

Behavioral Finance: 7 Ways Unwitting Emotions And Biases Can Adversely Affect Investments

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James Graves, Investment Advisor and Principal at Joppa Mill Advisors

investment theory is based on investors acting rationally with regard to advancing their own financial interests, within their limits of risk tolerance. The theory also presumes that in a liquid market items traded are fairly and efficiently valued. In reality, human emotion and bias can influence investment actions and results in irrational ways that can be either positive or negative. The discipline of identifying and gauging behavioral influence on actions and on markets is called “behavioral finance.” The magazine, “Psychology Today,” defines behavioral finance as the ways psychology affects investor behavior and financial markets.

James Graves, Investment Advisor and Principal at Joppa Mill Advisors said, “An important oversight in classic investment theory is ignoring the fact that investors are humans who don’t always act rationally. Assuming only rationality in investing can lead to unexpected and unproductive results.” As an example, Graves points to the recent post-Presidential election period where many were wary of the effects of impending tariffs on the world economy. Graves notes that the feeling of fear and apprehension drove some to liquidate their investment portfolios, even though the rational value of their investments had not materially changed. The result, for those liquidators, was that they missed out on the subsequent upturn in the markets.

Graves believes that to achieve the best long-term investment results, one should be mindful of behavioral financial effects and, in the long-term, work to minimize their influence. For the amateur investor, understanding behavioral influence and detaching rational investment decisions from its effects can often be difficult to do. Graves has identified 7 behavioral factors

that can be especially significant influencers. They include:

1) Herding

As with our post-Presidential election example above, the non-professional opinions of friends, family and pundits must be weighed against the realities of value. Just because the so-called herd is moving in one direction doesn't make their action wise.

2) Emotional Bias

There is little room for excessive emotions in financial analysis and planning. Such emotions as fear, anxiety, excitement, exuberance and others can motivate investors to be pushed in the wrong direction even in the face of sound investment analysis.

3) Confirmation Bias

If an investor strongly believes a certain way, they can sometimes undervalue or ignore information and facts that support an opposing viewpoint. One-sidedness can cause investors to maintain a false sense of over-confidence because they are missing seeing the total picture.

4) Recency Bias

When it comes to market movement, amateur investors can put too much stock in prior events or cycles and the degree of influence they may have on the future. Fallacious or exaggerated reactions to past stimuli, cycles or trends can lead to misguided decisions in the future.

5) Risk Avoidance

As damaging as exuberance or over-confidence can be, the opposite, or risk intolerance can also hold investors back from reaping potential gains. Today, risk tolerance can easily be gauged by relatively easy-to-take surveys. By knowing risk level, investors and advisors can assess and recommend the most comfortable investments that maximize results for that level.

6) Endowment Bias

Many amateur investors retain ownership of losing investments for a much longer time period than they should, hoping they will come back in value. The prudent investor should remove the emotional connection to a stock and craft a strategy for adroit liquidation and transfer of the remaining asset's value into productive investments that most quickly get back on the growth path.

7) FOMO (Fear Of Missing Out)



James Graves, Investment Advisor & Principal at Joppa Mill Advisors

Amateur investors can be motivated by greed into engaging in irrational risk because they believe that “it can’t miss”.

Said Graves, “To achieve the most effective long-term investing results, it’s important to understand basic financial principals and use them to analyze whether you believe a company will be a prudent investment. It will also be important to know what level is the risk tolerance in order to be able to decide whether the investment, under consideration will be in one’s comfort zone. A professional investment advisor, who is trained to filter out emotions in order to keep you on course to achieve long-term goals, can be quite helpful in these situations.”

ABOUT JAMES GRAVES

James Graves is a nationally recognized investment thought leader, investment advisor and Founder of at Joppa Mill Advisors. He began his career at Bankers Trust Company as a commercial lending officer before transitioning to BTCo.’s trading desk where he was an institutional bond salesman and subsequently underwrote and traded Federal Agency bonds. Decamping from New York, Graves has held senior positions with Wilmington Trust Company, T. Rowe Price, Acadian Asset Management, Morgan Stanley and Merrill Lynch. In addition to his holding the preeminent industry designation, Certified Financial Planner[®], he holds degrees from Trinity College in Hartford CT (B.A. English/Political Science) and New York University Stern School of Business (M.B.A.).

Investment advice is offered through Wealthcare Advisory Partners LLC dba Joppa Mill Advisors LTD. Wealthcare Advisory Partners LLC is a registered investment advisor with the U.S. Securities and Exchange Commission.

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