlight the growing significance of behavioural finance in understanding investor behaviour, market dynamics, and broader economic policy. As research in this field evolves, it is expected to further refine financial theories and provide practical guidance for both policymakers and practitioners.



In the context of behavioural finance, several key concepts and biases are commonly used to explain deviations from rational decision-making:

1. **Availability Heuristic** – A mental shortcut where individuals judge the likelihood or importance of events based on how easily examples come to mind. Recent, vivid, or memorable events tend to be overestimated in frequency or relevance.
2. **Framing Effect** – The influence of information presentation on decision-making. People may interpret identical information differently depending on whether it is framed in terms of potential gains or potential losses.
3. **Herd Behaviour** – The tendency of individuals to mimic the decisions of the majority, often disregarding their own knowledge or judgment. Such behaviour can contribute to the formation of market bubbles or sudden crashes.
4. **Loss Aversion** – The principle that losses are felt more intensely than equivalent gains. This bias often leads individuals to take excessive risks to avoid losses or, conversely, to avoid risks altogether, even when opportunities are favourable.
5. **Overconfidence** – The inclination of individuals to overestimate their knowledge, skills, or judgment. Overconfident investors often trade excessively, underestimate risks, and fail to diversify adequately.

## ESG Investment

Environmental, Social, and Governance (ESG) investment refers to the practice of allocating capital to companies or funds that adhere to defined sustainability and ethical standards. ESG criteria are designed to evaluate both the long-term financial viability of investments and their broader impact on society and the environment. The aim is to create value not only in terms of financial returns but also through positive contributions to social welfare and ecological sustainability.

- **Environmental Factors:** These relate to a company's impact on the natural environment, including its carbon emissions, energy usage, waste management, and overall resource efficiency. Environmental investments involve channeling financial resources into projects or assets that promote ecological sustainability, such as renewable energy, energy efficiency initiatives, waste reduction, pollution control technologies, sustainable agriculture, conservation programs, and green infrastructure.



- **Social Factors:** The social dimension considers how a company engages with its stakeholders, including employees, customers, and local communities. This includes aspects such as labour practices, employee welfare, diversity and inclusion, human rights, and product responsibility. Social investing—also known as socially responsible investing (SRI) or sustainable investing—integrates these ethical and social considerations into the investment decision-making process.
- **Governance Factors:** Governance focuses on the structures, policies, and processes through which a company is directed and controlled. This includes the quality of leadership, transparency, accountability, shareholder rights, and adherence to ethical and legal standards. Governance-focused investing emphasizes evaluating these factors to ensure sound management practices and long-term organizational stability.

In recent years, ESG investing has shifted from a niche practice to a mainstream trend, fueled by heightened awareness of environmental challenges, social justice concerns, and the growing demand for corporate accountability. The availability of ESG funds and investment products has expanded rapidly, offering investors opportunities to align financial objectives with personal values.

Importantly, behavioural finance plays a crucial role in ESG investment decisions. Investors are often influenced by their beliefs, values, emotions, and cognitive biases, which can shape their willingness to prioritize sustainability alongside financial returns. This behavioural dimension highlights that ESG investing is not driven solely by rational economic models, but also by psychological and social factors that influence modern financial decision-making.

## Review of Literature

Traditionally, investors have focused primarily on economic variables such as profitability and risk when making investment decisions. However, ESG investments extend this perspective by incorporating environmental and social considerations alongside economic factors. As highlighted by Maite Cubas-Díaz and Miguel Ángel Martínez Sedano (2017), ESG investments can be understood through frameworks such as the *Relative Sustainable Performance Measure (RSPM)* and the *Measure of Commitment-Failure (MC)*, which facilitate sustainable decision-making for both investors and companies.

The influence of behavioural biases creates both challenges and opportunities in sustainable investment. While such biases may hinder investor participation in socially responsible investing (SRI), they also provide scope for targeted interventions to improve engagement. Research shows that peer advice and



popular “hot stocks” strongly predict SRI participation, suggesting the importance of external social influences on investor behaviour. Moreover, investor reactions to extreme ESG events have driven greater integration of sustainability into financial strategies. Recent studies highlight demographic factors, with gender differences indicating that women in India exhibit a stronger inclination toward SRI compared to men (Amisha Gupta & Shumalini Goswami, 2024). Similarly, ESG disclosure practices have been found to play a critical role in shaping investment decisions, offering insights that may help investors refine their strategies while promoting a financial system oriented toward sustainability (Rajani Bhandary D, 2024).

Empirical evidence also demonstrates that ESG scores significantly affect investment allocations. Zhichao Yu et al. (2024) report a positive relationship between ESG performance and capital investment, but a negative association with environmental investment (EINV), underscoring the trade-offs firms face between financial goals and dedicated environmental expenditures. Furthermore, traditional financial metrics—such as firm size, debt ratios, cash reserves, and carbon emissions—continue to influence investment choices, reflecting the multifaceted nature of decision-making.

Investor preferences for ESG-aligned firms have been shown to increase market value and reduce the cost of capital for companies adopting sustainable practices, thereby incentivizing corporate shifts toward greener policies (Roman Kräussl et al., 2024). Finally, behavioural aspects remain central to ESG investing: biases influence investors’ perceptions of risk in equity markets and shape their sustainable choices, as observed in recent research by Jimnee Deka et al. (2023).

## Research Objectives

1. To analyse the behavioural factors influencing investor decisions toward ESG investments.
2. To identify key biases that drive ESG investment.

## Methodology

- **Data Collection:** A survey was conducted among retail and institutional investors across diverse demographics.
- **Variables:** Independent variables include behavioural factors (overconfidence, herding, framing, loss aversion), while the dependent variable is ESG investment preference.

## Discussions and Conclusion



Investor behaviour in ESG (Environmental, Social, and Governance) investment is shaped not only by rational assessments of profitability and risk but also by behavioural biases that significantly influence decision-making. Key biases relevant to the Indian context include overconfidence, herding, framing effects, and loss aversion, as well as gender-based differences in socially responsible investment (SRI) preferences.

**Overconfidence and ESG Decisions:** Overconfidence among investors manifests in excessive trading, higher risk-taking, and misinterpretation of market signals. This bias leads to both overreaction and underreaction to information. Overconfident investors often assume their knowledge or information is superior, causing them to overweight recent ESG-related news while neglecting other relevant data. Such tendencies can amplify market volatility, with exaggerated price movements in response to positive or negative ESG developments.

**Overreaction and Underreaction to ESG News:** Indian investors' ESG decisions are often influenced by overreaction or underreaction to sustainability-related events. Strong positive ESG disclosures may trigger excessive optimism, while negative news can provoke disproportionate pessimism, affecting the stability and attractiveness of ESG investments.

**Herding Behaviour in ESG Investments:** Herding reflects the tendency of investors to follow prevailing market trends or peer actions, often without independently evaluating underlying ESG factors. Investors motivated by ethical utility may align their choices with perceived group norms, shaped by sociological influences and identity-based preferences. In the Indian market, herding behaviour is hypothesized to have a statistically significant relationship with SRI adoption, as investors mirror group behaviour in pursuit of social conformity.

**Gender and SRI Decisions:** Gender plays an important role in shaping investment choices. Women are generally considered more cautious and socially conscious investors compared to men, who often display greater risk tolerance. Female investors tend to prioritize ESG considerations, including fair wages, environmentally responsible practices, and avoidance of industries such as tobacco or firearms. Consequently, women emerge as leaders in SRI, with investment behaviour strongly aligned to social and environmental impact.

**Framing Effects on ESG Decisions:** The framing effect demonstrates that investment decisions vary depending on how information is presented, even when the underlying facts remain unchanged. For example, framing ESG funds as “protecting the environment and ensuring long-term value” generates



greater investor interest, whereas framing them as “avoiding harmful industries with potential short-term costs” may discourage participation.

**Loss Aversion and ESG Investments:** Loss aversion suggests that investors experience the pain of losses more intensely than the pleasure of equivalent gains. In ESG investing, this bias deters conservative investors who perceive sustainable finance as uncertain or less profitable. As a result, loss aversion creates a barrier to ESG adoption despite its long-term benefits.

### **Empirical Insights**

Findings from the study reveal the following:

- Herding and framing effects strongly influence ESG adoption, especially when sustainability is positioned as a socially responsible choice.
- Overconfidence encourages risk-seeking investors to engage in ESG, driven by perceptions of superior performance.
- Loss aversion acts as a constraint, discouraging conservative investors concerned about uncertain or lower returns.
- Social norms and ethical considerations exert a stronger influence on ESG decisions than financial literacy.

### **Implications**

The results demonstrate that ESG investment decisions are not purely financial but are significantly shaped by behavioural dimensions. Investor choices are influenced by a combination of psychological biases and moral values, underscoring the need for financial advisors, institutions, and policymakers to account for behavioural tendencies when promoting sustainable investing. Behavioural finance, therefore, provides a critical lens to understand and predict ESG-related investment behaviour. By acknowledging these factors, financial institutions can design targeted interventions and innovative strategies that foster greater participation in sustainable finance.

### **Conclusion**

The analysis highlights that ESG investment decisions are not determined solely by financial considerations but are profoundly influenced by behavioural biases and social dynamics. Overconfidence leads investors to misinterpret ESG information, often resulting in excessive risk-taking and market



volatility. Similarly, overreaction, underreaction, and herding behaviour demonstrate how collective psychology shapes ESG adoption in India, sometimes at the cost of independent judgment. Gender differences further reveal that women are more inclined toward socially responsible investing, emphasizing values such as fairness, sustainability, and ethical practices. Additionally, cognitive factors such as framing effects and loss aversion significantly affect how ESG opportunities are perceived and acted upon.

Overall, these insights underscore the importance of integrating behavioural finance into the study of sustainable investments. By acknowledging the psychological, social, and ethical influences on investor behaviour, policymakers, regulators, and financial advisors can develop strategies that encourage greater participation in ESG markets. This includes designing awareness campaigns, improving ESG disclosures, and framing sustainable investments in ways that appeal both emotionally and rationally to investors. In doing so, the financial system can move closer to aligning profitability with long-term sustainability and responsible corporate practices.

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