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Abstract

This paper examines the effect of investor psychology of fund managers on the performance of the portfolios they manage. The study established that fund managers were influenced by risk aversion, overconfidence, herding behavior, risk aversion and greed in their investment decisions. The effect on portfolio performance was found to be positive and significant. The fund managers were found to be more prone to risk aversion and least prone to greed. Based on the findings, there is need for the enhancement of portfolio performance through aligning investor psychology traits with effective strategies. The effect of risk aversion suggests that cautious investors who weigh potential losses carefully are still able to achieve strong portfolio performance, potentially through balanced, well-diversified portfolios that manage downside risk. In terms of herding behavior, it depicts that popular investment trends can yield favorable results, though it also highlights the importance of monitoring market dynamics to avoid groupthink risks. The influence of over-confidence bias also implies that investors who trust their judgment and knowledge are likely to make bold investment choices, potentially leading to higher returns. Lastly, the influence of greed highlights that the desire for higher returns can drive effective portfolio growth, though it also points to the need for safeguards against excessive risk-taking. Our findings underscore the importance of understanding and managing investor psychology within portfolio management to balance risk with return, thereby optimizing performance.

Keywords: *Investor psychology, portfolio performance, risk, return, Efficient market hypothesis.*

1. Introduction

The Efficiency Market Hypothesis (Fama, 1970) considers investors as rational and utility maximizing. However, proponents of Behavioral Finance where investor psychology is domiciled argue that human beings are known to make decisions based on their intuitions and feelings which makes investors to be susceptible to illusions. Investor psychology involves the study of emotional and cognitive factors that influence how investors make financial decisions. It encompasses a range of biases and behaviors, such as fear, greed, overconfidence, and herding behavior that affect how investors perceive risks, opportunities, and market information. These psychological influences affect risk tolerance, reactions to market fluctuations, and investment strategies. Investor psychology is crucial because it explains why markets sometimes deviate from rational

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expectations, leading to phenomena like bubbles or crashes (Jiang *et al.,* 2019). By analyzing investor behavior, financial professionals can better predict market trends, improve investment strategies, and create policies that promote more stable markets.

The adoption of investor psychology in investment decisions has been challenged by the misconception that all investors make decisions based primarily on rational analysis and financial logic. In reality, psychological biases and emotional responses play a much larger role than often acknowledged (Evbayiro-Osagie & Chijuka, 2021). Many believe that investors, particularly institutional ones, are immune to cognitive errors like overconfidence, herd behavior, and risk aversion, but research shows these biases are prevalent across all levels of investing. For instance, overconfidence can lead investors to trade excessively, underestimating risks, while herd behavior causes them to follow market trends blindly, ignoring fundamentals. Risk aversion often makes investors hold onto losing positions too long, hoping for a recovery, rather than making rational, data-driven decisions (Ndung'u & Kung'u, 2022). As such investors do not have a single approach that guides their decisions to invest, making it challenging to assess portfolio performance uniformly.

The existing literature on investor psychology evidences its effect on investment decisions and stock performance (Kengatharan & Kengatharan, 2014; Vijaya, 2016; Aduda *et al.,* 2012; Cherotich, 2020). Most of the studies reviewed have focused on individual investors and few on institutional investors. The findings also depict contrary findings. For example, Kengatharan and Kengatharan (2014), found that overconfidence was found to have a negative and significant effect on investment performance which may be attributed to the excessive trading and the associated transaction costs. Loss aversion and regret aversion did not have a significant influence while herding had a negative influence. There are those studies which also depict a positive effect of investor biases on stock returns (Vijaya, 2016) while others evidence a negative opinion. Other studies have also found that investor biases have no effect on the stock market (Cherono, 2020). Kenyan investors often exhibit behavioral biases such as herd mentality, where they follow trends, leading to market bubbles or crashes, as seen during periods of heightened activity on the Nairobi Securities Exchange (NSE). Investment firms have responded by adopting strategies that address these biases, such as offering more diversified investment portfolios and focusing on long-term

returns rather than short-term market fluctuations (Muratenyi & Olando, 2022). Businesses also offer financial literacy initiatives designed to inform investors about typical psychological traps, such as loss aversion, which leads investors to sell winning assets too soon or hang onto losing ones for too long (Cherono *et al.,* 2019). This study is contextualized at the Nairobi Securities to fill the research gaps identified. Firstly, the need to provide a position on the contradicting findings on the effect of investor psychology on stock returns. Secondly to test the effect on fund managers who manage institutional portfolios.

Methodology

The study adopted a descriptive research design. The study targeted 51 managers of investment firms listed at Capital Market Authority (2024) and a census was carried out. The research involved both primary and secondary research instruments to gather data in the field. Primary data was collected through survey questionnaires which were sent to the investment fund managers of the investment firms. Data was analyzed using descriptive statistics and inferential statistics. The inferential analysis involved the use of Multiple regression. The model is presented below:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon$$

Y = Portfolio Performance

X_1 = Investor Over-confidence

X_2 = Herding Behavior

X_3 = Risk Aversion

X_4 = Investors Greed

X_5 = Experience (control variable)

X_6 = Education (control variable)

Results and Findings

A response rate of 72.5% was obtained. The descriptive statistics presented in Table 1 show that over-confidence among investors had a mean of 4.82, suggesting that the fund managers were more prone to this bias. The standard deviation was 0.842 and a slightly positive skewness (.350), indicating most responses were at the higher end. Herding behavior, with a mean of 3.80 and SD (.895), shows that the behavior was moderately common, though slightly less pronounced than over-confidence. Risk aversion had a mean of 3.90 and a higher skewness (.519), depicting

cautious investment tendencies, though more dispersed in responses (SD of .922). Investor greed had a mean (4.10) but displays near-symmetry in skewness (.007) and a more peaked distribution (-1.209 in kurtosis), implying consistent responses on greed-related traits. Portfolio performance had a mean of 3.16, with a slightly negative skewness (-.189) and lower kurtosis (-1.068), depicting mixed effect on portfolio performance relative to these behavioral traits. Participants' experience (control variable) levels are modest, as indicated by the mean of 2.25 and SD of 0.894, whereas variability suggests some variation in experience levels. Likewise, education (control variable) exhibits a similar central tendency and somewhat less variability than experience, with a mean of 2.33 and SD of 0.770. The skewness of 0.200 for both education and experience points to a nearly symmetrical distribution with only a tiny positive skew, meaning that values are dispersed very equally around the mean with few outliers.

Table 1: Descriptive results

Psychology dimensions	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
Over-confidence	4.82	.842	.350	.333	-.428	.656
Herding Behavior	3.80	.895	.231	.333	-.554	.656
Risk Adverse	3.90	.922	.519	.333	-.187	.656
Investors Greed	4.10	.855	.007	.333	-1.209	.656
Portfolio Performance	3.16	.967	-.189	.333	-1.068	.656
Experience	2.25	.894	.200	.785	.397	2.25
Education	2.33	.770	.200	.180	.397	2.33

Correlation Analysis

Correlation analysis was conducted to identify the nature and direction of the relationships between investor psychology and portfolio performance. The results are shown in Table 2:

Table 2: Correlation Analysis

Dimensions		Portfolio	Herding	Risk Averse	Greed	Over-confidence
Portfolio Performance	Pearson Corr	1				
	Sig. (2-tailed)					
Herding	Pearson Corr	.750**	1			
	Sig. (2-tailed)	.000				
Risk Aversion	Pearson Corr	.544**	.703**	1		
	Sig. (2-tailed)	.000	.000			
Greediness	Pearson Corr	.497**	.653**	.647**	1	
	Sig. (2-tailed)	.000	.000	.000		
Over-confidence	Pearson Corr	.526**	.683**	.646**	.780**	1
	Sig. (2-tailed)	.000	.000	.000	.000	

Table 2 shows that herding behavior exhibits a positive and significant correlation with portfolio performance (r = .750, p = .000), implying that the tendency of firm managers to follow group trends is highly associated with how their portfolios perform, potentially due to collective market movements impacting returns. Risk aversion also shows a significant correlation (r = .544, p = .000), indicating that a cautious approach to investment is positively associated with portfolio performance, through minimized losses in volatile markets. Over-confidence (r = .526, p = .000) also has a positive and significant correlation, suggesting that firm managers with high self-assurance in their decisions may drive their portfolios to perform better, though this can sometimes introduce risk. Finally, investor greed, with a significant correlation (r = .497, p = .000), indicates a notable positive and significant correlation, suggesting that while ambition for high returns contributes to performance, it may also come with risks to portfolio performance.

Regression Analysis

This section provides results for regression analysis. The findings are presented in Table 3, 4 and 5.

3.2.1 Model Summary

Table 3 shows that investor psychology explains 72.6% of the variation in portfolio performance (Adjusted R-square = 0.726). The regression coefficient (R) of 0.865 depicts a strong relationship between investor psychology and portfolio performance.

Table 3: Model summary

	R	R-Square	Adjusted R-Square	Std. Error of the Estimate
Model 1	.865[a]	.749	.726	.342

3.2.2 Analysis of Variance

Table 4 shows that the F-test is significant with a P value of < 0.05. This shows that the model representing investor psychology and portfolio performance is reliable and can be used for prediction.

Table 4: Analysis of Variance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	15.709	4	3.927	23.8.00	.007[b]
	Residual	5.271	32	.165		
	Total	20.980	36			

Regression Coefficients

Table 5 shows the regression coefficients of the model. The findings suggest that investor psychology factors significantly influence portfolio performance, while experience and education (control variables) showed non-significant effects. Specifically, overconfidence bias, risk aversion, herding behavior and investor greed exhibited a positive and significant relationship with portfolio performance with β values of 0 .421, 0.436, 0.240, and 0.226 respectively. However, the control variables (experience and education) depict a positive but insignificant relationship with portfolio performance.

Table 5: Regression Coefficients

Model	Unst. Coefficients	Std. Error	Standardized coefficients	t	Sig.
(Constant)	.299	.387		.773	.444
Manager Over-confidence	.421	.138	.466	3.052	.004
Manager Herding Behavior	.240	.114	.284	2.102	.042
Manager Risk Aversion	.436	.153	.492	2.844	.007
Manager Greediness	.226	.108	.207	2.091	.043
Experience	.008	.039	.019	.201	.842
Education	.052	.066	.068	.780	.440

These results are consistent with findings by Chang and Lin (2021), which found that over-confident investors often leverage their perceived market knowledge to make bold, sometimes risky, decisions that can lead to substantial gains, provided the market conditions are favorable. However, Zhao *et al.,* (2020) caution that while over-confidence can contribute to better performance, it may also increase susceptibility to market volatility if not balanced with strategic risk management.

The findings on herding behavior are consistent with Kengatharan and Kengatharan (2014) where a study among investors at the Colombo Stock Exchange found that anchoring bias had a positive and significant effect on performance. Contrary evidence forwarded by Kim and Nofsinger (2019) where herding was found to amplify market bubbles and crashes, suggesting that excessive conformity to group behaviors can be detrimental to individual portfolio performance.

The findings on risk aversion are consistent with Chen and Zhang (2022) who argue that risk-averse investors typically seek stable returns, thereby avoiding high-volatility investments that may lead to sudden losses. Furthermore, this aligns with Salim and Afzal (2021) where it was noted that risk-averse behaviors are advantageous during economic downturns, allowing investors to preserve capital. This study suggests that investors prioritizing stability over high returns may achieve reliable, steady growth in portfolio performance.

The findings on investor greed, characterized by an ambition for high returns, can improve portfolio outcomes, its benefits may be tempered by associated risks. Huang and Li (2023) found

that greedy investors may seek higher short-term returns, though this approach often introduces greater volatility. Similarly, Abbas and Haque (2020) found that while investor greed can drive growth, it frequently sacrifices long-term stability. The current findings emphasize that investor greed can enhance performance but requires careful management to avoid unsustainable risk exposure.

Conclusion and Recommendations

Fund managers of investment firms are influenced by investor psychology in their investment decisions. The study underscores the significant impact of investor psychological on portfolio performance. Over-confidence, with its significant influence, implies that investors who trust their judgment and knowledge are likely to make bold investment choices, potentially leading to higher returns. Similarly, herding behavior indicates that when fund managers align with popular investment trends, the yields are favorable though it highlights the importance of monitoring market dynamics to avoid groupthink risks.

Fund managers who are prone to risk aversion imply that they weigh potential losses carefully and are still able to achieve strong portfolio performance, potentially through balanced, well-diversified portfolios that manage downside risk. Lastly, the influence of investor greed highlights that the desire for higher returns can drive effective portfolio growth, though it also points to the need for safeguards against excessive risk-taking. Together, these findings underscore the importance of understanding and managing investor psychology among fund managers within portfolio management to balance boldness with caution, thereby optimizing performance.

The study recommends that there is need for the enhancement of portfolio performance through aligning investor psychology traits with effective strategies. For over-confident investors, it is suggested that investment firm managers incorporate regular self-assessment and seek external feedback to mitigate the potential risks of excessive confidence. On herding behavior, there is need for fostering independence in decision-making, investors should focus on research-driven choices and avoid undue reliance on market trends to improve performance consistency. In terms of risk aversion, investors can benefit from portfolio diversification, as this will allow them to balance security with moderate returns, maintaining stability even in fluctuating markets. Lastly, for

investors motivated by greed, adopting a long-term perspective with structured performance goals is recommended to avoid over-leveraging and excessive short-term risks.

Data Availability Statement

Data available on request from the authors

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