



International Journal of Commerce, Economics and Management Research (IJCEMR)

(An International Peer-Reviewed (Refereed) Journal)

Volume no. 1, Issue no 2, Page No. 93-101

Online ISSN: 3139-9320; Print ISSN: 3139-826X

Behavioural Biases and Mutual Fund Investment Decisions in India: Risk Perception, Construct Validity and Directions for Future Research

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Received: 24 August 2026, Revised: 21 September 2026, Accepted: 28 September 2026, Available Online: 30 September, 2026

<https://doi.org/10.68219/19fbmx67>

Abstract

Behavioural finance offers us an alternative explanation to the notion that investment decisions are always made based on the rational, unbiased processing of risk and return. This is a critical narrative review of the effects of overconfidence, loss aversion, herding, and anchoring, and of the role of mental accounting in investment decisions in Indian mutual funds, with a particular focus on the possible explanatory power of subjective risk perception. The article draws on theories of basic behavioural finance and recent research to investigate the conceptual similarity among risk perception, risk tolerance, and financial literacy. It highlights common methodological issues, such as relying on self-reported decisions, inadequate differential scoring of bias measures, mediation analysis across cross-sections, and limited geographic representativeness. A conceptual framework is developed to differentiate between direct bias–decision relations and indirect relations via perceived risk, and it proposes financial literacy and investor experience as context-sensitive conditions. The review is not intended to be comprehensive of the database or to calculate pooled effects. Rather, it promotes a measurement-oriented research agenda that stresses the need for validated measures, explicit investment outcomes, longitudinal or experimental designs, and open reporting of statistical results. These suggestions can enhance the interpretation and comparability of future studies of investors in Indian mutual funds.

Keywords: Behavioural finance, Mutual funds, Risk perception, Investment decisions, Measurement validity, Financial literacy, India

1. Introduction

The normative explanation of diversification and the tradeoff between expected return and investment risk is known as modern portfolio theory (MPT) (Markowitz, 1952). However, not all retail investors act on financial information in the way that is assumed in rational choice models. Prospect theory demonstrates that people's evaluations are reference dependent and that reactions to loss and gains can be asymmetric (Kahneman and Tversky, 1979). Further evidence for the systematic effects of salient cues on intuitive judgement under uncertainty is found in research on heuristics (Tversky & Kahneman, 1974).

In mutual funds, investors make choices on participation, selection of the scheme, contribution size, holding period, switching and redemption while professional managers are delegated to take the decision on security selection. The Indian setting is particularly pertinent because the investors are exposed to a growing variety of products, channels, and digitally-mediated information. Therefore, the study of the risk being faced by investors in Indian mutual funds should be separated from the perception of such risk by the investors.

In recent times, a general review of the behavioural biases is not unique enough. The connection between behavioural bias and risk perception and financial literacy has been theoretically explored by Hessa (2026) in a review of mutual funds. Singh et al. (2025) highlighted the major biases and factors influencing retail-investor decision-making, while Douhabi and Drissi (2026) systematically investigated biases and demographic moderators. The current article focuses just on the concept of separation, validity of measurement in this context and evidence required for evaluating the risk-perception pathway in the context of Indian mutual funds.

The three questions are: (a) what are mechanisms that are likely to connect selected behavioural biases to mutual fund decisions; (b) what is the theoretical importance of subjective risk perception; and (c) what measurement and design practices would enhance the inference in the investor research in India?

2. Review Approach and Scope

This is a critical narrative and conceptual review and is not a systematic review or meta-analysis. The sources were deliberately chosen to include basic theory, relevant studies into investor behaviour, recent reviews and methodological issues. A targeted Internet verification was conducted in October 2026 to find similar recent publications and verify available bibliographic data. A database search log (replicable), a duplicate screening process and a formal quality-appraisal protocol as well as a PRISMA flow were not performed. Therefore, no attempt has been made to make such claims as exhaustive coverage, numbers of eligible studies or aggregate effect sizes.

The synthesis focuses on literature on five constructs overconfidence, loss aversion, herding, anchoring, mental accounting, and on subjective risk perception, financial literacy, and mutual fund decision outcomes. The mechanisms are highlighted using evidence from wider securities markets but not as evidence of Indian mutual fund investors.

3. Literature Review and Theoretical Foundations

3.1 Overconfidence and information processing

Investors' overconfidence can make them think they can make more accurate judgments or discover better investments. Barber and Odean (2001) are associated with excessive trading and habits of investor behavior, but their evidence is based on common stock accounts in lieu of Indian mutual funds. Mutual funds have similar speculations such as chasing performance and over switching and overconfidence on fund selection. Transactions should not be assumed simply based on investment frequency: liquidity requirements, fees, taxes, and changes in investment objectives can also account for transactions.

3.2 Loss aversion and reference dependence

Prospect theory indicates that psychological effects of loss may be different than those of gain that are equivalent in value (Kahneman & Tversky, 1979). A temporary decrease below purchase price may be more significant to a mutual fund investor, and could impact redemption or retention. Loss aversion is not a general aversion to risk, however. Questions simply asking people if they prefer low-risk investments can only measure risk preference, not different valuations of gains and losses. The use of appropriate measurements needs to be specific and comparable gain/loss situations.

3.3 Herding and social information

Herding refers to mimicking or over-imitating the decisions made by other people. The choices regarding mutual funds can be made on the basis of social networks, financial influencers, peer recommendations and advisers. But the act of following a recommendation does not necessarily constitute a bias: an investor might benefit from the expertise or save information-search time by following the recommendation. Surveys should differentiate between uncritical imitation and informed advice-seeking and common reaction to the same market information.

3.4 Anchoring and mental accounting

Anchoring is a heuristic that occurs when a first valuation, expressed with a salient value, has a disproportionate influence on subsequent evaluation (Tversky & Kahneman, 1974). Historical performance, market levels and any new announcements can be used as benchmarks. Mental accounting is the process of putting money into “buckets” of money, each with its own decision rules (Thaler, 1985). When financial risks are similar, investors can have different perspectives on their retirement investments and short-term discretionary investments. These constructs need to be separated in the measurement model.

3.5 Financial Literacy and Appraisal of Own Competence

Financial literacy is correlated with the capacity to comprehend basic financial terms and make sound financial decisions (Lusardi & Mitchell, 2014). The distinction between objective knowledge and subjective confidence and practical decision skills should be made. While knowledge can moderate behavioural influences, this does not automatically imply that they can be eliminated. In a model, the authors should indicate whether literacy is a predictor, moderator or control, and may not have multiple roles in the model unless there is an explanation.

3.5 Financial literacy and perceived competence

Financial literacy is linked to understanding the fundamentals of finance and to the ability to make sound economic decisions (Lusardi & Mitchell, 2014). Objective knowledge and subjective confidence and decision skills should be separated. While there is a possibility that literacy will buffer the behavioral effects, it can't be assumed that it removes the possibility of loss aversion, herding or overconfidence. Models ought to identify no more than one role for literacy as predictor, moderator, or control (no more than three roles without justification).

4. Risk Perception as an explanatory mechanism

Subjective risk perception is the degree of risk an investor perceives as to the likelihood, severity and uncertainty of negative events. It is not the same as objective risk, as that relates to the characteristics of the investment, nor is it the same as risk tolerance which relates to the willingness or capacity to endure uncertainty. These differences are important because an investor could accurately identify a high risk and still be willing to take the risk for a long investment term.

Biases can be either positive or negative regarding risk. Overconfidence could lead to underestimating the impact of bad outcomes; loss aversion could make losses seem more significant; herding can have a social reassuring effect or can make losses seem worse; anchoring can focus on a specific past price or past return; mental accounting can affect how risks are perceived for different financial goals. These pathways are not proven, but rather are hypotheses.

Risk perception can be analysed statistically as a mediator between behavioural bias and a strictly defined investment performance. However, an indirect effect in cross section is not enough to confirm causal mediation since the direction of the effect can be reversed, and unobserved factors can influence perception, as well as choice. For stronger inference, theoretical justifications for the nature of the inference should be provided, discriminant validity should be established, appropriate estimation of indirect effects should be demonstrated, and, if possible, evidence from longitudinal or experimental studies should be presented.

5. Integrative Framework and Propositions

The proposed framework includes two paths:

Behavioural biases → mutual fund investment decisions

behavioural biases → subjective risk perception → mutual fund investment decisions.

Financial literacy and investment experience might be boundary conditions, and demographic and economic characteristics could be controls where theoretically justified.

P1. There are potentially unique relationships between overconfidence, loss aversion, herding, anchoring and mental accounting to specific decisions made by mutual funds.

P2. Empirically there are differences between subjective risk perception and risk tolerance, as well as between subjective risk perception and objective product risk.

P3. If measurement of the selected bias–decision associations is valid and the research design is appropriate, then the associations may statistically mediate subjective risk perception.

P4. Selected relationships may be affected by objective financial literacy and investor experience, but not in a consistent manner to reduce the biases.

The dependent variable must not be an omnibus variable, like “investment decision”. The researchers should clearly indicate the behaviours of participation, scheme selection, allocation and continuation of SIPs, switching/redeeming of the Schemes as they have been found with different antecedents and constraints.

6. Critical synthesis of the evidence

There are already reviews on the biases that retail investors face in their decisions and the behaviour of mutual funds (Hessa, 2026; Singh et al., 2025). The study by Pednekar et al. (2025) specifically focuses on behavioral biases in mutual fund investment decisions in India. These contributions provide substantive relevance without necessarily answering the question of whether the measures of the constructs are equivalent across samples or whether subjective risk perception is a causal channel. This article thus can only be interpreted at the level of plausible mechanisms and methodological requirements, not pooled directional effects.

Table 1. Selected literature and its relevance to the proposed framework

Source	Principal focus	Relevance / boundary
Markowitz (1952)	Portfolio selection	Normative risk–return benchmark
Kahneman & Tversky (1979)	Prospect theory	Reference dependence and loss evaluation
Tversky & Kahneman (1974)	Heuristics	Anchoring and uncertainty judgements
Thaler (1985)	Mental accounting	Goal-dependent evaluation of money
Barber & Odean (2001)	Overconfidence and trading	Stock-market evidence; not directly mutual funds
Lusardi & Mitchell (2014)	Financial literacy	Separating knowledge from confidence
Singh et al. (2025)	Retail investor bias review	Prior synthesis; scope overlaps

Pednekar et al. (2025)	Indian mutual fund investors	Directly relevant market context
Hessa (2026)	Mutual fund theoretical review	Closest overlap; requires differentiated contribution
Douhabi & Drissi (2026)	Systematic review of biases	Broader investment and demographic evidence

7. Research Gaps and Methodological Recommendations

7.1 Discriminant measurement

Survey items should be clearly designed to measure the constructs to which they are intended, and checked to see if there are any conceptual overlaps. Structure of the items can be evaluated by exploratory and confirmatory factor analysis, but there is no defensible model fit. Risk perception and risk tolerance should not be mixed together to get a "better" fit into the statistics.

7.2 Intention and behaviour

Stated intentions and recalled investment choices are informative but socially desirable and susceptible to recall error. Where ethically and practically possible, survey data should be correlated with transaction data, discontinuation or switching behaviour or experimental decisions that are incentive-compatible.

7.3 Sample coverage and context

Convenience samples of data from a single locality or recruitment network should not be interpreted as nationally representative. Eligibility criteria, recruitment methods, experience, geographic distribution and nonresponse are reported to help the reader determine eligibility and transferability.

7.4 Causal caution and clear analysis

Cross-sectional structural models should be described as associational. Reports should include information on sources of items, missing data, reliability/validity, direct and indirect effect estimation, confidence intervals and sensitivity checks. Simulations or illustrative examples do not support empirical characteristics of "real investors".

8. Research and practice implications.

The main take-away message for researchers is to focus on construct validity and on exactly specified investment outcomes before adding paths to elaborate statistical models. On the adviser / asset management side the framework proposes a distinction between objective risk and perceived risk on the one hand and the ability to bear risk on the other when disclosing the product and communicating with investors. In financial education, splitting knowledge from confidence is a method that can enhance programme design but the effectiveness of any intervention is a matter of empirical research.

9. Limitations

This manuscript is a selective narrative review and is not a systematic synthesis. The literature table is only representative of studies and not a complete list. The presented propositions are not empirically tested but are conceptual in this paper. Research obtained from the stock market doesn't always translate directly to mutual fund investors. The author is requested to conduct a broader literature search and to confirm all bibliographic information and requirements of the journal on his/her own before submission.

10. Conclusion

There may be useful explanations for variation in decisions to invest in mutual funds in terms of behavioural biases, but the usefulness of these explanations depends on how the constructs and decisions are defined. Subjective risk perception is not synonymous with risk tolerance, and is not a proven causal pathway in all contexts. There is a need for more specific construct delineation, instrument validation, behaviourally relevant outcomes, reporting transparency and finalised time design when studying the Indian mutual fund investors. The measurement-conscious approach provides a more precise contribution than simply reporting additional biases and self-reported decision contributions.

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