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The Psychology of Financial Decision Making

SUMMARY

The central element of our research is to explore the close relationship between financial decision making and emotions and psychological factors. In the field of modern finance, in addition to the model of rational decision making, the role of emotions and cognitive biases, which often change investor behavior, is receiving increasing attention. The aim of our research was to shed light on these factors, with a particular focus on self-confidence, emotional intelligence, and risk-taking propensity, and to examine how they influence investors' decisions.

Keywords: Financial Decision Making; Behavioral Finance; Psychological Factors;

JEL-codes: D81, G41; D91

INTRODUCTION

The process of financial decision-making is extremely complex, as it is not only based on rational thinking and data analysis, but also involves personal emotions and psychological factors. When making investment decisions, people often do not base their decisions solely on economic considerations, but are also influenced by emotional impulses. Amidst the constant changes in financial markets, the behavior of individual investors is largely determined by their current emotional state, their ability to control their emotions, and their propensity for various cognitive biases.

The aim of the research is to explore the role of psychological factors related to money in modern financial decision-making. It focuses on the extent to which emotional factors, self-confidence, emotional intelligence, and risk appetite influence investment decisions. The study also highlights how emotional reactions manifest themselves among experienced and novice investors, and how emotions triggered by market news can influence investor decision-making.

LITERATURE REVIEW

Looking back at past events, the recognition of the economic significance of psychological factors emerged with the development of classical political economy, through the work of Adam Smith and Jeremy Bentham. However, this approach was eventually replaced by the concept of homo economicus, which portrayed humans as rational, utility-maximizing beings. Later, John Maynard Keynes (1936) brought psychological explanations back to the forefront in order to understand economic cycles. Social scientist Herbert Simon (1955) questioned the tra-

ditional economic view of human nature and introduced the concept of „bounded rationality.” Although this concept only became widely known two decades later, it played a decisive role in the development of economic psychology and institutional economics. In the 1970s, the psychological study of decision-making processes gained new momentum. It was then that psychologists, notably Daniel Kahneman and Amos Tversky (1974), achieved breakthrough results that laid the foundations for behavioral economics as a separate field of research. Vernon Smith (1962) is credited with laying the foundations of experimental economics, which used laboratory experiments to simulate market exchanges and thus study the behavior of economic actors. His methods made it possible to test various alternative market mechanisms and study phenomena such as trust, reciprocity, and credibility. It is important to note that experimental economics is not the same as behavioral economics: while the former is primarily interested in the functioning and rationality of markets, the latter focuses on the psychological and cognitive aspects of individual decisions (Farkas, 2021).

Cognitive biases play a particularly important role in investment decisions, as they influence investors' investment strategies. Cognitive biases are mental errors that can steer investment decisions in an irrational direction. A good example of this is the so-called anchoring bias, a process in which people are influenced by specific information before making a decision. The anchoring heuristic was first introduced by Tversky and Kahneman (1974). According to this heuristic, anchoring bias is caused by people not sufficiently adjusting the value they receive as a starting point, so that their final decisions are aligned with it. Tversky and Kahneman stated that due to the anchoring effect, decision-makers' judgments are disproportionately biased toward the originally given number (Furnham & Boo, 2011).

According to Alberhasky (2024), the most common emotions influencing financial decisions are fear, greed, anxiety and depression, excessive self-confidence, regret, and shame. Fear is perhaps the strongest emotion when it comes to financial decisions. According to some studies, the fear of losing \$100 is twice as strong as the joy of winning \$100. This phenomenon is called loss aversion. So-called panic buying is driven by fear, causing people to make purchases without logical consideration. This type of consumer attitude was extremely common during the coronavirus pandemic. Greed can cause people to take excessive risks in pursuit of wealth. Anxiety and depression can lead to analysis paralysis, i.e., indecision. Overconfidence: the belief that financial knowledge makes one immune to financial mistakes, leading some people to take greater risks and make decisions that ignore rational factors. Overconfidence can increase in direct proportion to the age of consumers/investors, along with rising personal income. Regret about past financial

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mistakes can generate strong negative emotions that are difficult to overcome. Feelings of shame can lead to inaction in financial decision-making, especially among younger adults, who tend to perceive decisions as more complicated than they actually are. Avoiding decisions creates another mechanism for existing heuristics, which then determines the decision-making process, often at the expense of rational thinking. Emotional factors are extremely important when it comes to our financial behavior. Our current state of mind or mood can also influence our financial decisions. In his research, Selye (1976) emphasizes that money can never be the ultimate goal of a , as it has no value in itself and can therefore only serve as a means to achieve a goal that is valuable to us. In order to achieve peace of mind, we must separate the concepts of means and ends, as the ultimate goal of a balanced and happy individual must be self-actualization and the desire to earn the respect of others. According to his theory, although material security is important, the most important thing is for people to develop and perfect their own qualities. The traditional financial approach assumes that intellectual biases do not play a role in individuals' decision-making processes. In reality, however, people behave more like average, fallible beings than perfectly rational decision-makers who always strive to maximize their utility. Emotional intelligence refers to the ability to recognize and understand the emotions and judgments of others and to distinguish between different emotional states. Those with high emotional intelligence are better able to control their own emotions and are more empathetic towards others. In contrast, the „unconscious” refers to mental processes that remain hidden from the individual but directly influence their thinking and behavior. The unconscious primarily refers to the fact that people's actions are often not guided by conscious decisions, but by deep-seated thoughts, internal conflicts, and impulses (Irfan et al., 2023).

Understanding behavioral finance helps bridge the gap between traditional economic theories that assume rationality and real-world behavior driven by human emotions and perceptions. By acknowledging the existence of our cognitive biases and irrational tendencies in the financial sphere, we can better prepare ourselves to make sound investment decisions and achieve financial well-being (James, 2023).

Artificial intelligence is now present in almost every industry, and it is playing an increasingly important role in the financial sector. At the same time, there are areas where reliable human relationships remain key and these are based on emotional intelligence. Although finance is fundamentally based on numbers and data, working with people also carries an emotional charge. Emotional intelligence helps us to better manage our own and others' emotions, resulting in more balanced and rational decision-making, especially when it comes to long-term goals. People with high emotional intelligence typically have better control over their impulses and respond more consciously in stressful situations. Self-awareness is key here: if we recognize the triggers of our emotions, we can avoid rash decisions. Investors with high emotional intelligence are more likely to control their impulsive reactions, thus making more effective decisions in the long run (Fenton-O'Creevy et al., 2011). Risk tolerance varies from person to person and is also related to emotional intelligence. For example, people with higher emotional intelligence often take a more balanced approach to risk

because they are able to interpret stressful situations rationally (Mayer et al., 2008).

Financial advisors also play an important role: by empathizing with their clients' emotions and goals, they can help them make objective decisions. Open communication and trust can lead to long-term relationships. Developing emotional intelligence increases motivation and flexibility, which is particularly important in a changing market environment. Although AI and data analysis are becoming increasingly important, human factors remain irreplaceable on the road to financial success (Allard, 2024).

Individual propensity to save is closely related to the level of financial literacy. Individuals with financial knowledge tend to make more informed financial decisions, which also include saving behaviors. In contrast, low financial literacy often predicts future financial difficulties, particularly due to a lack of savings (Gathergood, 2012). A lack of financial knowledge goes hand in hand with a lack of long-term financial planning, which can hinder the development of future-oriented financial behavior. This results in a lack of ability and willingness to save, which significantly increases individuals' exposure to risk in the event of unexpected financial events (Hilgert et al., 2003). For a deeper understanding of financial behavior, it is important to emphasize the concept of financial self-efficacy, which refers to an individual's proficiency in financial decision-making and their sense of control over their financial situation (Lapp, 2010). Financial self-efficacy is closely related to self-confidence and presupposes stable financial awareness and relevant competencies. Financial self-efficacy, as a psychological factor, contributes to individuals making better financial decisions and actively striving to achieve financial security and well-being (Lown, 2011). Those who are confident in managing their finances find it easier to navigate unexpected financial situations and find solutions to problems more effectively. In contrast, those who are less confident in their financial abilities are more likely to fall into debt traps, are more inclined to accept unfavorable terms when taking out loans, and often lack savings that could serve as a safety net. A low level of financial self-efficacy can therefore be interpreted as a form of financial exclusion – not because someone lacks access to digital tools or services, but because they lack the knowledge and skills necessary to make informed financial decisions (Csiszárík-Kocsir, 2023).

RESEARCH METHODOLOGY

The aim of our research was to explore the extent to which emotions influence investment decision-making, with a particular focus on overconfidence, emotional intelligence, and risk-taking propensity. The study was based on primary quantitative research conducted using a questionnaire. The questionnaire was completed by 100 respondents in 2025 who had active investment experience or were interested in investing.

The questionnaire contained a total of 17 questions, which can be divided into three main topics:

Demographic data (e.g., age, gender, educational attainment): These data helped to understand the socioeconomic background of the respondents.

Financial experience and behavior: The questions focused on investment experience, investment instruments used, and investment objectives.

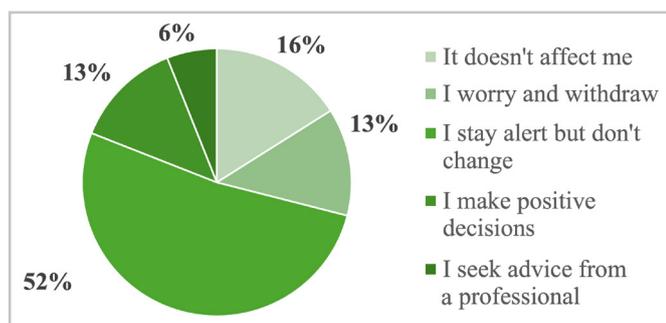


Figure 7. Impact of market news and events on respondents' investment decisions

Source: own research

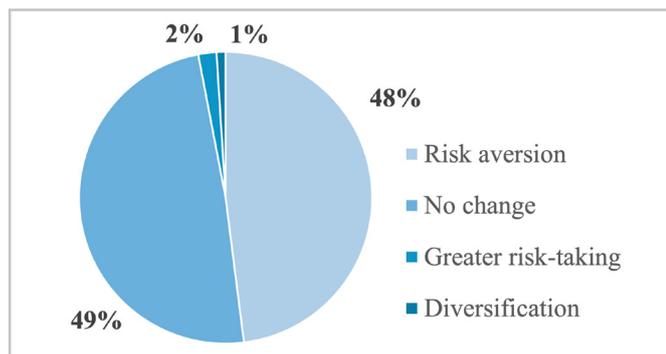


Figure 8. The impact of market volatility on the decision-making process

Source: own compilation

Overall, uncertainty plays a negligible role in the decisions of respondents.

Figure 6 shows the extent to which respondents feel that their emotions influence their investment decisions.

36% of the majority believe that emotions play only a moderate role in their decisions. According to 25% of respondents, emotions have a slight influence on their investment decisions. A 17% share of respondents reported either a high degree of emotional influence or no emotional influence at all. Based on the responses, emotions play a minor rather than a major role in investment decisions.

Figure 7 shows that 52% of respondents, i.e. more than half, stated that market news and events attract their attention but do not influence their decisions. The second most common response, at 16%, indicates that respondents are not affected by the news, so it has no impact on their investment decisions. Overall, it can be concluded that the majority of respondents do not change their decisions based on market news and events.

Figure 8 shows how market volatility influences respondents' decision-making.

The figure shows that, although with a minimal difference, the majority of the crowd, 49%, does not change its investment decisions in response to market volatility. Forty-eight percent of respondents are risk-averse, so they tend to refrain from making investment decisions in response to market volatility. Based on the results, it is clear that market fluctuations encourage the majority not to change their decisions or to avoid risk.

The next question asked about the level of self-awareness. On a Likert scale of 1 to 5, 60% of respondents chose 4, which indicates a high level of self-awareness, while 15% chose the highest option (5). Twenty-one percent chose the moderate category, and only 4% chose 1 or 2.

We also examined how the majority reacts to unexpected situations when making investment decisions. Based on self-reporting, 65% of the majority consciously manages the situation, while emotions dominate for 29%.

Finally, we sought to find out how respondents assess their investment decisions and to what extent they consider them rational. Respondents were again asked to answer this question on a Likert scale of 1 to 5. Fifteen percent consider their investment decisions to be completely rational, while 48% consider them to be largely rational. The moderate category was selected by 32%, and only 5% believe that their investment decisions are not rational.

Based on the answers to the questions, we conducted a statistical test to support our hypotheses.

1. *Hypothesis: Excessive self-confidence has a negative impact on the rationality of investment decisions.*

Based on the results of the responses to „respondents' self-confidence” and „level of rationality,” the t-test value is 0.037, while the correlation coefficient is 0.212. Based on the results of the t-test, the hypothesis is true, as it supports that excessive self-confidence does indeed have a negative effect on the rationality of investment decisions. Based on the value of the correlation analysis, the hypothesis is false because excessive self-confidence does not negatively influence rationality, but shows a weak positive correlation with it.

Conclusion: There is a significant difference between the two groups (based on the t-test), but the relationship between self-confidence and rationality is not strong. This may suggest that self-confidence can influence decisions, but not to a decisive extent.

2. *Hypothesis: Emotional intelligence is related to investor prudence.*

Based on the results of the responses regarding self-awareness and rationality, the t-test value is 0.044, while the correlation coefficient is 0.225. Based on the results of the t-test, the hypothesis is true because the p-value is significant, which means that emotional intelligence is indeed related to more prudent investment decisions. Based on the correlation analysis, the hypothesis is also true, as there is a relationship between emotional intelligence and deliberateness, even if this relationship is weak and therefore does not determine investor deliberateness.

Conclusion: Emotional intelligence is moderately related to investor deliberation, and the difference between the groups is statistically significant. Therefore, the hypothesis can be confirmed.

3. *Hypothesis: Investors' emotional state influences their risk-taking propensity.*

Based on the results of the responses to emotional influence and risk-taking propensity, the t-test value is 0.072, while the correlation coefficient is -0.035. Based on the results of the t-test, the hypothesis is false because the p-value exceeds the 5% significance threshold. However, it is close to the significance level, so it is possible that a significant correlation could be demonstrated with a larger sample or using a different method of analysis. Based on the correlation analysis, the hypothesis is indeed false, as emotional state does not significantly influence risk-taking propensity in light of the results.

Conclusion: Neither the difference between the groups nor the relationship is significant, so the hypothesis can be rejected. There is no clear correlation between emotional state and risk-taking.

CONCLUSIONS AND RECOMMENDATIONS

In this study, we analyzed in detail the impact of emotional and psychological factors on investment decision-making. The results clearly show that financial behavior is not only shaped by rational considerations, but that emotional reactions and various biases also play a significant role. Our research focused on self-confidence, emotional intelligence, risk tolerance, and loss aversion, as these are key factors in financial decision-making.

The results of the questionnaire survey confirmed that emotional intelligence is closely linked to more conscious investment decision-making. Emotional intelligence can help maintain composure, especially in times of market uncertainty. According to the data, excessive self-confidence often led to risk-seeking behavior, which did not always prove rational. In contrast, investors who were less confident tended to avoid losses and therefore took fewer risks.

Based on the research, it is recommended that training courses be introduced to help investors manage their emotions more consciously, thereby promoting more rational decision-making. In addition, it is recommended that investment advisors take into account the emotional state and behavioral patterns of their clients, as these can have a significant impact on their decisions. Overall, it can be concluded that developing emotional intelligence and psychological awareness can contribute to more stable financial results in the long term and help investors deal with financial challenges with greater confidence.

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