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Investor Herding Behavior from the Perspective of Behavioral Finance: Formation Mechanisms, Market Impacts, and Governance

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Abstract: Herding behavior is widely observed in behavioral finance, and its formation and market consequences are closely related to the conditions in which it occurs. Drawing on a review of the existing literature and theoretical analysis, this paper examines the formation mechanisms, market impacts, and governance pathways of herding behavior. The analysis indicates that herding is mainly related to information asymmetry and informational cascades, reputation and principal–agent mechanisms, psychological biases and sentiment contagion, as well as market structure and the institutional environment. The role played by these mechanisms can differ among investor types and across market states. Herding does not necessarily have the same effect on financial markets. Spurious herding and some forms of information-driven herding may not impair market efficiency. Emotion-driven herding, however, can weaken price discovery and amplify market volatility when it lacks sufficient informational support. To address the potential adverse effects of irrational herding on market efficiency, this paper proposes a coordinated three-level governance framework. The framework centers on improving the information environment, refining trading mechanisms and regulatory institutions, and strengthening incentive and constraint mechanisms for institutional investors.

Keywords: Herding Behavior; Behavioral Finance; Information Cascades; Market Efficiency; Investor Governance

1. Introduction

1.1 Research Problem

The Efficient Market Hypothesis assumes that investors act rationally and that information is freely available. This assumption has been questioned with the rise of behavioral finance. Evidence from market anomalies suggests that asset prices do not always fully incorporate available information. Herding behavior is one of the representative anomalies. It refers to a situation in which investors are influenced by the trading behavior of others and tend to make similar investment decisions, sometimes even weakening their independent judgment based on private information, thereby challenging the traditional assumption of investor rationality. Existing evidence also suggests that herding in China's stock market is regime-dependent and is more pronounced under high-volatility market conditions [1].

The economic consequences of herding behavior are not unidirectional. Existing studies show that short-term herding is often accompanied by significant price reversals: excess returns are negative following buy herding and positive following sell herding, with stronger herding associated with stronger reversals. These findings suggest that short-term herding may impair the efficiency of price discovery [2]. However, other studies find that pseudo-herding consistent with the direction of public information facilitates the incorporation of information into stock prices and is not accompanied by significant price reversals [3]. This divergence suggests that the market impact of herding is conditional. Understanding such conditionality requires returning to the underlying formation mechanisms: different types of herding may arise from different mechanisms and consequently produce different market outcomes. These divergent findings give rise to the core questions of this study: How does herding behavior emerge? What market impacts does it generate? How should it be governed?

1.2 Research Approach and Contributions

This study adopts a three-part analytical framework of "formation mechanisms—market impacts—governance pathways." Although the existing literature has accumulated substantial empirical findings, research on the underlying mechanisms remains dispersed across different academic traditions. Moreover, divergent findings on market impacts have not been systematically examined in terms of the conditions under which they hold, while governance discussions are often disconnected from mechanism analysis. These gaps suggest that herding needs to be examined in a more integrated way, including how it emerges, how its effects on the market may vary, and how it can be governed.

This study makes three main contributions. Four types of mechanisms are brought into the same analytical framework: information asymmetry and informational cascades, reputation and principal–agent relationships, psychological biases and sentiment contagion, and market structure and institutional incentives. The analysis also considers how these mechanisms operate and the conditions under which they may become more important. Different findings on the market impacts of herding are examined in relation to herding type, investor type, and market conditions. The differences among these factors may partly explain why studies do not always reach the same conclusions. The governance of herding is also considered in connection with its underlying mechanisms, with attention to the problems that different governance measures are intended to address and how these measures may work in practice.

2. Literature Review and Theoretical Foundations

2.1 Conceptualization and Typology of Herding Behavior

Herding behavior refers to a situation where investors are influenced by the trading decisions of others and make similar investment choices, such as buying or selling the same securities over a given period. The literature commonly distinguishes between intentional herding and spurious herding [3]. Intentional herding occurs when investors set aside their own private information and follow the direction of the group. This can lead to information blockage and reduce market efficiency. Spurious herding occurs when investors independently respond in similar ways to similar information. In this case, market efficiency does not necessarily decline. Based on a sample of 769 tax-exempt equity funds, predominantly pension funds, Lakonishok, Shleifer, and Vishny [4] found no significant evidence of institutional herding overall, although limited evidence was found for small stocks. Institutional investors may move in the same direction when they receive similar information, as noted in the same study. They may also take positions against irrational trades by individual investors. Institutional trading can contribute to market stability under certain conditions. At the same time, observing herding alone is not sufficient to determine its consequences for the market.

Herding can also be distinguished as rational or irrational. Rational herding may arise from information externalities, reputational concerns, or principal–agent relationships. Investors may make similar decisions in these situations because they receive shared information or respond to similar incentives. Irrational herding is more closely associated with psychological biases, sentiment contagion, and limitations in cognitive ability. Rational and irrational herding do not fully correspond to intentional and spurious herding. These two classifications can be used to examine the market impacts of herding behavior and the related governance pathways.

2.2 Theoretical Foundations of Herding Behavior

The theoretical foundations of herding behavior can be traced to information economics and behavioral decision theory. Informational cascade theory was developed independently by Banerjee [5] and Bikhchandani et al. [6]. Its core logic is that, in a sequential decision-making environment, later decision-makers infer information from the actions of earlier decision-makers. When the actions of earlier decision-makers become more consistent, later investors may rely less on their own private signals. Some may even disregard these signals and follow the group instead. The decisions made in this way may be individually rational, but their accumulation can still lead to collective inefficiency. Once an informational cascade forms, private information held by later investors may no longer be reflected in market prices. Prices may then become less effective in

aggregating information. The reputational herding model proposed by Scharfstein and Stein [7] focuses on institutional investors, particularly fund managers. When agents' compensation and career prospects depend on relative performance evaluation, deviating from the consensus can leave them bearing the consequences alone if their decision turns out to be wrong. Following the crowd, however, means that they can at least "share the blame." Even institutions with private information may be encouraged to follow the group because of reputational concerns. At the individual level, Prospect theory, bounded rationality, and sentiment contagion theory in behavioral finance help explain irrational herding. These theories are also relevant to the subsequent analysis of herding mechanisms.

2.3 Three Research Streams on Herding Behavior

Later studies have examined this literature from different perspectives, mainly focusing on information, incentives, and psychology. Research on information shows that informational cascades can emerge in situations more complicated than those described in early models. The reputation hypothesis has also been applied to herding in some settings involving analysts and fund managers. Research on investor psychology has examined herding among individual investors, particularly in relation to behavioral biases and sentiment. Cognitive biases and sentiment contagion may make investors more likely to behave in similar ways. Recent evidence also shows that market memory can affect subsequent retail investor herding through cognitive mechanisms, while institutional herding varies with investor sentiment [8,9]. At the same time, studies have identified divergent findings regarding the market impacts of herding: short-term herding may be associated with price reversals, whereas spurious herding driven by public information may facilitate the incorporation of information into stock prices [2,3]. Herding may arise through different mechanisms across investor types. Its effects on the market may also vary accordingly.

2.4 Research on Herding Governance and the Positioning of This Study

Research on herding governance has focused mainly on information disclosure, investor education, and trading mechanisms. Better information disclosure can improve transparency and reduce information asymmetry. This may weaken investors' reliance on the actions of others. Investor education can also strengthen independent judgment and risk awareness, while reducing the tendency to follow the crowd in response to sentiment. Research on trading mechanisms, meanwhile, examines how institutional design shapes investors' behavioral incentives. However, some governance discussions remain insufficiently connected to the mechanisms underlying herding behavior and lack a systematic analysis of the specific mechanisms targeted by different governance measures and the logic through which they operate. Overall, existing research remains relatively fragmented with respect to formation mechanisms, lacks a sufficiently systematic examination of the conditions under which market impacts vary, and leaves room for further integration of governance discussions with mechanism-based analysis. This study therefore provides an integrated analysis centered on formation mechanisms, market impacts, and governance pathways.

3. Formation Mechanisms of Investor Herding Behavior

Based on the above research positioning, this chapter analyzes the formation mechanisms of herding behavior from four dimensions: information, reputation, psychology, and institutions.

3.1 Information Asymmetry and Informational Cascade Mechanisms

Information asymmetry is an important condition for the formation of herding behavior. Under conditions of information asymmetry, investors may infer others' private information by observing their trading behavior. When private signals conflict with public information, investors may reassess their own information and choose to follow the group after observing sufficiently strong signals of group behavior. Once a cascade is established, however, the private information of subsequent investors may no longer readily enter market prices, thereby weakening the information-aggregation function of prices. The sequential decision-making models of Banerjee [5] and Bikhchandani et al. [6] reveal the core paradox

underlying this mechanism: each investor's following behavior may be rational at the individual level, yet its cumulative consequences may lead to lower efficiency of information utilization at the collective level. This logic of "individual rationality leading to collective inefficiency" constitutes one of the important economic explanations for herding behavior.

3.2 Reputation Concerns and Principal–Agent Mechanisms

The reputation mechanism explains why institutional investors may rationally choose to engage in herding. Scharfstein and Stein [7] argued that agents' compensation and career prospects are affected by relative performance evaluation. Deviating from the group means bearing alone the consequences of an incorrect decision, whereas following the crowd at least allows the agent to "share the blame." Institutions may follow the group even when they possess private information because of reputational concerns. The reputation mechanism works through the incentive structure rather than the inference of information, unlike information cascades. This helps explain why institutional investors may continue to conform even when private information is available to them.

3.3 Psychological Biases and Emotional Contagion Mechanisms

The psychological pathway helps explain the micro-level basis of irrational herding. Herd mentality leads investors to regard the choices of the majority as a signal of correctness. A lack of confidence in one's own judgment makes investors more likely to refer to others' decisions. Regret aversion causes investors to fear the psychological loss resulting from an independent decision that turns out to be wrong, leading them to reduce the psychological responsibility associated with independent decision-making by following the majority. Emotional contagion may give rise to a self-reinforcing process: changes in emotion trigger behavioral convergence, which in turn further reinforces market sentiment, forming a cycle of "emotion—behavioral convergence—emotion reinforcement." Unlike the information inference and incentive constraints emphasized in the previous two sections, the psychological mechanism focuses on investors' limitations in cognitive ability and emotional control, and mainly explains the formation of irrational following behavior.

3.4 Market Structure, Institutional Incentives, and an Integrated Analytical Framework

Market structure and institutional factors constitute the environmental conditions for the formation and evolution of herding behavior. A relatively high proportion of individual investors may make some investors more susceptible to market sentiment and the trading behavior of others. Differences in the quality of information disclosure may increase uncertainty in information acquisition and induce investors to rely more heavily on the behavior of others. Relative performance evaluation mechanisms may reinforce reputational concerns among institutional investors, while trading mechanism features such as liquidity constraints may also intensify convergent trading.

This study conceptualizes the four categories of mechanisms as having a certain hierarchical differentiation: information mechanisms create the conditions for the formation of herding behavior; incentive mechanisms explain why institutional investors may adopt follow-the-crowd strategies under specific constraints; psychological mechanisms explain irrational herd following driven by cognitive biases and emotions; and institutional and market environments affect the intensity of the first three mechanisms and the conditions for their persistence. The dominant mechanism may vary across investor types and market states. Existing research suggests that individual investors may be more strongly influenced by psychological and information mechanisms, whereas institutional investors may be more strongly affected by reputational and incentive mechanisms. During periods of heightened market stress or volatility, multiple mechanisms may also reinforce one another, making herding behavior more likely to emerge [10].

4. Market Impacts of Investor Herding Behavior

The market consequences of herding behavior generated through the mechanisms discussed above depend on the type of herding and market conditions. This chapter analyzes the market impacts of herding behavior from three dimensions: pricing efficiency, volatility and

liquidity, and conditionality.

4.1 The Impact of Herding Behavior on Asset Pricing Efficiency

The impact of herding behavior on pricing efficiency depends on the type of herding and its underlying formation mechanism. True herding may impede the incorporation of private information into prices. When investors deliberately suppress private signals and follow the group, the amount of private information embedded in prices may decline, thereby weakening the price discovery function. Based on high-frequency data, Zhu et al. [2] found that short-term herding behavior is often followed by significant price reversals: excess returns are negative following buying herds and positive following selling herds, with stronger herding associated with stronger reversals. These findings suggest that short-term herding may impair the efficiency of price adjustment. However, spurious herding or information-driven herding does not necessarily undermine efficiency. Li et al. [3] found that spurious herding consistent with the direction of public information facilitates the incorporation of information into stock prices and is not accompanied by significant price reversals. This suggests that when investors act similarly in response to common public information, such coordinated trading does not necessarily impede price discovery and may instead facilitate the incorporation of public information into prices. Therefore, the impact of herding behavior on pricing efficiency is not unidirectional. The key lies in whether herding prevents private information from being incorporated into market prices and in the information underlying the observed convergence in trading.

4.2 The Impact of Herding Behavior on Market Volatility and Liquidity

The impact of herding behavior on market volatility is likewise conditional. During periods of heightened market stress, herding behavior may intensify, and convergent trading may further amplify downward pressure. When investors sell collectively, concentrated selling pressure may depress prices, and falling prices may in turn reinforce pessimistic sentiment, creating a self-reinforcing downward process. Under normal market conditions, however, information-driven coordinated trading may accelerate the incorporation of public information into prices, and its impact on short-term volatility depends on the speed of information adjustment and the market trading environment. In terms of liquidity, herding behavior may be accompanied by concentrated order flow: collective buying concentrates demand, while collective selling concentrates supply, and order flow imbalance may lead to short-term changes in market liquidity. Overall, the impact of herding behavior on volatility and liquidity depends on market conditions, the type of herding, and its formation mechanism. There is no unidirectional conclusion that it necessarily exacerbates volatility or necessarily improves liquidity [9-11].

4.3 Conditionality and Heterogeneity in the Impact of Herding Behavior

The effects of herding behavior on the market can differ across conditions and investor types. The mechanisms involved are not necessarily the same for different investors. For institutional investors, herding may be more closely related to information acquisition, trading interactions, and reputational incentives. Individual investors, by comparison, may be more strongly influenced by public information, others' trading behavior, and market sentiment. In terms of market conditions, information-driven coordinated trading during normal periods may facilitate price discovery, whereas emotion-driven convergence during periods of market stress may further amplify market volatility. Existing studies also suggest that herding behavior exhibits a certain degree of market-state dependence. In terms of herding type, spurious herding and some forms of information-driven herding do not necessarily impair market efficiency, whereas emotion-driven herding lacking an informational basis is more likely to generate adverse market consequences. From the perspective of market structure, in markets with a relatively high proportion of individual investors, psychological and emotional factors may play a more important role. Overall, the market consequences of herding are not determined by herding behavior alone but are jointly shaped by formation mechanisms, investor types, and market conditions. This conditional analysis also provides a basis for linking governance measures to specific formation mechanisms in the following chapter.

5. Governance Pathways for Investor Herding Behavior

5.1 Improving the Information Environment and Investor Education

Optimizing the information environment is an important pathway for governing herding behavior. Information asymmetry is an important trigger of herding behavior: when investors have difficulty obtaining sufficient information, they may infer information by observing the behavior of others. Improving the quality of information disclosure and enhancing information transparency can help reduce information search costs and lessen investors' reliance on the behavior of others, thereby helping to reduce blind following that lacks an informational basis. Investor education, meanwhile, focuses on investors' own capabilities. Improving financial literacy and risk awareness can strengthen independent judgment and reduce excessive reliance on market sentiment and the behavior of others. The two approaches address the information and psychological mechanisms, respectively. Together, they are likely to help reduce irrational herding by improving the information environment and strengthening investors' decision-making capacity.

5.2 Trading Mechanisms and Regulatory Institutional Design

Institutional design shapes the incentives and constraints that influence how herding behavior emerges. Better standards for information disclosure can improve transparency and give investors a more adequate data base for their decisions. Information intermediaries are also part of this process. Professional and independent services provided by financial analysts and other intermediaries may reduce investors' excessive reliance on informal information and the trading behavior of others. Trading arrangements can affect herding through another channel. Margin trading and securities lending, for example, change transaction costs, risk exposure, and the constraints faced by investors, which may in turn affect their trading decisions. The purpose of governance is not to eliminate coordinated trading as such. Greater attention should be given to herding that lacks a sufficient informational basis and may interfere with price discovery. This distinction matters because spurious herding and information-driven herding do not necessarily impair market efficiency. In such cases, excessive intervention could even make it more difficult for information to be incorporated into prices. What matters for institutional design is how different forms of herding arise and what effects they may produce. Regulation and trading systems can then be adjusted in response to these differences, rather than being directed toward the simple elimination of herding behavior.

5.3 Institutional Investor Constraints and a Multi-Dimensional Governance Framework

Institutional investors can also be affected by herding mechanisms. Within institutions, reputational concerns and pressures arising from relative performance evaluation may encourage agents to conform to the group. Deviating from the group may put agents' career prospects at risk, making them more likely to follow the prevailing direction even when private information is available. Therefore, constraining institutional behavior is an important component of governance. Reform directions include extending evaluation periods, strengthening a long-term investment orientation, and improving principal–agent incentives, so that institutional managers have stronger incentives to exercise independent judgment rather than focusing excessively on short-term relative performance and reputational risk.

On this basis, a coordinated three-layer governance framework comprising information, institutional, and institutional-investor layers can be constructed. The information layer primarily addresses insufficient information acquisition and judgment capacity, reducing information asymmetry and cognitive limitations through improved information disclosure and investor education. The institutional layer adjusts the costs, benefits, and constraints of following behavior through trading mechanisms and regulatory design. The institutional-investor layer, through reforms to evaluation mechanisms and principal–agent mechanisms, reduces the career risks faced by institutional managers when deviating from the group, giving them stronger incentives to make independent decisions based on their own information. The three layers of governance work in coordination to jointly reduce irrational

herding behavior lacking an informational basis from the three dimensions of the information environment, institutional constraints, and institutional incentives.

6. Conclusions and Implications

This paper provides an integrated analysis of the formation mechanisms, market impacts, and governance pathways of investor herding behavior from the perspective of behavioral finance. The study identifies several factors associated with herding behavior, including information, incentives, psychology, and the institutional environment. The effects of such herding on the market depend on its form. Spurious herding and some forms of information-driven herding do not necessarily impair pricing efficiency. Emotion-driven herding may weaken price discovery and exacerbate market volatility when it lacks a sufficient informational basis. Therefore, the focus of governance should not be on eliminating all coordinated trading, but on taking measures targeting irrational herding behavior that may impair market efficiency and its formation mechanisms.

In terms of governance, coordinated efforts should be advanced across three dimensions: the information environment, institutional design, and institutional incentives. Reducing Reducing information asymmetry and cognitive limitations requires better information disclosure and investor education. Trading mechanisms and regulatory systems can also be adjusted to change the costs, benefits, and constraints associated with the formation of herding behavior. For institutional investors, stronger evaluation and principal–agent mechanisms can support a longer-term investment orientation. In addition appropriate incentives can be designed to encourage independent decision-making.

This study relies mainly on theoretical analysis and a synthesis of existing literature rather than independent empirical testing. The relative importance of different mechanisms has not yet been quantitatively verified. Future research could use micro-level trading data to examine how these effects vary across investor types, market states, and herding types. Such data would also allow comparisons across different markets.

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