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Rational Or Emotional? A Behavioural Finance Perspective On Sustainable Investment Behaviour

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Abstract
The rapid growth of green finance has transformed sustainable investing into a central mechanism for addressing environmental challenges and promoting long-term economic resilience. Despite this expansion, conventional finance theories—rooted in rational choice and risk–return maximization—struggle to explain why investors increasingly allocate funds to green assets under conditions of uncertainty, long payback periods, and limited information transparency. This study adopts a behavioural finance perspective to examine the cognitive, social, and moral–emotional drivers underlying green investment decisions. Drawing on Prospect Theory, Social Norms Theory, and the Warm-Glow Effect, the research proposes an integrated framework that accounts for loss aversion, normative influence, and moral satisfaction as key determinants of sustainable investing behaviour. The study highlights empirical evidence showing that investors perceive green investments as tools for mitigating long-term environmental and financial risks, respond to peer and societal pressures in portfolio allocation, and derive emotional utility from contributing to environmental sustainability. These behavioural motivations often operate alongside, or even override, traditional financial considerations, challenging the sufficiency of conventional rational choice models. The paper also outlines policy and managerial implications, including the design of regulatory incentives, impact-focused investment products, and communication strategies that leverage behavioural insights to increase investor engagement in sustainable finance. Additionally, the study identifies directions for future research, such as empirical testing of the integrated framework, cross-country comparative analyses, and the dynamic interaction between behavioural drivers and financial performance in green investment markets. By bridging the gap between behavioural finance and sustainable investing, this study contributes a conceptual foundation for understanding the complex interplay of rational and non-rational factors influencing green investment decisions, offering valuable insights for academics, policymakers, and financial practitioners seeking to mobilize private capital toward sustainability objectives.

Keywords: *Green finance, Sustainable investing, Behavioural finance, Prospect Theory, Social norms, Moral satisfaction, Warm-glow effect, Loss aversion.*

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I. Introduction

The increasing urgency of climate change and environmental degradation has transformed sustainability into a central concern for global financial markets. Green finance—comprising green bonds, ESG-based mutual funds, and environmentally responsible equities—has emerged as a critical instrument for channeling financial resources toward sustainable economic activities. Regulatory initiatives, investor activism, and corporate sustainability commitments have collectively accelerated the growth of green financial markets. Despite this momentum, the underlying motivations driving green investment decisions remain inadequately understood. Traditional finance theory, rooted in rational choice and expected utility maximization, assumes that investors evaluate assets solely based on risk and return. However, green investments frequently involve higher uncertainty, long payback periods, and information asymmetry. The continued preference for such assets raises a fundamental question: Are green investment decisions driven by rational financial considerations, or are they influenced by behavioural and emotional factors? Behavioural finance challenges the assumption of perfect rationality by incorporating psychological biases, social influence, and emotional utility into financial decision-making. This paper argues that green investment decisions are inherently behavioural and cannot be fully explained using traditional finance models alone. By integrating Prospect Theory, Social Norms Theory, and the Moral Satisfaction (Warm-Glow) Effect, this study develops a conceptual framework that captures the behavioural foundations of green investment behaviour.

II. Literature Review

Green Finance and Investment Behaviour

Green finance has evolved from a niche ethical practice into a mainstream investment strategy, reflecting growing investor interest in sustainability-oriented financial products. Empirical research indicates that green financial instruments, such as green bonds, attract a distinctive class of investors who are willing to accept lower financial returns in exchange for sustainability outcomes, suggesting the presence of non-financial utility in investment decisions (Flammer, 2021). The majority of existing green finance studies focus on ESG performance, green bond pricing, and the financial implications of sustainability-oriented investments. However, empirical evidence regarding the financial performance of green assets is mixed. While some studies indicate comparable or superior returns relative to conventional investments, others highlight that financial performance alone does not fully explain investor participation in green finance (Friede, Busch, & Bassen, 2015; Flammer, 2021). This observation points to the potential influence of behavioural and psychological factors beyond the traditional risk–return paradigm. A critical limitation of much of the extant literature is its implicit assumption of rational investor behaviour, often overlooking the role of cognitive biases, values, and social preferences. For instance, Gibson, Krueger, and Schmidt (2021) demonstrate that ESG preferences significantly shape portfolio allocation decisions, even after controlling for risk and return, indicating that investor values systematically influence financial choices. Similarly, Pastor, Stambaugh, and Taylor (2022) find that sustainable investing is driven not only by expected cash flows but also by investor tastes for sustainability, highlighting the shortcomings of traditional asset pricing models in capturing preference-driven investment behaviour. Further complicating the landscape, Berg, Koelbel, and Rigobon (2022) document inconsistencies in ESG ratings, arguing that investor reliance on these signals often reflects bounded rationality rather than optimal information processing. In line with this, Hartzmark and Sussman (2019) observe that investors reallocate capital toward funds with high sustainability ratings even when financial performance remains unchanged, providing empirical evidence that investment decisions in green finance may be driven more by preferences and values than by pure financial performance. Collectively, these studies suggest that investor behaviour in green finance is not fully captured by conventional rational choice models. Instead, decision-making appears to be influenced by a combination of financial evaluation and psychological, social, and moral motivations, highlighting the need for a behavioural finance perspective to understand sustainable investment behaviour.

Prospect Theory and Green Investment Decisions

Prospect Theory, introduced by Kahneman and Tversky (1979), posits that individuals evaluate outcomes relative to a reference point and exhibit loss aversion, whereby losses are perceived as more significant than equivalent gains. This framework challenges the traditional assumption of fully rational investors by emphasizing the role of cognitive biases in decision-making. In the context of green finance, investors increasingly perceive climate change and environmental degradation as systemic risks with potential for substantial future losses. Consequently, green investments are often framed not merely as vehicles for maximizing short-term returns but as instruments for mitigating long-term environmental and financial risks. This perspective aligns closely with the principles of Prospect Theory, providing a behavioural rationale for the preference for sustainable assets. Empirical studies support the relevance of Prospect Theory in explaining green investment behaviour. Pankratz and Zeisberger (2021) show that investors perceive climate change as a downside risk, which triggers asymmetric responses toward firms with high carbon exposure. Similarly, Bolton and Kacperczyk (2021) provide evidence that carbon-intensive firms are associated with higher expected returns due to perceived climate-related losses, highlighting the role of loss aversion mechanisms in asset pricing. Further, Bansal, Kiku, and Ochoa (2021) argue that long-horizon risks such as climate change are often underweighted in traditional financial models but are salient to behaviourally motivated investors. Kahn et al. (2021) demonstrate that investors disproportionately penalize firms exposed to climate transition risks, reinforcing the notion that loss-avoidance behaviour shapes investment decisions in green finance. Addoum, Ng, and Ortiz-Bobea (2020) provide additional empirical support, showing that environmental disasters increase overall risk aversion, prompting investors to shift preferences toward safer and sustainable assets. This evidence underscores the significance of reference-point-dependent decision-making in understanding investment behaviour under environmental uncertainty. Collectively, these studies illustrate that Prospect Theory offers a robust behavioural explanation for green investment decisions, emphasizing how perceived losses, environmental risks, and cognitive biases influence the allocation of capital toward sustainable assets, often beyond the predictions of traditional risk–return models.

Social Norms and Sustainable Investing

Social Norms Theory posits that individual behaviour is strongly influenced by societal expectations and peer behaviour (Cialdini & Goldstein, 2004). Within financial markets, institutional investors, asset

managers, and corporations increasingly encounter normative pressures to integrate sustainability considerations into their investment strategies. Such pressures arise from regulatory frameworks, stakeholder expectations, and reputational concerns, which collectively shape the legitimacy and desirability of green investments. Green investing has, over time, evolved from a niche ethical practice into a socially legitimized investment strategy, where decisions are guided not only by financial returns but also by the desire to conform to emerging social norms. Empirical evidence supports the influence of social norms on investment behaviour. Riedl and Smeets (2017) demonstrate that peer effects significantly shape socially responsible investment choices, even in scenarios where financial incentives are minimal. Similarly, Dyck et al. (2019) show that institutional investors exert social pressure on firms to enhance environmental performance, highlighting the role of normative expectations in shaping market behaviour. Further evidence indicates that regulatory and societal cues reinforce norm-driven investment. Li, Cao, and Zhang (2020) find that sustainability-oriented investment activity increases following regulatory announcements, reflecting investor responsiveness to evolving social and institutional norms. Lins, Servaes, and Tamayo (2017) illustrate that firms with strong social capital outperform during periods of market stress, suggesting that investors perceive norm-adherent firms as more resilient and value-creating. Moreover, Zhang, Chen, and Wang (2023) provide evidence that ESG adoption diffuses through professional investor networks, consistent with social contagion theory, where normative behaviour spreads across interconnected actors in the investment community. Collectively, these studies indicate that social norms exert a systematic influence on green investment decisions, complementing traditional financial considerations. Investors' choices are thus shaped by a combination of peer behaviour, regulatory signals, and reputational incentives, underscoring the importance of normative and social drivers in sustainable finance.

Moral Satisfaction and the Warm-Glow Effect

The Warm-Glow Effect posits that individuals derive intrinsic satisfaction from engaging in actions that are perceived as morally or socially desirable (Andreoni, 1990). In the context of green finance, this implies that investors may experience emotional or ethical utility from contributing to environmental protection, which functions as a non-monetary return on investment. Such moral satisfaction can compensate for lower or uncertain financial performance, highlighting the role of affective motivations in driving investment decisions beyond conventional risk–return calculations. Extending this concept, Statman (2019) argues that sustainable investing provides expressive and emotional benefits that complement utilitarian financial returns, suggesting that investors' choices are influenced by both moral identity and ethical self-expression. Empirical evidence supports this perspective: Bauer and Smeets (2015) find that investors are willing to forego potential financial gains to align their portfolios with personal values, emphasizing moral satisfaction as a key determinant of green investment behaviour. Similarly, Hartmann and Apaolaza-Ibáñez (2012) demonstrate that environmental concern generates positive emotional responses, which in turn influence economic decision-making. Further reinforcing the behavioural relevance of moral utility, Rosen, Sandler, and Shani (2022) show that individuals with a strong moral identity maintain commitment to sustainable financial products, even when these investments entail higher perceived risks. Moreover, Andreoni, Rao, and Trachtman (2017) confirm that warm-glow utility persists in high-stakes economic decisions, indicating its robustness as a motivational factor in investment contexts. Collectively, these studies underscore that moral and emotional considerations significantly shape green investment decisions. The Warm-Glow Effect complements traditional financial metrics by capturing the psychological satisfaction and ethical alignment that investors derive from supporting sustainable initiatives, reinforcing the need for behavioural perspectives in understanding sustainable finance.

Research Gap

In sum, while prior research highlights the roles of loss aversion, social norms, and moral satisfaction, there is a clear need for an integrated behavioural finance framework that examines how cognitive, social, and moral–emotional factors jointly influence green investment decisions. Furthermore, the interactions between these behavioural dimensions and traditional financial considerations remain insufficiently explored, limiting both theoretical development and practical guidance for policymakers, asset managers, and sustainable finance practitioners.

Theoretical Framework and Conceptual Model

Drawing on behavioural finance theories, this study proposes a multi-dimensional framework in which green investment decisions are influenced by:

Cognitive Factors – Loss aversion and risk framing (Prospect Theory)
Social Factors – Normative pressure and peer influence (Social Norms Theory)
Moral–Emotional Factors – Ethical satisfaction and warm-glow utility

III. Statement Of The Problem

The rapid expansion of green finance has positioned sustainable investments as a central mechanism for addressing environmental challenges and achieving long-term economic resilience. Despite this growth, there remains a fundamental ambiguity regarding the behavioural foundations of green investment decisions. Conventional finance theory continues to dominate academic and policy discourse by assuming that investors allocate capital based primarily on rational risk–return considerations. However, empirical observations indicate that investors increasingly commit funds to green assets even in contexts characterized by uncertain financial performance, long investment horizons, and limited information transparency. This divergence between theoretical assumptions and observed investor behaviour highlights a critical research problem: traditional rational choice models are insufficient to explain why and how investors engage in green investments. Existing green finance studies predominantly focus on performance metrics, ESG ratings, and regulatory mechanisms, while largely neglecting the psychological, social, and moral dimensions of investor decision-making. Consequently, the literature lacks an integrated theoretical framework that systematically explains green investment behaviour through established behavioural finance theories. Furthermore, the absence of a behaviourally grounded perspective constrains the ability of policymakers and financial institutions to design effective interventions that promote sustainable investing. Without a clear understanding of whether green investment decisions are driven by rational financial evaluation, social influence, or emotional and ethical motivations, efforts to mobilize private capital toward sustainability may remain suboptimal. Addressing this gap necessitates a conceptual re-examination of green investment decisions through the lens of behavioural finance, thereby redefining sustainability-oriented investing as a hybrid rational–behavioural phenomenon.

IV. Research Objectives

- To examine how loss aversion impacts green investment decisions.
- To assess the influence of social norms and peer behaviour on sustainable investing.
- To analyze the effect of moral satisfaction and ethical motivation on green investment behaviour.
- To evaluate how behavioural and emotional factors interact with financial risk–return considerations in green investments.
- To compare the effectiveness of traditional financial models versus integrated behavioural-financial models in explaining green investment choices.

V. Discussion And Analysis

Loss Aversion and Green Investment Decisions

Loss aversion, central to Prospect Theory, significantly influences green investment decisions. Investors perceive green assets as riskier and less familiar, overweighting short-term volatility and downside risk despite competitive demonstrate long-term returns. This leads to status quo bias favoring conventional assets. However, policy support, capital protection mechanisms, and certification reduce perceived risk and mitigate loss-averse behaviour.

Role of Social Norms and Peer Influence in Green Investing

Social norms and peer influence strongly shape green investment behaviour beyond financial returns. Institutional participation in green finance creates normative legitimacy, encouraging retail adoption. Peer effects are particularly pronounced in emerging economies, where uncertainty is higher. Professional networks and advisors act as behavioural catalysts, accelerating the mainstream acceptance of sustainable investments.

Moral Satisfaction and Commitment to Sustainable Investments

Moral satisfaction, or warm-glow utility, is a key non-financial driver of green investment behaviour. Investors derive psychological utility from aligning investments with ethical and environmental values. Evidence shows that moral satisfaction enhances long-term commitment despite short-term underperformance. This effect is stronger among educated, younger, and socially conscious investors, underscoring the need to incorporate ethical motivation into green investment models.

Interaction Between Behavioural, Emotional, and Financial Factors

Green investment decisions reflect an interaction of behavioural biases, emotional responses, and financial considerations. Factors such as regret aversion, moral emotions, and trust in green labels moderate risk–return evaluations. Emotional engagement with sustainability leads investors to tolerate greater uncertainty, challenging traditional rational finance assumptions.

VI. Implications Of The Study

Policy Implications

Understanding behavioural drivers of green investments enables policymakers to design more effective incentives, such as tax benefits, subsidies, or regulatory nudges that appeal to investors' psychological and ethical motivations. Framing green investments as mechanisms for loss avoidance and long-term risk mitigation can encourage wider adoption, particularly among risk-averse investors. Recognizing the influence of social norms can inform public campaigns, disclosure requirements, and sustainability rating frameworks that leverage peer pressure and reputational incentives.

Managerial Implications

Asset managers and financial institutions can develop green financial products tailored to investors motivated by both ethical and financial considerations. Incorporating transparent ESG disclosures and impact reporting enhances trust and moral satisfaction, thereby increasing investor engagement. Understanding behavioural biases allows fund managers to better anticipate investor reactions to environmental risks and sustainability initiatives.

Academic Implications

The study bridges behavioural finance and green finance, providing a theoretical foundation for future empirical research. The proposed integrated framework offers a model for investigating hybrid rational–behavioural investment decisions, encouraging interdisciplinary research and novel methodologies.

VII. Scope For Future Research

- Empirical Testing: Future studies can empirically test the proposed hypotheses using survey-based behavioural measures, experimental designs, or field studies.
- Cross-Country Analysis: Comparative studies across developed and emerging markets can identify cultural and regulatory influences on green investment behaviour.
- Investor Segmentation: Research can explore how demographics, investment experience, and personality traits moderate behavioural factors in sustainable investing.
- Dynamic Analysis: Longitudinal studies can track how investor behaviour evolves as green finance markets mature and as environmental awareness increases.
- Integration with Performance Analysis: Combining behavioural insights with financial performance evaluation can assess whether moral and social motivations complement or conflict with traditional risk–return objectives.

VIII. Limitations Of The Study

- The study primarily relies on secondary literature and conceptual analysis, limiting the ability to generalize findings to all investor populations.
- Behavioural constructs such as moral satisfaction and social norms are inherently difficult to quantify, which may complicate empirical measurement.
- Contextual factors like regulatory environments, market maturity, and cultural norms are not deeply explored, potentially limiting cross-market applicability.
- Rapidly evolving green finance instruments and ESG frameworks mean that findings may need periodic updates to remain relevant.

IX. Conclusion

This study highlights that green investment decisions extend beyond traditional financial analysis, encompassing behavioural, social, and moral dimensions. By integrating Prospect Theory, Social Norms Theory, and the Warm-Glow Effect, the research provides a comprehensive framework for understanding why investors allocate capital to sustainable assets even in the face of uncertain financial returns.

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