Journal of Educational Research: Shiksha Shastra Saurabh
Journal homepage: www.ksc.edu.np/ksc-publication-details/9

Herding Behavior in Nepali Stock Market

Sabina Maharjan
Lecturer, Kathmandu Shiksha Campus
Email: mhrsabina22@gmail.com

Abstract

The study explores how cognitive biases affect the aspect of retail investor's herding behavior in the context of Nepalese market. This study is based upon the theoretical aspect of Prospect theory and Behavioral theory. Perfect theory explains how investors strengthen herding behavior are tending losses more fatly than equal profits. Behavior Finance theory explains systematic departure from rationality. In terms of theoretical aspect for connecting psychological biases to collect market behavior is succeeding by these frameworks. The study was taken from 250 active retail investors from Nepal stock exchange (NEPSE) which emphasis the qualitative approach with cross sectional research design along with structured questionnaire. The analysis was approved with the 5-point Likert scale through different data gathered together for the analysis with different statistical tools like regression models, PCA, correlation, ANOVA and reliability test. The findings show that whereas loss aversion and regret aversion mainly affect choices through herding behavior and overconfidence which has both direct and indirect effects on the investment decisions. The explanatory significance of behavior variables in developing countries was highlighted by regression models, which accounted for around half of the variance in investment decision making. By confirming a mediation model in the Nepalese setting and showing that herding behavior increases the impact of cognitive biases on investment results, this study adds to the body on behavioral finance. The results have consequences for policy actions meant to improve market stability, regulatory supervision, regulatory supervision and investor education.

Article Info/ Article History

OPEN ACCESS

Received: September 25 2025
Revised: October 6, 2025
Accepted: December 7 2025
Published: December 25, 2025
DOI: https://.doi.org/10.3126/sss.v25i1.90500

Keywords: *Behavioral Finance Theory, Cognitive Biases, Herding Behavior, Investment Decision, Prospect Theory, Nepal Stock Exchange, Retail Investors*

Introduction

Investors are rational actors that maximize utility based on comprehensive knowledge, according to classical finance theories. Empirical data from developing and global markets, however, contradicts this notion by demonstrating that social conformity and psychological biases frequently influence investing behavior (Kahneman & Tversky, 1979). In order to explain anomalies like excessive trading, speculative booms and herd-driven collapses, and behavioral finance combines ideas from psychology and economics. It increases volatility and destabilizes markets herding behavior defined as investors' propensity to copy the actions of others rather than rely on independent analysis which has garnered much scholarly interest (Dewi, 2023; Xing et al., 2024; Sabir et al., 2025). During optimistic periods, retail investors in Nepal frequently follow market consensus, which exacerbates bubbles and collapses (Rijal, 2023; Gurung et al., 2024; Kunwar, 2021). In addition to being a social phenomenon, herding is a calculated reaction to perceived safety in numbers and uncertainty.

Herding tendencies are further reinforced by cognitive biases. Investors that are overconfident tend to overestimate their expertise and forecasting skills which frequently leads to excessive trading and crowd alignment (Gurung et al., 2024; Rana, 2025; Mufti et al., 2023). According to Prospect Theory, investors experience loss aversion more strongly than comparable profits which leads them to follow the lead in order to reduce risk (Pokharel, 2020; Rawat, 2023). Independent decision-making is discouraged by regret aversion as investors want to avoid taking responsibility for bad results by imitating others (Rana, 2025; Pokharel, 2020). These prejudices produce a psychological setting in which investing decisions are heavily influenced by herding.

By utilizing different advanced statistical methods to assess a mediation hypothesis, our work fills up these gaps. Prospect theory Kahneman and Tversky (1979) helps to explain about people evaluate potential gain and loss indefinitely. There may arises about the problem of loss and gain. With the focus of Behavioral Finance Theory, it also helps in analyzing psychological factors with aspect of cognitive limitations for financial decisions. Overconfidence causes investors to underestimate risks and overestimate their capacity for the prediction which results in portfolio diversification (Gurung et al., 2024; Mufti et al., 2023; Rana, 2025). Anchoring bias value can cause inertia in decision making when investors become fixated with reference points highs (Rawat, 2023; Nasarudin et al., 2022). Loss aversion causes investors to hold losing stocks for too long

and sell winning stocks too soon because it represents a higher emotional reaction to losses than to profits (Pokharel, 2020; Gurung et al., 2024).

According to Rana (2025) and Mufti et al. (2023), investors are motivated by regret aversion to steer clear of actions that may cause them to regret them in the future which encourages herding behavior to reduce accountability for unfavorable results. Therefore, herding is higher in bull markets and during global crises according to Xing et al. As well as herding highlighted as a crucial behavioral feature according to Kunwar (2021). However, in the context of Nepal herding highlighted as a crucial feature among investors (Rijal, 2023).

Therefore, recent research is still dispersed and frequently concentrates on individual's biases without proper mediation effect regarding to financial decision. The studies conducted in Nepal are still dispersed and frequently concentrate on individual biases without considering the impact of mediation shows the research gap. It is understudied how social media, financial literacy, and investor mood contribute to herding behavior.

Theoretical Framework

A theoretical framework provides the intellectual foundation of a research study by identifying and explaining the key theories and concepts that guide the investigation. It helps the researcher understand the phenomenon under study in a systematic way and clarifies how variables or experiences are conceptually related. A theoretical framework does not merely function as a set of rigid rules; rather, it serves as a lens through which meanings, practices, and experiences are interpreted within specific social and institutional contexts.

Theoretical frameworks are particularly important in studies focusing on teachers' professional practices, motivation, classroom management, or pedagogical development, as these areas are shaped by both personal cognition and social interaction. The framework helps explain how teachers construct meaning from their experiences, how they respond to challenges, and how their professional identities evolve over time. By drawing on relevant theories, the researcher can better interpret participants' narratives, actions, and reflections.

The theoretical framework of this study includes the discussion of the following theories:

Behavioral Finance Theory (BFT), Shefrin (2000)

Behavior Finance Theory acts as the inner concept for the framework for the study examining how cognitive bias leads the investors deviate towards the concept of

investment in the stock market along with the decision of financial analysis. It challenges the assumptions of traditional finance by highlighting the errors in judgment like overconfidence, loss aversion and herding. Among 20 Review articles incorporate this theory for the explanation of market anomalies and irrational behavior in the study of Behavior context of investment in Nepal.

Prospect Theory (PT) Kahneman and Tversky (1979)

Prospect Theory explores that evaluate the performance of investors potential gains and losses relative to a reference point with losses perceived more rapidly than equivalent gains. This assumes to regret aversion and herding, as investors seek to avoid the emotional pain of loss by herding trend of others. According to Pokharel (2020), Rawat (2023) and Gurung et al. (2024) utilizes this theory towards Nepalese investors resulting its impact in explaining risk-averse and herding behavior.

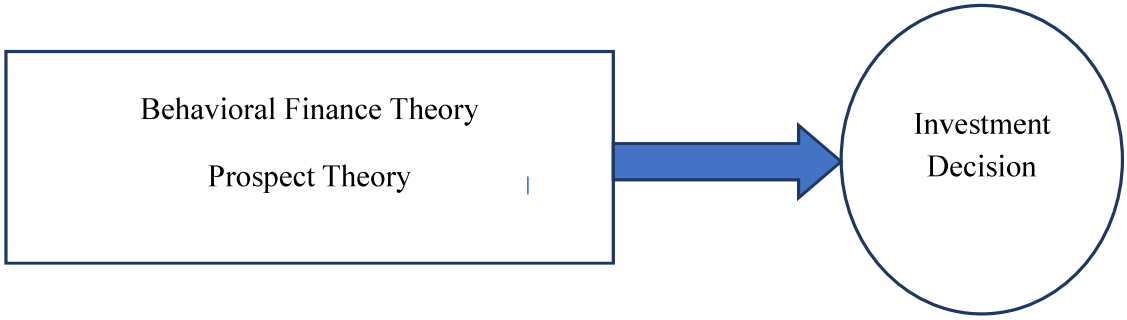

Figure 1: Conceptual Framework

This study explores the effect of cognitive biases particularly loss aversion, regret aversion, overconfidence on herding behavior among Nepalese stock market investment decision. Overconfidence leads investors overestimate their action and knowledge in decision making abilities which results in excessive trading and a tendency to follow others during market conditions. Loss aversion navigates investors to avoid realizing losses, attempting them to minimize other's perception with controlling component of risk. Likewise, regret aversion discourages independent decision making due to the fear of making wrong decision and choices which may lead to follow the herding crowd to avoid regret in future. Generally, these cognitive biases contribute to herding behavior where investors imitate the action of others rather than focus on their own analysis and decision of financial analysis which results in the phenomena such as bubbles and crashes.

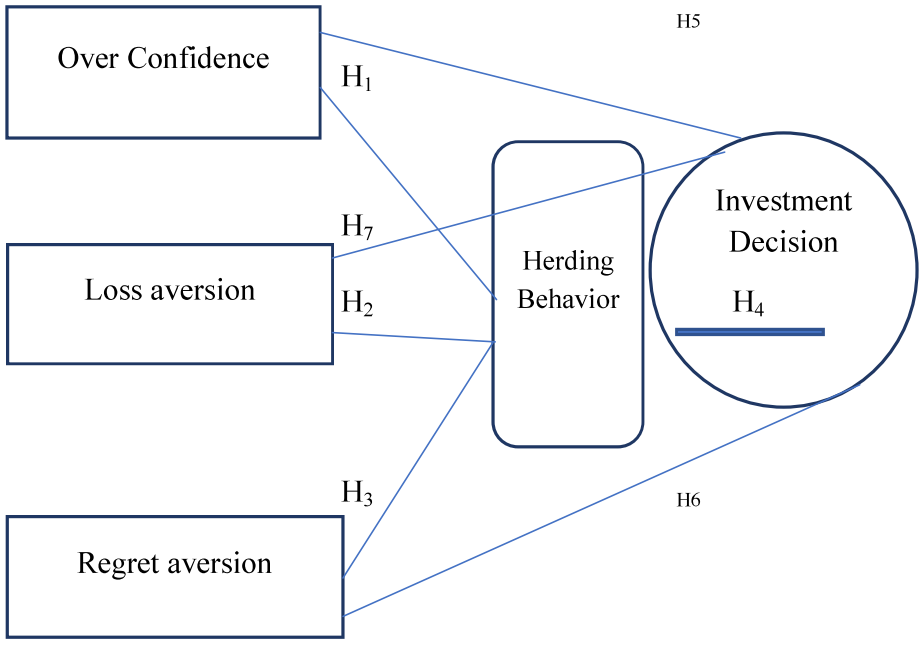

Figure 2: Hypothesis Relationships

H1. Overconfidence positively influences herding behavior. Overconfident investors overestimate their predictive abilities and trade excessively, often aligning with the crowd (Gurung et.al. 2024; Rana 2025; sabir et al., 2025; Multi et al., 2023).

H2. Loss aversion positively influences herding behavior. Prospect Theory (Kahneman & Tversky, 1979) explains that losses loom larger than gains. Investors therefore majority behavior to minimize perceived risk (Pokharel, 2020; Rawat, 2023; Mufti et al., Rijal, 2023).

H3. Regret aversion positively influences herding behavior. To avoid personal accountability for poor outcomes, investors often follow others' choices, reducing independent analysis (Pokharel, 2020; Gurung et al., 2024; Rana, 2025; Mufti et al., 2023).

H4. Herding behavior mediates the relationship between cognitive biases and investment decisions. Herding amplifies volatility and speculative bubbles acting as a channel through which biases influence final investment choices (Rijal, 2023; Dewi, 2023; Xing et al., 2024; Lobao &Almeida, 2024).

H5. Herding behavior mediates the relationship between overconfidence and investment decisions. Herding acts as the channel through which overconfidence influences final investment choices (Gurung et al. (2024); Rana (2025); Sabir et al. (2025); Mufti et al.

(2023) all confirm that overconfident investors trade excessively focuses on trust on realistic and often herding when confidence is challenged.

H6. Herding behavior mediates the relationship between regret aversion and investment decisions. Herding thus becomes the mechanism that converts regret aversion into collective investment choices. Pokharel (2020); Gurung et al., (2024); Rana (2025); Mufti et al. (2023) findings show regret adverse investors herd to avoid responsibility and reduce the emotional burden of wrong decisions.

H7. Herding behavior mediates the relationship between loss aversion and investment decision. Herding transfers, the psychological effect of loss aversion into perfect sell/hold or purchase decisions. Pokharel (2020); Mufti et al. (2023); Rijal (2023) evidence that loss averse hold losers too long, sell early and herd to reduce risk exposure.

Methods

A quantitative research approach along with cross sectional survey design was used in this study to target those retail investors who had experienced of two year trading on NEPSE. Investors with two year experience were selected as purposive selection approach with the validated structures questionnaires that were delivered by both methods physically and virtual(Barber &Odean,2001:Gurung et., 2024; Mufti et al., 2023; Pokharel,2020).For the analysis of construct, a five point Likert scale, spanning from strongly disagree to strongly agree, was used to code the responses. The sample size was determined to be between 350 and 400 respondents according to the previous study of behavior finance research in Nepal and South Asia based on SEM criteria (Rawat, 2023; Gurung et al., 2024; Sabir et al., 2025).

Different types of steps were done in data analysis process. Investor's profile and factor levels were created using descriptive statistics. Measurement consistency was verified using reliability and validity tests, such as Cronbach's alpha, KMO, Bartlett's and Principal Component analysis. Initially insights into the relationship between variables were accepted through correlation analysis. The primary study used bootstrapping to validate mediation effects and structural Equation Modeling (SEM) to examine direct and mediated connections.

Robustness checks increased in the results, while diagnostic tests including normality, multicollinearity and model fit index CFI and RMSEA, $x^2$for validity.

Results and Discussion

The internal consistency of the measurement scales in this research was verified by the reliability analysis. The range of Cronbach's values, which indicate acceptable to exceptional reliability, was 0.588 to 0.875. Loss Aversion (a= 0.714) and Herding Behavior (a= 0.638) exhibited intermediate reliability, but Investment Decision (a= 0.875) AND overconfidence (a = 0.850.588)8) showed good dependability. Despite being lesser, regret aversion (a = 0.588) was kept because of its theoretical significance. These findings support the measuring tool's reliability and support their use in further research.

Table 1. *Reliability test*

Scale	Cronbach's α	Interpretation
Investment Decision	0.719	Excellent reliability
Overconfidence, Loss Aversion, Regret Aversion, Herding	0.858	Strong reliability
Overconfidence (subset)	0.719	Acceptable reliability
Loss Aversion	0.714	Acceptable reliability
Regret Aversion	0.588	Weak reliability (items reduced after PCA)
Herding Behavior	0.638	Moderate reliability

Investment decisions, herding behavior and cognitive biases all showed strong positive correlation, according to correlation analysis. Herding and Overconfidence were shown to be highly associated indicating that investors who overestimate their capacity for prediction are more inclined to follow the herd when faced with uncertainty (Gurung et al., 2024; Rana, 2025). Herding was positively correlated with loss aversion indicating that investors who are afraid of losing money typically follow the lead in order to reduce perceived risk (Pokharel, 2020; Rawat, 2023). Additionally, there was a strong correlation between herding and regret aversion suggesting that investors avoid making autonomous decisions in order to lessen the emotional impact of regret (Mufti et al., 2023).

These connections were subsequently validated via structural equation modeling. Loss aversion and regret aversion mostly affected choices through herding behavior, confidence had both direct and indirect effects on investment decisions. The explanatory significance of behavior variables in developing economies was heighted regression models which accounted for around half of the variance in investment decision making. Bootstrapping validated hypothesis H4 through H7 by confirming the mediating function of herding with CFI over 0.90 and RMSEA below 0.08, diagnostic tests showed that the model satisfied acceptable fit indices, guaranteeing the validity and generalizability of the results.

Principal Component Analysis (PCA)

From the (PCA) Principal Component Analysis, the dimensions of construct Overconfidence, Loss Aversion, Regret Aversion, Herding Behavior and Investment Decision are strongly loaded. From the Dimensions of Construct Anchoring Bias item was removed due to weak load. The selected constructs indicated sufficient variance, justifying in final framework.

Table 2. *Component loadings (varimax rotation)*

Item	Component 1	Component 2	Component 3	Uniqueness
OC1	0.711	–	–	0.488
OC2	0.665	–	–	0.553
OC4	0.558	–	–	0.619
OC5	0.551	0.503	–	0.441
LS1	–	0.555	0.364	0.554
LS2	–	–	0.619	0.526
LS3	–	0.447	0.657	0.345
LS4	–	0.517	–	0.731
LS5	–	–	0.735	0.428
RA1	0.570	–	–	0.575
RA2	0.309	–	0.638	0.444
RA3	–	0.395	0.398	0.683
RS4	–	–	0.689	0.466
RA5	–	–	0.649	0.574
HB1	–	0.406	0.358	0.654
HB2	–	–	0.537	0.669
HB3	–	0.601	0.476	0.398
HB4	0.483	–	–	0.642
HB5	–	0.823	–	0.244
INV1	0.490	0.716	–	0.246
INV2	0.734	–	–	0.412
INV3	0.768	–	–	0.352
INV4	0.571	0.626	–	0.275

From the above analysis of PCA overconfidence, Loss Aversion, Regret Aversion, Herding and Investment Decision as valid constructs and Anchoring Bias was excluded due to poor loading.

Descriptive Statistics

From the Descriptive results, Cognitive biases among Nepalese retail investors revealed moderate level. Overconfidence averaged (3.07), which suggests investors average believe in their abilities of financial decision. Similarly, Loss Aversion and Regret

Aversion (M =3.42) and (M =3.41) respectively high than other dimensional construct showing high emotional responses to loss and regret. According to the analysis of Herding component here the value (M = 3.29) was prevalent by the reflection of crowd following tendencies in the investment of Nepalese stock market. Similarly, Investment decision (M = 3.17) indicates moderately reliance on biases and herding. Therefore, the descriptive analysis highlights M Moderates effect on biases and herding showed tendencies shaping investor choice.

Table 3. *Descriptive statistics*

Variable	Mean	SD	Min	Max	Skewness	Kurtosis
Overconfidence (meanOC1)	3.07	0.867	1.25	4.75	-0.138	-0.629
Loss Aversion (meanLS1)	3.42	0.789	1.20	5.00	-0.637	0.517
Regret Aversion (meanRA1)	3.41	0.613	1.60	4.80	-0.233	0.488
Herding Behavior (meanHB1)	3.29	0.669	1.20	4.60	-0.729	1.66
Investment Decision (meanINV1)	3.17	0.899	1.00	5.00	-0.293	-0.181

Correlation Analysis

From the above Correlation analysis, it demonstrated significant relation with all variables. Overconfidence correlated strongly with investment decision (r= 0.625, p < 0.001) confirming its predictive role. Similarly herding behavior also showed a significant positive correlation with investment decision (r= 0.480, p<0.001). Likewise, Regret Aversion moderately correlated with both Herding (r= 0.525, p = 0.001) and Investment Decision (r = 0.306, p <0.005). Loss Aversion, however showed weak and non- significant correlation. Overall analysis from correlation, over confidence and Herding Behavior are the most primitive element in the investment decision of Nepalese share market.

Table 4. *Correlation matrix*

Variables	Overconfidence	Loss Aversion	Regret Aversion	Herding	Investment Decision
Overconfidence	1	–	–	–	–
Loss Aversion	0.011 (ns)	1	–	–	–
Regret Aversion	0.203 (ns)	0.577***	1	–	–
Herding	0.307*	0.577***	0.525***	1	–
Investment Decision	0.625***	0.229 (ns)	0.306*	0.480***	1

Overconfidence, Regret Aversion and Herding Behavior show significant positive correlation with the decision of Investment in Nepalese stock market.

Regression Analysis

Regression results further validated the hypotheses. Overconfidence had a strong positive effect on Investment Decision (B=0.556-0.636, p <0.001) while Herding Behavior also significantly influenced decisions (B=0.351-0.428, p <0.05). Loss Aversion and Regret Aversion did not show significant direct effects, although their correlations suggest indirect influence through herding. The model explained approximately 50% of the variance (R^3= 0.50), indicating that cognitive biases and herding jointly account for half of the variation in investment decisions among Nepalese retail investors.

Table 5. *Regression results (dependent variable: investment decision)*

Predictor	Estimate (β)	SE	t	p	Interpretation
Overconfidence	0.556 – 0.636	0.107–0.127	5.0–5.2	<0.001	Strong positive effect
Loss Aversion	0.045 – 0.080	0.149–0.152	0.30–0.54	ns	No significant effect
Regret Aversion	-0.012 – 0.054	0.182–0.184	0.07–0.30	ns	No significant effect
Herding Behavior	0.351 – 0.428	0.171–0.178	2.0–2.4	0.020–0.052	Significant positive effect

From the Regression Analysis it explains about the Model fit. Model Fit shows R^2= 0.50. It means the model explains 50 % of variance in Investment decisions which also describe about goodness of fit.

Conclusion

From the overall study, the analysis of result confirms herding act as the mediating element in the investment decision of Nepalese Stock market. The cognitive bias and herding behavior act as the strong component in the investment decision of Nepalese. Regarding to above finding the different aspects and other psychological aspects of cognitive bias acts as the prevailing elements with mediating factor of herding in investment decision. Due to different restricted access of information, infrastructure limitations and increasing impact of social media, these findings were consistent with research overall the world.

However, by experimentally testing a mediation model in an emerging market, herding affects the cognitive bias in the investment decision in the major context of Nepal. Therefore, regulatory monitoring, policy implications required to improve further progress in investment decision. Further studies should examine moderating elements including investor attitude, digital platforms and financial knowledge help to clarify the dynamics of herding behavior in Nepalese stock market.

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