

From Herding to Overconfidence: An Analysis of Retail Investor Behavior in Korea's KOSPI Bull Market

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Abstract

From 2025 to 2026, the Korean stock market saw an unprecedented bull run that was driven by retail investors. This paper discusses the phenomenon with a focus on the behavioral finance literature, especially the cognitive biases of herding and overconfidence. The study builds on previous literature, such as the empirical study of overconfident trading and theoretical frameworks like Prospect Theory, to qualitatively analyze the episode in the Korean market based on recent studies on the behavior of retail investors in emerging markets. The research pinpoints three typical patterns of behavior: social narratives about the unfair distribution of wealth and housing unaffordability influenced large-scale herding; early market successes fed into overconfidence; and government policy signals strengthened irrational risk-taking. The results indicate that the KOSPI bull market is a textbook example of the convergence of behavioral biases at the societal level, a phenomenon that has not been examined comprehensively in the literature. The paper is part of a stream of research on behavioral finance in Asian markets and provides implications for retail investor protection policies.

Keywords

behavioral finance, herding behavior, overconfidence bias, emerging markets

1. Introduction

South Korea's stock market stepped onto the stage of one of the biggest financial dramas of the decade in 2025. The KOSPI index even briefly surpassed 8,000 points by May 2026, after surging by more than 75% from a year ago, on the back of an unprecedented retail frenzy [1]. In a nation of only 51 million, active trading accounts hit 105 million, and there were stories of people leaving their jobs to trade full-time. This bizarre event brings up a question, which has never been answered by classical finance theory: why do millions of ordinary people rush into the equity markets at historically high valuations, pouring their savings into high-risk assets?

In this paper, it is suggested that the KOSPI bull market of 2025-2026 cannot be fully explained using rational expectations models. Rather, it is a fascinating real-life example of behavioral finance, demonstrating how herding and overconfidence biases can take place at a societal level. The social narratives around the unaffordability of housing, the explicit signals in government policies targeting a KOSPI level of 5,000 points,

and the mass migration of capital caused Korean retail investors to show collective biases that prevented the market from reaching equilibrium.

2. Research Objective

Cognitive biases have been extensively reported in the behavioral finance literature regarding their impact on individual investment decisions. Kahneman and Tversky (1979) laid the groundwork for the study of deviations from rational decision-making under uncertainty [2], and Barber and Odean (2000, 2001) showed that overconfidence is a factor in retail investors' excessive trading [3, 4], which can negatively affect their portfolios. The crowd mentality effect, where investors adopt herd behavior and stop making investment decisions based on their own judgment, has also been seen in other markets, such as the emerging Asian markets (Tan et al., 2008) [5].

Yet, there is a significant gap in the literature. Most of the research looks at these biases independently in environments of market decline or moderate volatility. Much less focus has been given to the synergies between herding and overconfidence, reinforcing each other in a prolonged bull market—especially one driven by structural social grievance issues like housing affordability, and fueled by explicit policy commitments made by governments. The KOSPI bull market of 2025–2026 is just such a case and has not been analyzed through a behavioral finance lens yet.

Hence, this paper is guided by the following three research objectives:

Research Objective 1: The first objective of this research is to evaluate the role of herding behavior in driving the massive influx of retail investors into the 2025–2026 KOSPI bull run.

Research Objective 2: The second objective seeks to analyze the specific nature of overconfidence bias among Korean retail investors, highlighting how early market gains fueled excessive risk-taking such as leveraged trading and sector concentration.

Research Objective 3: The final objective investigates how social narratives regarding wealth inequality and government policy signals served as external catalysts for these societal-level behavioral biases.

These questions help to create a coherent picture of the psychological processes involved in one of the most spectacular retail investor surges in Asian history, and to assess whether the theoretical arsenal of behavioral finance is adequate to account for the behavior of markets at this scale and pace.

3. Literature Review

3.1 Foundations of Behavioral Finance

Behavioral finance theories are based on the seminal work of Kahneman and Tversky (1979) [2], whose Prospect Theory cast doubt on the rational actor model that had long been the hallmark of classical economics. Kahneman and Tversky showed that people do not measure outcomes in absolute terms of wealth, but in terms of gains and losses with respect to a reference point. Most importantly, they demonstrated that the psychological costs associated with a loss are roughly twice those of a comparable gain, a phenomenon called loss aversion. This unequal weighting of outcomes may account for the fact that investors make systematically irrational decisions even in the face of objective probabilities. The conceptual foundation for later behavioral finance research, such as the study of overconfidence and herding, was provided by Prospect Theory.

Shiller (2000) built upon this framework at the level of market dynamics to suggest that asset price bubbles are not aberrations but natural consequences of collective psychological behaviors [6]. Citing data from the dot-com bubble, Shiller argued that market prices—driven by what he termed "irrational exuberance"—soar far above their intrinsic values and inevitably correct when there are no underlying fundamentals to justify them. This macro-level view is especially pertinent to the KOSPI case, as retail involvement increased to unprecedented levels at a time when valuations were already high.

3.2 Overconfidence Bias

Overconfidence is one of the most commonly supported by empirical evidence among the cognitive biases documented in behavioral finance. In a classic study of 66,465 household brokerage accounts in the U.S. during 1991-1996, Barber and Odean (2000) discovered that the most active trading households had an annual return of only 11.4% versus the 17.9% annual return for the market [3]. They concluded that overconfidence (the tendency for investors to overestimate the accuracy of their knowledge and the reliability of their judgments) results in increased trading activity, which directly harms the performance of investors' portfolios. Households typically traded 75% of their portfolio each year, which resulted in a systematic loss of returns due to transaction costs.

In addition, Barber and Odean (2001) found that overconfidence is not randomly distributed across all investors [4]. They found that males traded about 45% more than females, and that this over-trading cost male investors 2.65 percentage points of net return per year. That difference was explained by a known psychological phenomenon: males have a greater tendency to exhibit an overconfidence bias than females in areas like finance. The results are especially significant for the Korean context, where the demographic profile suggests that younger male investors were disproportionately represented among new market entrants during the bull market years of 2025–2026.

Gervais and Odean (2001) provided a dynamic model that can account for the emergence and buildup of overconfidence over time [7]. Under their model, traders with early market success succumb to biased self-attribution, taking excessive credit for gains that are largely driven by favorable market conditions rather than personal skill. The more positive returns created during a bull market, the more investors feel they have the foresight and wisdom to buy and sell stocks, and thus the more aggressive they become. The model suggests that overconfidence is most prominent early in a trader's career and in the midst of an uptrend. Both of these conditions characterized the influx of new retail investors into the KOSPI in 2025.

3.3 Herding Behavior

Herding is the behavior of investors who forgo their own independent judgment and follow the herd mentality. Christie and Huang (1995) were among the first to propose a systematic empirical test for herding using the cross-sectional standard deviation of returns (CSSD): When investors herd, the returns of individual stocks should converge around the market return, which results in a decrease in the standard deviation of returns across stocks [8].

Broadening this methodology, Tan et al. (2008) applied the cross-sectional absolute deviation (CSAD) measure and found significant evidence of herding in the Chinese A-share and B-share markets [5], both during rising and falling markets. They found the herding effect to be more pronounced for domestic retail investors in the A-share market, implying that this behavior is mainly driven by individual investors, rather than institutional participants, in Asian emerging markets. This result has direct implications for the Korean case, as retail investors overwhelmingly dominated the trading volume during the 2025–2026 rally.

Previous studies have consistently found that herding increases in situations of information asymmetry, social influence, and ambiguity [9]. In the Korean case, all three conditions were fulfilled: many newcomers to the investment world lacked experience in making investment decisions; social media and peer networks strengthened narratives about a lack of affordability in the housing market and the need to address wealth disparities; and government statements explicitly confirming a KOSPI target of 5,000 points gave a strong directional signal that suppressed independent assessment.

3.4 Interaction Between Herding and Overconfidence

The relationship between herding and overconfidence is frequently studied separately, but there is a smaller, growing amount of literature that looks into their interaction. Nofsinger and Sias (1999) showed that an uptick in herding activity is often followed by a market reversal [10], which implies that prices are pushed beyond their fundamental values by collective behavior. Importantly, overconfidence could exacerbate herding: investors who believe their portfolios are performing well due to their own skills might be less inclined to question the wisdom of the group, and more likely to view the actions of other investors as evidence of their bullish thesis. In this way, the two biases operate as complementary processes: a highly overconfident investor

faces less psychological resistance to joining the crowd, and the resulting herding behavior provides the social proof necessary to keep their overconfidence intact.

Empirical research on this interaction has been limited and remains scant in the context of long bull markets in emerging Asian economies. The 2025–2026 KOSPI episode is therefore a unique and important natural experiment, allowing for the examination of the combined dynamics of these two biases at an unprecedented scale.

4. Key Finding

In the Korean case, three interrelated findings result from the application of this framework. First, herding behavior is easy to spot: it was observed when millions of new retail investors bought into a handful of large-cap tech, battery, and semiconductor stocks simultaneously in 2025. This finding is similar to the results of Tan et al. (2008) [5], who found that herding increases when markets are booming, and aligns with Bikhchandani and Sharma (2001) [9], who noted that herding is higher in markets with high information asymmetry. Most of the new market entrants were inexperienced in investing and were therefore particularly sensitive to the social influence they received via online communities and peer networks.

Second, overconfidence was expressed in the form of a very large increase in leveraged trading. By mid-2025, the levels of margin loans on the KRX had reached record highs, suggesting that a large share of retail investors were systematically misestimating downside risk, just as Barber and Odean (2000) found among U.S. household investors [3]. To put this into perspective, market observations show that the opening of margin accounts among younger demographics was disproportionately higher. Struggling with housing affordability, these investors were therefore more likely to chase outsized returns by leveraging high-risk debt. The early periods of gains seem to have led to a self-attribution bias, in line with Gervais and Odean's (2001) model: investors who had bought when the market was rising incorrectly attributed their positive returns to their own skill rather than to favorable market conditions [7], promoting the purchase of more aggressive positions. The rapid pace at which these margin loans were accumulated suggests a collective illusion of control.

Third, government policy served as a powerful external amplifier. The government's explicit KOSPI target of 5,000 points functioned as a credibility signal that suppressed independent judgment and reinforced directional herding. Restrictions on short-selling further reduced the market's capacity for price correction, allowing behavioral biases to accumulate without the disciplining influence of informed bearish traders. This institutional dimension is not captured by existing behavioral finance models, which were developed largely in Western contexts with more neutral regulatory environments.

5. Discussion

5.1 Limitation

This study has several limitations. The absence of individual account-level transaction data prevents causal inference about the relationship between specific biases and investment outcomes. It is also methodologically difficult to distinguish herding from rational responses to shared public information. Furthermore, since the study relies on aggregate trading data rather than direct behavioral metrics, it is difficult to exclude alternative explanations for the observed patterns, such as investors responding rationally to actual changes in risk-return dynamics. Future research with access to brokerage-level data could more precisely test the mechanisms identified here.

5.2 Future Research Directions

Based on these limitations, a number of directions for further research have been identified.

First, obtaining brokerage-level transaction data would enable researchers to directly measure the degree of overtrading and portfolio concentration by individual investors, as opposed to drawing inferences solely from aggregate margin lending statistics.

Second, cross-country comparisons could determine whether the interaction between herding and overconfidence seen in the Korean example exists in other emerging markets with similar retail-driven bull runs, such as in Southeast Asia or Latin America.

Third, survey-based or experimental instruments might yield more direct evidence of the proposed psychological mechanisms, supplementing the market-level data used in this study. For example, future research could adopt the approach of Glaser and Weber (2007) [11], utilizing calibration questionnaires to directly measure investor overconfidence alongside measures of social media exposure.

Last, because policy signaling proved to be an important amplifying force in this case, future research might investigate the impact of other forms of policy communication (e.g., explicit price targets versus less explicit macroprudential guidance) on retail investor behavior in bull markets.

6. Conclusion

This paper has examined the 2025–2026 KOSPI bull market through a behavioral finance lens, arguing that the extraordinary surge in retail participation cannot be adequately explained by rational expectations theory. Instead, the episode represents a rare convergence of two mutually reinforcing cognitive biases—herding and overconfidence—operating at a societal scale and amplified by structural social grievances and explicit government policy signals.

The central finding is that herding and overconfidence did not operate independently. Mass retail entry created observable price momentum that attracted further crowd-following behavior, while widespread early gains bred the self-attribution bias that Gervais and Odean (2001) predict will generate overconfidence [7]. The result was a feedback loop: overconfidence reduced the psychological friction that might have led investors to resist the crowd, while herding provided the social proof that sustained overconfident beliefs. Government policy—through its KOSPI target and short-selling restrictions—reinforced both dynamics simultaneously.

The policy implications are significant. Regulators should recognize that periods of low interest rates and rising asset prices are precisely the conditions under which behavioral biases intensify most acutely. Targeted measures—such as mandatory risk disclosures for margin products, cooling-off periods for first-time leveraged accounts, and financial literacy initiatives directed at younger retail investors—could help mitigate the most harmful consequences of these biases without restricting broader market access.

More broadly, this paper contributes to a growing body of research on retail investor behavior in emerging Asian markets. The KOSPI episode offers a significant natural experiment for future study: with clear temporal boundaries and a distinct retail-driven character, it is well-suited to causal investigation using brokerage account-level data. Methodological approaches such as difference-in-differences designs—comparing investors who entered the market before and after the government’s policy signal—could yield more precise estimates of how external anchors amplify herding. Ultimately, this case demonstrates that the conceptual tools of behavioral finance, developed largely in Western contexts, retain powerful explanatory relevance when applied to new market environments, provided that local institutional conditions are taken seriously.

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Conflicts of Interest

The authors declare no conflict of interest.

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