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A Research Study Examining the Dynamics of Risk and Return Through the Lens of Behavioral Finance, Focusing on the Psychological Factors influencing decision-making in equity market investments.

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Abstract

The rapid expansion of the Indian stock market can be attributed to the processes of liberalization, privatization, and globalization, alongside a rising global demand and supply. This growth has necessitated substantial capital investment to establish new business ventures that meet the needs of this expansive market. The equity market is crucial in providing the funds required for these initiatives. Key growth indicators, such as GDP, national income, and per capita income, are significantly affected by the contributions of the equity market. Furthermore, it plays a vital role in facilitating long-term capital growth and controlling inflation, which are essential for the healthy performance of the financial market. However, the effective operation of both the financial and equity markets is largely determined by the investment choices made by investors. It is often observed that investors' reactions are influenced by socio-economic, cultural, and psychological factors that may arise within society. The effects of these reactions manifest in the investment decisions made in the equity market. Any changes in these aforementioned factors can lead to corresponding impacts on the country's economy, highlighting the direct or indirect relationship between investment activities and external events. The lack of research in understanding investor behavior and decision-making strategies necessitates further investigation into how investors approach their decisions regarding investments. The current study aims to illuminate the behavioral factors that predominantly influence investment decisions and their subsequent effects on the equity market. Data for this analysis was collected from 1,100 individual investors in Varanasi through a meticulously designed questionnaire. Statistical analyses were conducted to enhance the factual understanding of the research study. The results of these analyses indicate that behavioral factors, including heuristics, prospect theory, and market dynamics, significantly affect investors' decision-making processes. This study highlights the influence of behavioral finance on investment choices and its implications for the equity market. Additionally, based on the research findings, the study offers a series of recommendations for investors.

Keywords—Equity Market, Investor Investors' psychological factors, social-economic factors,

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Introduction

Behavioral finance encompasses concepts related to human emotions such as fear, greed, ambition, anxiety, panic, vanity, envy, and happiness. These emotions significantly shape the investment mindset of individuals, and their impact on the decision-making processes of investors is currently under investigation (Birau, 2011). The theories of behavioral finance explore how psychological factors affect investors' actions within financial markets. In contrast to traditional theories that portray investors as rational actors, the examination of risk and returns reveals a picture of market inefficiency. Consequently, behavioral finance emerges as a compelling alternative to classical finance (Birau, 2012). The motivations driving investors' decisions, along with the shortcomings of traditional models and the anomalies present in financial markets, have led to an increased reliance on behavioral finance frameworks. While the efficient market hypothesis posits that capital markets are informationally efficient and that volatility is inherently unpredictable, behavioral finance offers insights grounded in the psychological and emotional dimensions of investment decisions, addressing the irrational aspects of investor behavior as well.

This study offers an examination of the behavioral characteristics of investors in Varanasi. It seeks to shed light on how psychological factors affect investment decisions and their subsequent repercussions on the Indian equity market. The equity market provides investors with the potential to generate profits from their investments, typically yielding higher returns compared to other available investment options. However, the returns from the equity market are subject to fluctuations influenced by various factors, resulting in inconsistent trends. Investors often experience both upward and downward movements due to changing demand and supply dynamics, which can lead to capital loss in the equity market. Nevertheless, these risks and returns are considered inherent to investment activities, as the stock market allows for relatively easy entry and exit for investors.

The expectations and beliefs held by investors play a significant role in shaping their investment choices. Therefore, analyzing these beliefs and expectations is crucial for understanding how investor decisions affect equity markets. Behavioral finance theory examines cognitive factors such as complexity, market reactivity, heightened expectations, risk aversion, and varying levels of confidence and overconfidence regarding market performance. This framework aids investors in recognizing both rational and irrational thought processes related to investment. Research by Birau (2012) indicates that certain psychological factors can influence investors' judgments, potentially leading to errors in their interpretation of information and the formation of beliefs.

Barberis and Thaler (2003) identified two fundamental components of behavioral finance: limits to arbitrage, which highlight the challenges faced by rational traders in correcting market distortions created by less rational participants, and psychology, which illustrates the various ways in which individuals deviate from complete rationality. Sewell (2007) characterized behavioral finance as “the examination of the psychological factors influencing the behavior of financial practitioners and the resulting impact on markets.” This field integrates cognitive and behavioral theories with traditional economics and finance to better understand investor decision-making (Ackert and Deaves, 2009).

Behavioral finance encompasses a broad spectrum of perspectives aimed at predicting financial markets through the lens of emotional and psychological factors. It delineates characteristics such as actions and interpretations based on data gathered by individuals to make informed investment choices. Additionally, it underscores the potential pitfalls of rationality in defining and addressing certain economic variables. Consequently, behavioral finance serves as a framework for understanding the psychological processes that can identify and forecast movements in financial markets (Talangi, 2004).

Thaler (1999) elaborated on the importance of the behavioral finance framework. He posits that the market comprises two distinct categories of investors: rational investors, who adhere closely to economic theories and act in accordance with textbook principles, and quasi-rational investors, who strive to make sound investment choices but often fall prey to predictable errors. The characteristics of these investors differ based on various factors, including financial circumstances, socio-economic status, age, gender, religion, educational attainment, cultural traditions, marital status, and ethnicity. These factors shape their expectations and beliefs, which significantly influence their investment decisions. The behavioral finance framework, which focuses on the cognitive psychology of investors, suggests that the investment decision-making process can be examined through several variables, such as conservatism, overreaction, overconfidence, preconceived notions, herding behavior, representativeness, excessive optimism, irrationality, and the influence of media.

Review of Literature

Gervais, S., et al. (2003) discuss how investor overconfidence during investment activities affects both the economy and the expectations regarding risk and return among investors. Their research utilized empirical methods, employing a carefully designed questionnaire to collect data from individual investors across various sectors. The results indicated a connection between investors' mental states and their decision-making processes, which subsequently influences economic conditions and stock market performance.

Sivaramakrishnan (2016) examined how attitudinal factors, particularly financial literacy, affect individual investment choices. This study employed a mixed-methods research design, incorporating both qualitative and quantitative analyses. A comprehensive questionnaire was administered to survey 506 retail investors from diverse regions of India. The findings demonstrated that financial literacy plays a crucial role in shaping investors' intentions. However, the study also identified a negative influence from three specific attitudinal factors: the challenges faced, risk aversion, and perceptions of regulatory bodies.

Shusha and Touny (2016) investigated the influence of four attitudinal factors on investment decisions: investors' mood, impulsive decision-making, decision accuracy, and overconfidence. The research involved data gathered from 400 randomly chosen investors on the Egyptian stock exchange, with approximately 255 providing substantial responses. The study aimed to determine whether the effects of these factors varied according to the demographic profiles of the respondents. The results indicated that attitudinal elements, including decision accuracy, impulsive choices, and investors' mood, had a significant impact on investment decisions. Furthermore, it was evident that the influence of these attitudinal factors was moderated by the demographic characteristics of the investors.

Praba (2016) examined how socio-demographic factors affect the financial risk tolerance of retail investors. The research involved a sample of 405 participants, which included employees from various sectors such as banking, non-banking financial institutions, insurance, mutual funds, educational organizations, and IT or IT-enabled services. The study took into account multiple variables, including geographic location, occupation, economic status, accessibility, age, and gender. A thirteen-item questionnaire was administered to the sample group. The results indicated that income, age, and gender were significant determinants of investors' risk tolerance.

Sarwar and Afaf (2016) examined the differences in how psychological and economic factors influence the decision-making processes of individual investors. They designed a comprehensive questionnaire and employed convenient sampling to gather data from 254 participants. To identify the key components of both psychological and economic influences, they applied factor analysis as their statistical method. The findings revealed that psychological factors explained 61.671% of the variance, whereas economic factors accounted for 56.697%. This indicated that psychological influences had a more significant effect on the decision-making of individual investors than economic factors. Consequently, it is crucial to assess psychological influences in conjunction with socio-economic factors when analyzing their impact on investment decisions.

Patel and Modi (2017) examined how demographic factors, including age, gender, education, income, marital status, and family size, affect investor preferences. The research employed a descriptive design and utilized convenience sampling to collect primary data from 100 investors in South Gujarat. A structured questionnaire was used for data collection. The results indicated that demographic factors such as age, gender, and income significantly influenced investors' decision-making. However, it was noted that these factors alone may not necessarily lead investors to choose a specific stock.

Stella (2018) explored the impact of demographic factors, including gender, age, income, education, occupation, and savings, on the decision-making elements of investors. A sample of 220 respondents from Chennai, Tamil Nadu, was selected using convenience sampling. Various statistical methods, including interval estimation, Chi-square tests, and correlation analysis, were employed to test the hypotheses. It was observed that demographic factors like gender, age, marital status, annual income, educational qualification, etc. significantly influenced only certain elements of investment-related decision-making.

Kengatharan (2014), Luondnad Ha (2011), and Sochi (2017) have emphasized that analyzing these factors is crucial for understanding how investors manage the irrational elements that impact their investment choices, all while preserving their preferences and individual needs. In this context, the following sections will review research that has explored the effects of various behavioral factors on investor decision-making.

Javed and Marghoob (2017) conducted a study aimed at examining the impact of behavioral elements, including overconfidence, prospect theory, market dynamics, and anchoring, on the investment decisions of both individual traders and institutional portfolio managers operating in the Pakistani stock market. Data were collected from 50 equity managers from institutions and banks that had investments across different stock exchanges. A structured questionnaire was employed for data

collection, and statistical methods such as descriptive statistics, regression analysis, correlation analysis, and reliability analysis were utilized for data evaluation. The results indicated that heuristic factors, particularly overconfidence and anchoring, significantly influenced investment decision-making.

Kanojia et al. (2018) carried out a study to assess the impact of behavioral biases, such as overconfidence, representative bias, herd behavior, cultural bias, cognitive dissonance, disposition effect, and mood, on the investment decisions of individuals living in Delhi. The study found that heuristic factors, especially representative bias and overconfidence, had a substantial effect on the decision-making processes of investors.

Dickenson et al. (2018) sought to explore the relationship between risk tolerance, investor personality, and behavioral finance. The research also examined how these behavioral finance elements impact the decision-making processes of investors. Utilizing a random sampling technique, the study selected participants who had invested in companies listed on the South African stock exchange. An online survey was conducted with a sample of 1,171 individuals. The results indicated that investors with low risk tolerance exhibited tendencies towards loss aversion and mental accounting biases, often leading them to retain under-performing stocks for extended periods, thereby increasing their risk exposure. In contrast, investors with medium risk tolerance demonstrated risk-averse behaviors, making investment choices after reflecting on previous financial missteps. Additionally, the study found that investors with high risk tolerance frequently displayed self-control biases.

Quasim et al. (2019) investigated the effects of herding behavior and overconfidence on investor decision-making. Data were collected through questionnaires distributed to 150 active investors in the Pakistan stock market, resulting in 100 completed responses. The ordinary least squares (OLS) method was employed to analyze the relationship between investor decision-making and the biases of herding behavior and overconfidence. The findings revealed a significant impact of herding behavior on the decisions made by investors.

Sarwar et al. (2016) emphasized the predominant role of psychological factors over socio-economic factors in influencing investor decisions, raising doubts about the relevance of socio-economic considerations in this context. These identified limitations prompted the current study to omit both attitudinal and socio-economic elements. Statman (2020) argues that investors in the financial markets should be regarded as rational rather than irrational. This perspective marks a transition in behavioral finance towards its second generation, which focuses on analyzing market volatility.

Srivastava et al. (2019) demonstrated the importance of neural activity in financial decision-making. Through a series of experiments, they established connections between decision-making functions and specific brain regions associated with financial contexts, including aspects such as risk, reward, and levels of ambiguity.

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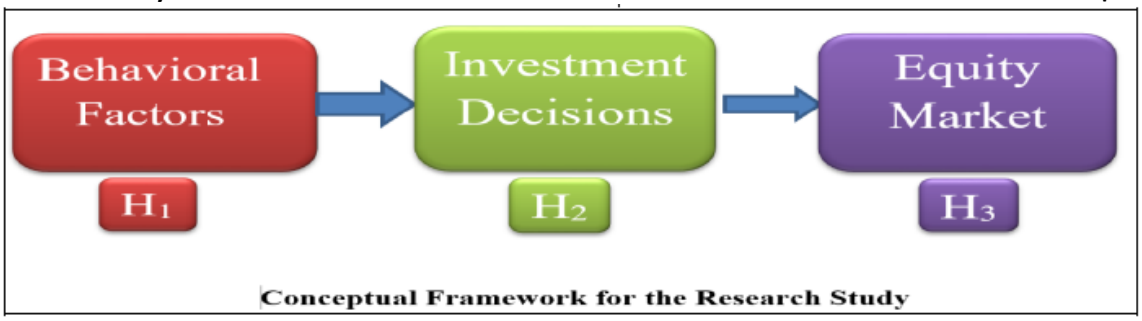

Conceptual Framework for the Research Study

Research Study Hypotheses

1. H1a: Heuristic elements of investor behavior have a significant effect on investment decisions.

2. H1b: Prospect-related aspects of investor behavior significantly influence investment decisions.

3. H1c: Market-related factors of investor behavior have a substantial impact on investment decisions.

4. H2: The investment decisions made by investors significantly affect the equity market.

Statement of the Problem

A significant portion of the Indian economy relies heavily on various industries, which, in turn, depend substantially on organized equity markets to meet their capital needs. This relationship indicates a direct link between the stock market and industrial development, a key focus area for the Indian economy. An upward trend in the stock market typically signifies economic growth, while a downward trend suggests economic decline.

Investors tend to be highly responsive to both internal and external influences. Their decision-making processes are often shaped by a complex interplay of factors, including socio-cultural, socio-economic, and psychological elements. This fluctuating behavior among investors can significantly impact the performance of the equity market, which in turn affects the broader economy. Consequently, there is a growing interest among researchers to explore the various behavioral factors that influence investor decisions. This study aims to investigate the irrational behaviors exhibited by investors regarding their investments and the subsequent effects on the equity market and the economy.

Objectives of the Study

• To examine the behavioral factors that affect investors' decision-making processes,

• To analyze the influence of investment decisions on the performance of the equity market, and

• To create and evaluate a theoretical framework model, proposing strategies to facilitate informed investment decisions by considering behavioral biases.

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Scope of the Study

This research focuses on the financial system within the Indian context, emphasizing the operations of financial markets and institutions. The effectiveness of these components is closely linked to the types and nature of investments made by investors. Consequently, this study aims to investigate investor behavior and the decision-making processes related to their investments, thereby motivating an exploration of how behavioral factors impact these decisions.

Research Methodology

This research study commenced with the identification of the research problem, followed by a comprehensive literature review to explore the extensive applications of relevant concepts and contexts. Drawing from this thorough review and existing investment decisions informed by behavioral theories, a conceptual framework was developed, and hypotheses were established for the study. Subsequently, a structured questionnaire was designed for data collection, which was then validated through reliability and validity assessments conducted via a pilot study. Data were collected for analysis based on the determined sample size, utilizing appropriate statistical tools and techniques.

A) Sampling

The data collection for this investigation utilized a simple random sampling method, focusing on investors from Varanasi. To ascertain the precise sample size, a statistical formula was applied. In this study, Cochran's formula for finite populations was employed, utilizing statistical data regarding investors in the stock market. The following formula was used.

$$n = \frac{\left(\frac{Z^2 p(1-p)}{e^2}\right)}{1 + \frac{Z^2 p(1-p)}{e^2 N}}$$

where n = sample size;

Z = z-score (1.96 for 95% confidence interval);

p = % picking a choice (0.5); and

e = margin of error (0.04 in the present case).

B) Data Analysis

A comprehensive analysis was conducted utilizing frequency analysis, descriptive statistics, ANOVA, T-tests, chi-squared statistics, correlation analysis, linear regression, confirmatory factor analysis (CFA), and structural equation modeling (SEM) to ensure precise results.

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C) Data Collection

a. Primary Data

The primary data for this study was gathered through a meticulously administered structured questionnaire directed at the respondents.

Secondary Data

To obtain secondary data, relevant literature, including books, articles, journals, and online resources pertinent to the objectives of the current study, was thoroughly reviewed.

Limitations of the Study

- This research is restricted to the Indian context, specifically focusing on Varanasi city. Consequently, the findings are derived solely from the perspectives of the respondents involved.

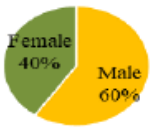
- The scope of the study is confined to examining the behavioral factors that affect investment decisions and their subsequent influence on the equity market.

- The data collection was limited to the convenient availability of investors willing to provide information, which means that the data is tied to a specific time-frame.

Analysis and Interpretation

Table 1: Gender-Based Demographic Characteristics of Participants

Gender	Frequency	Percent
Male	656	60.00
Female	444	40.00
Total	1100	100.0

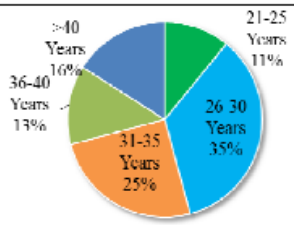


Gender

Source: Field survey

Table 2 : Age-Based Demographic Characteristics of Participants

Age (Years)	Frequency	Percent
21-25 Years	120	10.9
26-30 Years	384	34.9
31-35 Years	276	25.1
36-40 Years	144	13.1
>40 Years	176	16.0
Total	1100	100.0



Based on AGE

Source: Field survey

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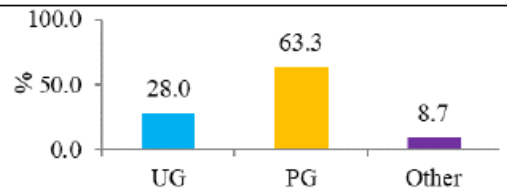
Table 3: The academic qualifications of the investor participants

Education	Frequency	Percent
UG	308	28.0
PG	696	63.3
Other	96	8.7
Total	1100	100.0

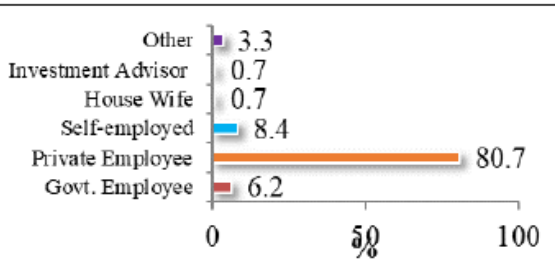


Education level of investor respondents

Source: Field survey

Table 4 The professional roles of the investor participants

Occupation	Frequency	Percent
Govt. Employee	34	6.2
Private Employee	444	80.7
Self-employed	46	8.4
House Wife	4	0.7
Investment Advisor	4	0.7
Other	18	3.3
Total	550	100.0

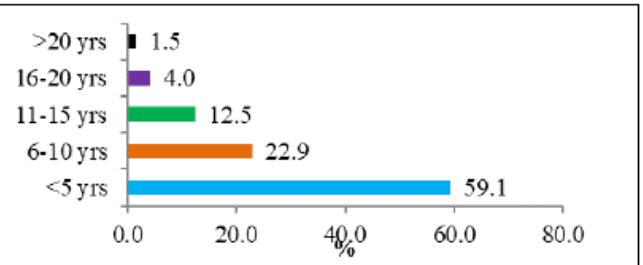


Occupation of investor respondents

Source: Field survey

Table 5 The Professional Roles of the Investors Paticipants

Experience (in years)	Frequency	Percent
< 5	325	59.1
6-10	126	22.9
11-15	69	12.5
16-20	22	4.0
> 20	8	1.5
Total	550	100.0



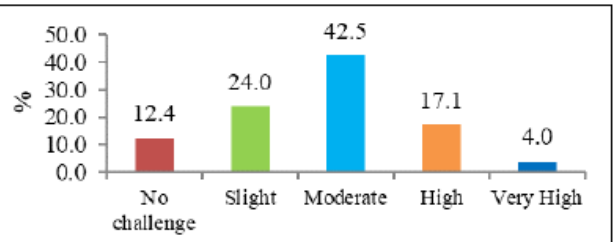
Experience of Investors

Source: Field survey

Table 6: Issues Associated with the Decision-Making in Investment Activities

Challenges	Frequency	Percent
No challenge	136	12.4
Slight	264	24.0
Moderate	468	42.5
High	188	17.1
Very High	44	4.0
Total	1100	100.0

Source: Field survey



Challenges involved in investment decision making

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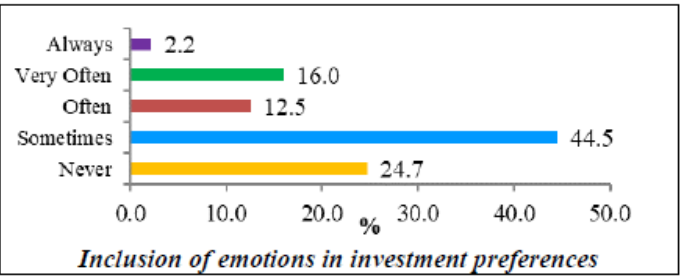
Table 7: The influence of emotional responses on investment decisions

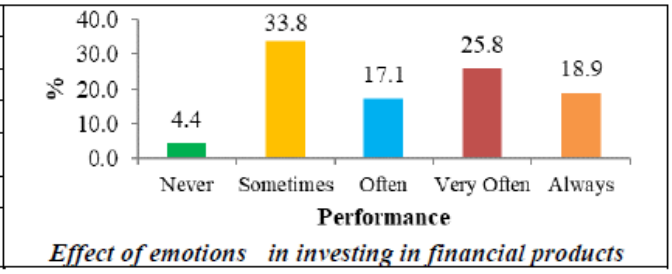
Emotions	Frequency	Percent
Never	272	24.7
Sometimes	490	44.5
Often	138	12.5
Very Often	176	16.0
Always	24	2.2
Total	1100	100.0



Source: Field survey

Table 8: The Influence of Emotions on Investment Decisions in Financial Products

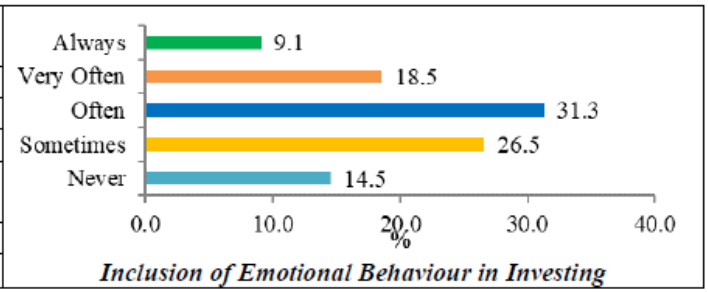
Performance	Frequency	Percent
Never	48	4.4
Sometimes	372	33.8
Often	188	17.1
Very Often	284	25.8
Always	208	18.9
Total	1100	100.0



Source: Field survey

Table 9: The Role of Emotional Behavior in Investment Decisions

Emotional Behavior	Frequency	Percent
Never	160	14.5
Sometimes	292	26.5
Often	344	31.3
Very Often	204	18.5
Always	100	9.1
Total	1100	100.0



Source: Field survey

The data presented indicates that a significant proportion of female investors tend to follow male investors, with the majority falling within the age range of 20 to 30 years, followed closely by those aged 31 to 36. This suggests that both younger and middle-aged individuals are more actively engaged in investment activities compared to other age demographics. Furthermore, the research highlights that most investors possess postgraduate degrees and have accumulated substantial experience in the equity market. Their emotional responses significantly influence their decision-making processes, as they encounter various challenges related to investing, selecting financial products, and determining their investment preferences, all of which involve risks associated with potential returns.

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H1a: Heuristic factors influencing investor behavior have a significant effect on investment decisions.

Table 10: Descriptive Analysis of the Impact of Heuristic Factors on Investment Decisions.

Variables	Mean	Std. Deviation
Investment decisions	4.974	0.179
Overconfidence	4.375	0.171
Availability bias	4.391	0.185
Representativeness	4.707	0.162

Source: Field survey

Table 11: Model Summary for the impact of heuristic factors on investment decision

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
				R Square Change	F Change	df1	df2	Sig. F Change
0.835	0.69723	0.692	0.313	0.697	22.572	3	546	0.000

Source: Field survey

H1b: Prospect factors of investor behaviour significantly impact the investment decision.

Table 12. Descriptive for the impact of prospect factors on investment decision

Factors	Mean	Std. Deviation
Investment decisions	4.974	0.679
Regret aversion	4.393	0.909
Loss aversion	4.535	1.025
Mental accounting	4.646	0.831

Source: Field survey

Table 13: Model Summary for the impact of prospect factors on investment decision

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
				R Square Change	F Change	df1	df2	Sig. F Change
0.866	0.75	0.013	0.402	0.117	30.412	3	546	0.000

Source: Field survey

H1c: Market factors of investor behaviour significantly impact the investment decision.

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Table 14 Descriptive statistics for the impact of market factors on investment decision

Variables	Mean	Std. Deviation
Investment decisions	4.974	0.679
Past trends	4.777	0.799
Market Information	*4.633*	*0.882*

Source: Field survey

Table 15 Model summary for the impact of market factors on investment decision

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
				R Square Change	F Change	df1	df2	Sig. F Change
0.851	**0.724**	**0.200**	**0.207**	**0.003**	**69.832**	**2**	**947**	**0.000**

Source: Field survey

H2: The investment decisions of investors significantly impact the equity market.

Table 16 Descriptive statistics for the impact of investment decision on investment pattern of investors while investing in equity market.

Variables	Mean	Std. Deviation
Pattern of Investment	4.495	0.703
Investment decisions	4.974	0.679

Source: Field survey

able 17. Model summary for the impact of investment decision on investment pattern of investors while investing in equity market.

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
				R Square Change	F Change	df1	df2	Sig. F Change
0.880	**0.7744**	**0.029**	**0.317**	**0.230**	**103.884**	**1**	**978**	**0.000**

Source: Field survey

Interpretation

The preceding analysis indicates that behavioral factors significantly affect investors' investment decisions, which in turn influence the performance of the equity market. The feedback from participants reveals a tendency to consider the risk and return associated with various investment options. Furthermore, the investment choices made by individuals are shaped by their behavioral inclinations. The regression analysis presented above demonstrates a correlation between investment decisions, behavioral factors, and equity market performance, suggesting that each element impacts the others.

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Findings

The descriptive statistics from this study outline the various constructs that affect investors' decisions to engage in different investment avenues, as well as their perceptions of overall investment performance. The highest average score for investment decisions was linked to the practice of regularly reviewing and comparing investment performance, followed closely by the allocation of additional funds for long-term investments. This reflects a psychological aspect of investors that significantly shapes their views on investment decisions.

Investment decisions and the performance of equity market portfolios are influenced by a range of factors. The analysis revealed that the behavioral factors of respondents, including heuristic, prospect, and market influences, have a positive effect on their investment decisions.

Conclusion

The analysis and research conducted demonstrate that behavioral factors significantly influence investment decisions, exhibiting a positive correlation. The study specifically examines the investment behaviors of retail investors, revealing a connection between their decision-making processes and performance in the equity market. Respondents indicated that making investment decisions is a challenging endeavor, with many acknowledging that emotional factors play a crucial role in this process.

Investors willing to take on higher risks for the potential of greater returns in the equity market tend to favor long-term securities, which are indicative of their behavioral tendencies. Additionally, these investors actively monitor stock market trends and available reports. The findings confirm that behavioral factors positively correlate with investment decisions. Furthermore, the performance of investment portfolios is largely determined by the investment decisions and patterns of investors, with the research indicating that 75% of investment performance is influenced by these patterns. This underscores the positive relationship between investors' behavioral factors, their decision-making, and the resulting performance in the equity market.

Suggestions

Regular assessment of advantages and disadvantages, along with a review of investment performance, is crucial for achieving optimal results. Investors should closely monitor current market trends to make informed decisions regarding their investment options. As the primary participants in the equity market, investors must engage in systematic and thorough analysis to mitigate any adverse effects on their financial well-being and stability. Those willing to embrace risk may consider investing in derivatives, which have the potential for higher returns. For safer and more substantial long-term gains, it is advisable for investors to allocate funds to mutual funds and adopt a Systematic Investment Plan (SIP) approach. Mutual funds are particularly recommended for financial investments related to property acquisition, travel, and weddings.

To ensure a well-rounded investment strategy, it is important to explore multiple investment avenues. Prior to undertaking significant risks and to maintain a balanced portfolio, seeking guidance from market experts can enhance performance outcomes. The long-term viability of an investment should be evaluated based on the rate of return (RoR), while the actual worth of an investment should be assessed through capital gains. Consequently, these factors should be taken into account when formulating investment strategies within the equity market.

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