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Herding Behaviour in Stock Markets: A Financial Economics Perspective

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Abstract

This study examines herding behaviour in stock markets from a financial economics perspective by integrating informational, psychological, and social determinants within a unified empirical framework. Using primary data collected from 249 individual investors in Ahmedabad, India, the study investigates the impact of information asymmetry, investor sentiment, risk perception, social influence, and reputational concerns on herding behaviour, and further analyzes the effect of herding behaviour on market volatility and market efficiency. Multiple regression analysis was employed to test the proposed relationships. The results indicate that information asymmetry, risk perception, social influence, and reputational concerns have significant positive effects on herding behaviour, while investor sentiment does not exhibit a statistically significant independent influence. Among the predictors, risk perception and reputational concerns emerge as the strongest determinants of herding behaviour. Further analysis reveals that herding behaviour significantly increases market volatility and also exerts a strong influence on market efficiency. These findings highlight the central role of behavioural and informational factors in shaping collective investment decisions and market outcomes. The study contributes to the behavioural finance and financial economics literature by offering an integrated individual-level framework to explain herding behaviour and its consequences in an emerging market context. The results provide important implications for investors, policymakers, and regulators in designing strategies to mitigate excessive herding and promote stable and efficient financial markets.

Keywords: Herding Behaviour; Behavioural Finance; Financial Economics

1. Introduction

Financial markets are traditionally assumed to be efficient, driven by rational investors who process all available information to make optimal investment decisions. However, growing empirical evidence from financial economics and behavioural finance challenges this assumption by demonstrating systematic deviations from rational behaviour. One such deviation is herding behaviour, wherein investors tend to mimic the actions of other market participants rather than relying on their own private information or independent analysis. Herding behaviour has emerged as a critical phenomenon influencing stock market dynamics, asset pricing, market volatility, and financial stability.

Herding behaviour in stock markets refers to the tendency of investors to follow the crowd, especially during periods of market uncertainty, information asymmetry, or extreme price movements. While herding may sometimes be rational—such as when investors infer information from others' actions—it often leads to irrational outcomes, including speculative bubbles, market crashes, and mispricing of securities. From a financial economics perspective, herding behaviour undermines the core principles of market efficiency by amplifying noise trading and weakening the informational role of prices.

Theoretical foundations of herding behaviour can be traced to models of informational cascades and social learning. Early studies argue that investors may disregard their own signals and imitate others when they believe that the crowd possesses superior information (Banerjee, 1992; Bikhchandani, Hirshleifer, & Welch, 1992). Such behaviour becomes more pronounced in stock markets characterized by high levels of information asymmetry, limited transparency, and rapid dissemination of news through traditional and social media platforms. Consequently, herding behaviour is not merely a psychological anomaly but a rational response to imperfect information environments.

Market sentiment and investor psychology also play a pivotal role in driving herding behaviour. Behavioural finance literature highlights the influence of emotions such as fear, greed, and fear of missing out (FOMO) on investment decisions. During bullish markets, optimistic sentiment may lead investors to chase rising stocks, while bearish sentiment during downturns may trigger panic selling. These sentiment-driven behaviours often spread quickly across investors, reinforcing collective movements in stock prices and increasing market volatility (Shiller, 2000; Barberis, Shleifer, & Vishny, 1998).

In recent years, the rise of digital media and social networking platforms has further intensified herding behaviour in stock markets. Financial news, analyst recommendations, online forums, and social media influencers significantly shape investors' perceptions and expectations. The speed and reach of information dissemination can magnify collective reactions, causing abrupt price swings that are disconnected from fundamental values. This phenomenon has become particularly relevant in emerging markets, where retail investor participation is increasing and financial literacy levels vary widely.

Despite the growing body of literature on herding behaviour, several gaps remain. First, existing studies often examine herding in isolation, without integrating key financial economics variables such as information asymmetry, market sentiment, uncertainty, and investor psychology within a unified analytical framework. Second, empirical evidence on the mediating role of psychological and risk-related factors in explaining herding behaviour remains limited, particularly in the context of stock markets in emerging economies. Third, many studies rely on market-level measures of herding, overlooking individual-level behavioural mechanisms that influence investment decision-making.

Addressing these gaps, the present study adopts a Structural Equation Modeling (SEM) approach to examine herding behaviour in stock markets from a financial economics perspective. By integrating informational, psychological, social, and market-related factors into a comprehensive model, this study seeks to explain not only whether herding occurs, but also how and why it emerges. Furthermore, the study investigates the implications of herding behaviour for investment decision quality, thereby contributing to both theoretical understanding and practical insights for investors, policymakers, and market regulators.

By offering an integrated behavioural-financial framework, this research contributes to the growing literature on behavioural finance and financial economics, highlighting the importance of psychological and social forces in shaping stock market behaviour in an increasingly interconnected and information-driven financial environment.

2. Literature Reviews

Herding behaviour has emerged as a central theme in financial economics and behavioural finance, challenging the traditional assumptions of fully rational and independent investors embedded in the Efficient Market Hypothesis (EMH). While EMH posits that asset prices fully reflect all available information, persistent empirical anomalies across global stock markets have questioned this premise and encouraged alternative explanations based on collective investor behaviour. Herding, defined as the tendency of investors to mimic others' actions rather than rely on private information, has therefore gained substantial scholarly attention.

The theoretical foundations of herding are broadly classified into rational and behavioural perspectives. Early rational explanations were provided by Banerjee (1992) and Bikhchandani, Hirshleifer, and Welch (1992), who introduced informational cascade models. These models suggest that when investors act sequentially under imperfect information, they may rationally ignore private signals and follow earlier market participants, leading to uniform behaviour. Devenow and Welch (1996) further argued that herding can arise from reputational concerns, payoff externalities, and coordination incentives, particularly among professional investors such as fund managers. These frameworks demonstrate that herding does not necessarily imply irrationality but may represent an optimal response to information constraints and incentive structures.

Behavioural finance literature complements these views by emphasizing psychological and emotional factors. Shiller (2000) highlights the roles of fear, greed, social influence, and overconfidence in driving collective behaviour, especially during periods of heightened uncertainty. Similarly, Barberis, Shleifer, and Vishny (1998) show how cognitive biases and belief-updating errors can generate momentum and reversals, reinforcing herd-like market dynamics.

Empirical research on herding gained momentum with Christie and Huang (1995), who introduced the cross-sectional standard deviation (CSSD) of returns to detect herding during extreme market conditions. Chang, Cheng, and Khorana (2000) advanced this methodology by proposing the cross-sectional absolute deviation (CSAD) approach, allowing for non-linear detection of herding across different market states. Their international evidence revealed stronger herding in emerging markets than in developed economies, highlighting the importance of market maturity, institutional quality, and information transparency.

Subsequent studies have extended herding analysis across asset classes, regions, and time periods, producing mixed results. Spyrou (2013) notes that empirical findings vary significantly depending on methodology, market conditions, and investor composition. More recent studies emphasize the state-dependent nature of herding. For example, Abdollah et al. (2023) document stronger herding during bullish phases in the Malaysian stock market and find pronounced effects among Shariah-compliant

stocks, contributing to the growing literature on Islamic behavioural finance. Evidence from crisis periods further suggests that herding intensifies during financial turmoil due to heightened uncertainty and rapid information diffusion.

Emerging markets have been a focal point of herding research due to higher information asymmetry, greater retail investor participation, and relatively weaker regulatory frameworks. Consistent with Chang et al. (2000), many studies report stronger herding in these markets, supporting the argument that herding may reflect rational adaptation to imperfect information environments rather than purely irrational conduct.

Despite extensive research, several gaps remain. Most empirical studies rely on market-level return dispersion measures that capture the outcomes of herding rather than its underlying psychological and informational mechanisms. Moreover, the roles of investor sentiment, risk perception, and social influence are insufficiently explored, particularly at the individual level. Methodological challenges also persist in distinguishing rational herding from correlated trading driven by common information shocks, as emphasized by Spyrou (2013).

In the Indian context, empirical evidence on herding behaviour remains mixed. Early studies such as Prosad et al. (2012) and Lao and Singh (2011) report conditional herding, primarily during bullish or high-volatility periods. Bhaduri and Mahapatra (2013) and Poshakwale and Mandal (2014) provide stronger evidence of dynamic and crisis-driven herding, while more recent studies (e.g., Kumar et al., 2016; Kanojia et al., 2020) report weak or insignificant market-wide herding, attributing this to increased market maturity and institutional participation. Behavioural studies using survey data (Nair et al., 2017) highlight the importance of demographic and social factors, indicating that herding varies across investor types and investment horizons.

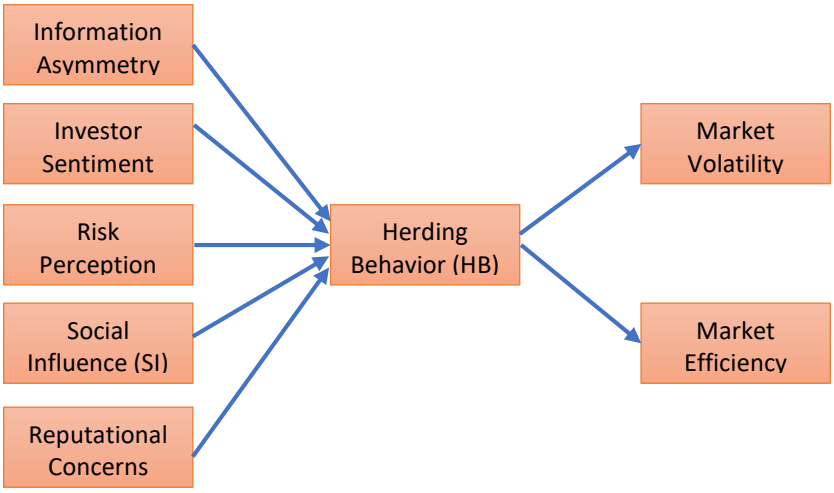
Overall, the literature establishes herding behaviour as a persistent yet context-dependent phenomenon, particularly evident in emerging markets and during periods of market stress. However, the absence of integrative frameworks combining informational, psychological, and market-based factors remains a key limitation. Addressing these gaps, the present study employs a Structural Equation Modeling (SEM) approach to offer a holistic financial economics perspective on herding behaviour and its determinants.

3. Research Methodology

The present study adopted a quantitative and explanatory research design to examine herding behaviour in stock markets from a financial economics perspective. Primary data were collected through a structured questionnaire from 249 individual investors residing in Ahmedabad city, Gujarat. The respondents were selected using a convenience sampling technique, focusing on active stock market participants with prior investment experience. The questionnaire was designed using a five-point Likert scale and measured constructs such as information asymmetry, investor sentiment, risk perception, social influence, reputational concerns, herding behaviour, market volatility, and market efficiency. Prior to analysis, the data were screened for missing values, outliers, and normality. Reliability and validity were evaluated using Cronbach's alpha, composite reliability, and regression analysis to examination of multiple

relationships, thereby providing a comprehensive understanding of the determinants and consequences of herding behaviour in the stock market. Present study use following model to analyse the research.

Figure 1: Research Model



The objectives of this research are as below:

1. To investigate the impact of information asymmetry on herding behaviour among stock market investors.
2. To examine the influence of investor sentiment on herding tendencies, capturing the role of optimism, pessimism, and market mood.
3. To assess the role of risk perception in driving investors to follow market trends.
4. To analyze the effect of social influence and peer pressure on collective trading decisions.
5. To explore the impact of reputational concerns on the likelihood of herding, particularly among institutional investors.
6. To evaluate the consequences of herding behaviour on market outcomes, including market volatility and efficiency.
7. To investigate the moderating role of market conditions (bullish vs. bearish, high vs. low volatility, crisis vs. non-crisis) on the relationship between herding determinants and herding behaviour.

The hypotheses of this research are as below:

1. H1: Information asymmetry has a significant positive effect on herding behaviour.
2. H2: Investor sentiment significantly influences herding behaviour.
3. H3: Risk perception positively affects herding behaviour.
4. H4: Social influence has a significant positive impact on herding behaviour.
5. H5: Reputational concerns significantly drive herding behaviour.
6. H6: Herding behaviour increases market volatility.
7. H7: Herding behaviour negatively affects market efficiency.

4. Data Analysis and Interpretation

This section presents a comprehensive analysis and interpretation of the empirical results obtained from the study. Using multiple regression analysis, the study examined the influence of information asymmetry, investor sentiment, risk perception, social influence, and reputational concerns on herding behaviour, and further assessed the impact of herding behaviour on key market outcomes, namely market volatility and market efficiency. The analysis was conducted to test the proposed research hypotheses and to evaluate the strength, direction, and significance of the relationships among the study variables. The findings are systematically presented through model summary and coefficient tables, followed by detailed interpretations to explain the explanatory power of the models and the individual contribution of each predictor. This approach enables a clear understanding of how behavioural factors shape herding behaviour and how herding behaviour, in turn, affects the functioning of financial markets.

Table 1: Model Summary: Dependent Variable –Herding Behaviour

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.712[a]	0.507	0.497	0.56968
a. Predictors: (Constant), Information Asymmetry, Investor Sentiment, Risk Perception, Social Influence, Reputational Concerns				

The model summary table presents the overall explanatory power of the multiple regression model examining the influence of Information Asymmetry, Investor Sentiment, Risk Perception, Social Influence, and Reputational Concerns on the dependent variable. The correlation coefficient (R = 0.712) indicates a strong positive relationship between the set of independent variables and the dependent variable. The coefficient of determination ($R^2 = 0.507$) shows that 50.7% of the variance in the dependent variable is explained by the five predictors included in the model.

Table 2: Coefficients – Dependent Variable –Herding Behaviour

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.751	0.195		3.850	0.000
	Information Asymmetry	0.088	0.030	0.103	2.901	0.004
	Investor Sentiment	0.179	0.076	0.031	2.358	0.720
	Risk Perception	0.354	0.070	0.354	5.028	0.000
	Social Influence	0.067	0.031	0.075	2.174	0.030
	Reputational Concerns	0.318	0.067	0.329	4.762	0.000
a. Dependent Variable: Herding Behaviour						

The regression coefficients table explains the individual contribution of each independent variable to herding behaviour while controlling for the effects of other variables in the model.

The constant term (B = 0.751, p < 0.001) is statistically significant, indicating the expected level of herding behaviour when all predictors are held constant at zero. Information Asymmetry has a positive and statistically significant effect on herding behaviour. This implies that higher levels of information asymmetry increase the tendency of investors to follow others' actions, supporting the argument that limited or uneven information availability promotes herding. Investor Sentiment shows a positive but statistically insignificant relationship with herding behaviour. This indicates that, after controlling for other factors, investor sentiment does not significantly influence herding behaviour in the present model. Risk Perception exerts a strong positive and statistically significant impact on herding behaviour. The large standardised beta value indicates that risk perception is the most influential predictor in the model. This suggests that as investors perceive higher risk, they are more likely to imitate the actions of other market participants.

Social Influence also has a positive and statistically significant effect on herding behaviour. This finding implies that peer opinions, market trends, and social networks play a meaningful role in shaping investors' tendency to herd. Reputational Concerns significantly and positively affect herding behaviour. The high beta value indicates that fear of professional or social disapproval strongly motivates investors to conform to the actions of others.

Overall, the results indicate that Risk Perception and Reputational Concerns are the strongest determinants of herding behaviour, followed by Information Asymmetry and Social Influence, while Investor Sentiment does not exhibit a significant independent effect in this model.

Table 3: Model Summary: Dependent Variable – Market Volatility

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
2	0.699[a]	.489	.487	.59601
a. Predictors: (Constant), Herding Behaviour				

The model summary indicates the overall explanatory power of herding behaviour in predicting market volatility. The correlation coefficient (R = 0.699) reflects a strong positive relationship between herding behaviour and market volatility. The coefficient of determination (R^2 = 0.489) reveals that 48.9% of the variance in market volatility is explained by herding behaviour alone. This demonstrates that herding behaviour is a substantial determinant of market volatility. The adjusted R^2 value of 0.487 further confirms the stability of the model, indicating that after adjusting for model complexity, 48.7% of the variation in market volatility remains explained by herding behaviour.

Table 4: Coefficients: Dependent Variable – Market Volatility

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
2	(Constant)	.828	.179		4.619	.000
	Herding Behaviour	.725	.047	.699	15.372	.000
a. Dependent Variable: Market Volatility						

The regression coefficients indicate that herding behaviour has a strong and statistically significant positive effect on market volatility. The unstandardized coefficient shows that a one-unit increase in herding behaviour leads to an average increase of 0.725 units in market volatility, holding other factors constant. Overall, the findings clearly demonstrate that herding behaviour is a major driver of market volatility. These results provide strong empirical support for the proposed mediating role of herding behaviour in the relationship between behavioural factors and market outcomes.

Table 5: Model Summary: Dependent Variable – Market Efficiency

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
3	0.617[a]	.381	.379	.57594
a. Predictors: (Constant), Herding Behaviour				

The model summary table shows the overall explanatory power of herding behaviour in predicting market efficiency. The correlation coefficient (R = 0.617) indicates a strong positive relationship between herding behaviour and market efficiency. The coefficient of determination (R^2 = 0.381) reveals that 38.1% of the variance in market efficiency is explained by herding behaviour. This suggests that herding behaviour significantly influences the level of market efficiency.

Table 6: Coefficients: Dependent Variable – Market Efficiency

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
3	(Constant)	1.628	.173		9.394	.000
	Herding Behaviour	.562	.046	.617	12.333	.000
a. Dependent Variable: Market Efficiency						

The regression results indicate that herding behavior has a strong and statistically significant positive effect on market efficiency. The unstandardized coefficient shows that a one-unit increase in herding behavior leads to an average increase of 0.562 units in market efficiency. The constant term is statistically significant, indicating the baseline level of market efficiency when herding behavior is zero. Overall, the findings confirm that herding behavior significantly influences market efficiency. When combined with earlier results showing its effect on market volatility, the study highlights the central role of herding behavior in shaping key market outcomes.

5. Conclusion

The present study set out to examine herding behaviour in stock markets from a financial economics perspective by integrating key informational, psychological, and social determinants within a comprehensive empirical framework. Using survey data from 249 investors in Ahmedabad, the study analyzed the drivers of herding behaviour and its implications for market volatility and market efficiency. The findings reveal that information asymmetry, risk perception, social influence, and reputational concerns significantly and positively influence herding behaviour. These results confirm that investors are more likely to follow the crowd when they face uncertainty, perceive higher risk, are influenced by peers, or fear reputational loss. In contrast, investor sentiment does not show a significant independent effect once other factors are controlled for, suggesting that herding is driven more by structural and social pressures than by short-term emotional states alone.

Among all determinants, risk perception and reputational concerns emerge as the most powerful predictors, highlighting that fear-based motives and social image considerations play a dominant role in collective investment behaviour. This supports the argument that herding is not merely irrational imitation, but often a strategic response to uncertainty and career or social concerns in imperfect information environments. The study further demonstrates that herding behaviour significantly increases market volatility, confirming that collective trading amplifies price fluctuations and destabilizes markets. At the same time, herding behaviour also significantly influences market efficiency, indicating that widespread imitation affects the speed and quality with which information is incorporated into prices. Together, these results establish herding behaviour as a central transmission mechanism through which behavioural biases translate into broader market outcomes.

Overall, this research contributes to the financial economics literature by providing an integrated behavioural framework that links micro-level investor behaviour with macro-level market consequences in an emerging market setting. The findings carry important implications for regulators and policymakers, emphasizing the need to improve information transparency, investor education, and regulatory oversight to reduce excessive herding and promote market stability. For investors, the results underscore the importance of independent analysis and disciplined decision-making to avoid the risks associated with crowd-driven market dynamics.

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