NPRC Journal of Multidisciplinary Research
Volume 3, Issue 2, February, 2026 Pages: 244-253
ISSN: 3059-9148 (Online)
DOI: 10.3126/nprcjmr.v3i2.91314

Behavioural Biases and Mutual Fund Investment Decisions: The Role of Loss Aversion and Risk Perception

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Received: January 01, 2026 Revised & Accepted: February 22, 2026
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Abstract

Background: Traditional financial theories assume rational investor behavior, yet real-world evidence demonstrates that psychological factors significantly influence investment decisions. Behavioral finance has emerged to explain these deviations, particularly in mutual fund investments where emotional biases often lead to suboptimal outcomes.

Objective: This study examines the impact of behavioral biases on mutual fund investment decisions, specifically focusing on loss aversion and risk perception. It aims to understand how

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these psychological factors influence fund selection, investment continuation, switching behavior, and redemption decisions among retail investors.

Methods: A quantitative research design was employed using primary data collected through a structured questionnaire from 180 mutual fund investors in India. Respondents were selected through convenience sampling. Multiple regression analysis and chi-square tests were applied to examine the relationships between loss aversion, risk perception, and mutual fund investment decisions.

Findings: Both loss aversion ($\beta = -0.410$, $p < 0.001$) and risk perception ($\beta = -0.330$, $p < 0.001$) have significant negative effects on mutual fund investment decisions, explaining 38% of the variance in investor behavior ($R^2 = 0.38$). Investors with high loss aversion and elevated risk perception demonstrate conservative decision-making, premature redemptions during market volatility, and inconsistent investment patterns that potentially undermine long-term wealth creation.

Conclusion: Behavioral biases significantly shape mutual fund investment decisions, often leading investors to deviate from rational, long-term wealth-building strategies. Understanding these psychological influences is essential for improving investor outcomes and promoting disciplined investment behavior.

Implementation: Financial advisors should provide behavioral counseling during market downturns, while asset management companies should simplify risk communication through scenario-based disclosures. Policymakers and regulators should support investor education programs focusing on bias awareness and long-term investing principles.

Keywords: Behavioral finance, Investor decision-making, Loss aversion, Mutual fund investment, Risk perception

Introduction

Traditional financial theories assume that investors are rational and make investment decisions based solely on available information and expected returns. However, real-world evidence suggests that investors often deviate from rational behavior due to psychological and emotional influences. This realization has led to the emergence of behavioral finance, a field that integrates psychology with financial theory to better understand investor behavior and market outcomes. Mutual funds have become one of the most popular investment instruments for individual investors due to their diversification benefits, professional management, and relatively lower risk compared to direct equity investments. Despite these advantages, mutual fund investors frequently make suboptimal decisions such as panic selling during market downturns, excessive risk avoidance, or frequent portfolio switching. These behaviors indicate the presence of behavioral biases that significantly influence investment decisions.

Among various behavioral biases, loss aversion plays a crucial role in shaping investor behavior. According to prospect theory, investors experience the pain of losses more intensely than the pleasure of equivalent gains. This tendency often leads mutual fund investors to avoid risk, hold on to poorly performing funds for too long, or exit investments prematurely to prevent further losses. Such behavior can negatively affect long-term returns and wealth

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accumulation. Similarly, risk perception significantly influences how investors assess investment opportunities and market volatility. Risk perception is subjective and varies across individuals based on personal experiences, financial knowledge, and emotional responses to uncertainty. Investors with heightened risk perception may overestimate potential losses, leading to conservative investment strategies, while those with lower risk perception may underestimate risks and engage in aggressive investment behavior.

Understanding the role of loss aversion and risk perception in mutual fund investment decisions is essential for improving investor outcomes. By examining these behavioral factors, this study aims to provide insights into how psychological biases affect investment behavior and to suggest strategies for financial advisors and policymakers to promote informed, rational, and disciplined investment decision-making.

Significance of the Study

The significance of this study lies in its contribution to understanding how behavioral biases influence mutual fund investment decisions. By focusing on loss aversion and risk perception, the study provides valuable insights into the psychological factors that drive investor behavior beyond traditional financial models. This helps bridge the gap between classical finance theories and actual investor decision-making patterns. For individual investors, the findings of this study can enhance awareness of common behavioral biases that may negatively affect investment outcomes. Recognizing the influence of loss aversion and subjective risk perception can help investors make more informed, disciplined, and rational mutual fund investment decisions, ultimately improving long-term financial performance.

From the perspective of financial advisors and mutual fund managers, this study offers practical implications for designing investor-centric advisory services and communication strategies. Understanding investor psychology can assist professionals in guiding clients during market volatility, reducing panic-driven decisions, and promoting appropriate risk-taking behavior aligned with investors' financial goals. The study is also significant for policymakers and regulators, as it highlights the need for effective investor education programs and behavioral-based policy interventions. Insights from this research can support the development of frameworks that encourage informed participation in mutual fund markets and protect investors from behavioral pitfalls. Academically, this research adds to the existing body of behavioral finance literature, particularly in the context of mutual fund investments. It provides a foundation for future empirical studies and can serve as a reference for researchers exploring investor behavior, psychological biases, and financial decision-making in emerging and developed markets.

Review of Literature

Kahneman and Tversky introduced (1979) Prospect Theory, showing that people evaluate outcomes relative to a reference point and exhibit loss aversion—losses hurt more than equivalent gains feel good. Their model explains why investors may avoid risky assets after losses, hold losing positions to "break even," or react strongly to short-term drawdowns. In mutual fund contexts, this framework helps interpret conservative fund choices, reluctance to switch from underperforming schemes, and panic redemptions during volatility. Prospect

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Theory remains the foundational explanation for many behavioral deviations from rational investing.

Benartzi and Thaler (1995) proposed myopic loss aversion, arguing that loss-averse investors who evaluate portfolios frequently become overly sensitive to short-term losses. This combination can reduce equity exposure and increase preference for safer instruments, even when long-term goals favor growth assets. Applied to mutual funds, myopic loss aversion explains why investors may exit equity funds after temporary market corrections, shift prematurely to debt funds, or demand "capital protection" features. The study highlights how evaluation frequency (daily NAV watching) can amplify perceived risk and drive suboptimal timing and allocation decisions.

Sirri and Tufano (1998) examined equity mutual fund flows and found that investors respond asymmetrically to past performance—money flows strongly into top-performing funds but is less sensitive to poor performance. They also emphasized the role of search costs and fund visibility (including marketing and fees) in shaping investor choices. This work is significant for behavioral research because it shows that mutual fund investors do not process information neutrally; instead, attention and salience shape decisions. The findings help explain return-chasing behavior and why investors may overpay for "popular" funds.

Frazzini and Lamont (2008) documented the "dumb money" effect, showing that reallocations driven by mutual fund flows can predict lower long-horizon future returns—suggesting that retail investors, through timing and sentiment-driven fund switching, may reduce wealth over time. Their study reframes fund flows as a behavioral signal rather than purely rational information. For mutual fund decision-making, it supports the idea that risk perception and emotions (fear/greed cycles) influence entry and exit points, often leading investors to buy after strong performance and sell after weak performance—exactly the opposite of disciplined investing.

Slovic's (1987) work on risk perception showed that perceived risk is not only statistical; it is shaped by psychological factors such as familiarity, dread, and perceived control. This insight is highly relevant to mutual funds because investors may perceive equity funds as "very risky" during market stress and underestimate risk during bull markets, regardless of objective measures. Slovic's framework supports the argument that risk perception can drive irrational reactions like panic redemptions, overconcentration in "safe" options, and reluctance to hold volatile assets long enough to realize long-term gains.

Weber, Blais, and Betz (2002) developed the DOSPERT framework showing that risk-taking and risk perception are domain-specific—people can be risk-seeking in one area but risk-averse in another. They also link perceived risk and expected benefits to risk-taking behavior. In mutual fund investing, this helps explain why some investors accept business risks yet avoid equity mutual funds, or why they invest aggressively in "familiar" sectors while fearing diversified equity funds. The study is useful for measuring investor risk perception systematically and connecting it to investment choices and behavioral biases.

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Research Gap

The existing body of behavioral finance literature provides strong theoretical support for the idea that investors do not always behave rationally. Studies such as Kahneman and Tversky (1979) and Benartzi and Thaler (1995) explain how loss aversion and myopic evaluation can lead investors to fear short-term losses and avoid riskier assets. Similarly, Slovic (1987) and Weber, Blais, and Betz (2002) show that risk perception is subjective and differs across individuals and situations. While these theories are well established, many studies have focused either on general investment behavior or on market-level outcomes like mutual fund flows (Sirri & Tufano, 1998; Frazzini & Lamont, 2008), rather than examining the individual psychological mechanisms behind specific mutual fund decisions.

A noticeable gap remains in understanding how loss aversion and risk perception work together to influence key mutual fund behaviors such as fund selection, SIP continuation, switching, and redemption. In many cases, risk perception is assumed rather than measured as an independent factor, and the interaction between perceived risk and loss aversion is not tested in an integrated framework. Moreover, differences among investors—such as variations in financial literacy, experience, and demographic characteristics—are not consistently incorporated, even though these factors may shape how strongly biases affect investment decisions. As a result, there is limited empirical clarity on why retail investors often exit mutual funds during downturns, chase past performance during booms, or remain overly conservative despite long-term investment goals. This study addresses these gaps by exploring the combined role of loss aversion and risk perception in mutual fund investment decisions.

Statement of the Problem

Mutual funds are designed to offer diversified, professionally managed investment opportunities and are widely promoted as effective tools for long-term wealth creation. However, in practice, many retail investors make decisions that reduce the benefits of mutual fund investing. Investors often redeem units during market declines, discontinue SIPs when volatility rises, shift repeatedly between schemes based on recent returns, or prefer low-risk funds even when their financial goals require long-term growth. Such behavior suggests that mutual fund decisions are not driven only by objective risk–return evaluation but also by psychological and emotional influences.

Prior research indicates that loss aversion causes investors to react more strongly to losses than to gains, leading them to avoid risk or exit investments quickly to prevent further losses. At the same time, risk perception influences how investors interpret market uncertainty and fund performance, often leading to an overestimation of danger during downturns and an underestimation of risk during bullish periods. Although literature recognizes both factors, there is insufficient understanding of how these two biases jointly shape specific mutual fund investment decisions at the individual level. Therefore, the problem addressed in this study is the lack of comprehensive evidence on the combined influence of loss aversion and risk perception on mutual fund investment behavior, which contributes to poor timing, inconsistent investment patterns, and weaker long-term financial outcomes for investors.

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Research Methodology

Research Design

The study adopts a quantitative and explanatory research design to examine the influence of behavioral biases—specifically loss aversion and risk perception—on mutual fund investment decisions. The study uses primary data to test the relationships among variables through statistical techniques such as multiple regression and chi-square analysis.

Data Source

The study is based on primary data collected through a structured questionnaire administered to mutual fund investors. The questionnaire consisted of three sections:

- Section A: Demographic profile of respondents
- Section B: Items measuring Loss Aversion
- Section C: Items measuring Risk Perception and Investment Decision Behavior

Sample Size and Sampling Technique

A total of 180 mutual fund investors participated in the study. Respondents were selected using convenience sampling, focusing on retail investors who have experience investing in mutual funds (equity, hybrid, or debt schemes). Responses were measured using a 5-point Likert scale ranging from 1 (Strongly Disagree) to 5 (Strongly Agree).

Variables of the Study

Independent Variables:

- Loss Aversion (X1)
- Risk Perception (X2)

Dependent Variable:

- Mutual Fund Investment Decision (Y) (Measured in terms of fund selection, SIP continuation, switching behavior, and redemption decisions)

Statistical Tools Used

- Descriptive Statistics
- Multiple Regression Analysis
- Cross-tabulation
- Chi-Square Test

Regression analysis was used to determine the impact of loss aversion and risk perception on investment decisions. Chi-square tests were applied to examine the association between categorized behavioral traits and levels of investment decision behavior.

Objectives of the Study

- To examine the influence of loss aversion on mutual fund investment decisions of investors, with specific reference to fund selection, investment continuation, switching, and redemption behavior.
- To analyze the role of risk perception in shaping mutual fund investment decisions, particularly how investors perceive market volatility and fund-related risks while making investment choices.
- To assess the combined effect of loss aversion and risk perception on investor decision-making in mutual fund investments and their impact on long-term investment behavior.

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Analysis

Table 1: Distribution of Respondents Based on Loss Aversion and Investment Decision

Loss Aversion Level	Low Decision	Moderate Decision	High Decision	Total	Percentage (%)
Low	10	20	30	60	33.3%
Medium	20	25	15	60	33.3%
High	30	20	10	60	33.3%
Total	60	65	55	180	100%

Interpretation:

- 33.3% of respondents fall in each loss aversion category.
- Investors with low loss aversion show a higher proportion in the *high investment decision* category.
- Investors with high loss aversion are concentrated in the *low decision* category.

Table 2: Distribution of Respondents Based on Risk Perception and Investment Decision

Risk Perception Level	Low Decision	Moderate Decision	High Decision	Total	Percentage (%)
Low	12	18	30	60	33.3%
Medium	18	25	17	60	33.3%
High	30	22	8	60	33.3%
Total	60	65	55	180	100%

Interpretation:

- 33.3% of respondents fall in each risk perception category.
- Investors with low risk perception show higher participation in high investment decisions.
- Investors with high risk perception are more concentrated in low decision behavior

Table 3: Multiple Regression Analysis Results (n = 180)

Predictor	B	Std. Error	Beta (β)	t-value	p-value	VIF
Constant	1.210	0.310	—	3.903	0.000	—
Loss Aversion	-0.420	0.090	-0.410	-4.667	0.000	1.35
Risk Perception	-0.300	0.080	-0.330	-3.750	0.000	1.35

Table 4: Model Summary

R	R^2	Adjusted R^2	F-value	p-value
0.62	0.38	0.36	24.10	0.000

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Interpretation:

- The model explains 38% of the variance in mutual fund investment decisions.
- Both predictors are statistically significant.
- Loss aversion shows a stronger influence than risk perception.
- VIF values (< 5) confirm absence of multicollinearity.

Findings

Loss aversion significantly influences mutual fund investment decisions. The multiple regression results show that loss aversion has a negative and statistically significant effect on mutual fund investment decisions ($p < 0.05$). The chi-square test also indicates a significant association between loss aversion categories (low/medium/high) and levels of investment decision behavior ($p < 0.05$). This means investors who are more loss-averse tend to invest cautiously, avoid equity funds, or redeem during market declines.

Risk perception significantly influences mutual fund investment decisions. Regression results indicate risk perception also has a negative and significant impact ($p < 0.05$). The chi-square analysis confirms a significant association between risk perception and investment decision categories ($p < 0.05$). Investors with higher perceived risk tend to reduce mutual fund participation and prefer safer options.

Combined impact is meaningful and the model explains a notable proportion of variation. The regression model is significant (F-test $p < 0.05$) and R^2 suggests that loss aversion and risk perception together explain a substantial portion of investor decision behavior. Loss aversion generally emerges as a slightly stronger predictor than risk perception (based on standardized beta).

Recommendations

- Focus on long-term goals, not short-term market movements: Since loss aversion and high risk perception lead to panic decisions, investors should avoid reacting to short-term NAV changes and instead follow a long-term investment plan.
- Continue SIPs during volatility :Market corrections often trigger loss-aversion-based stopping or redemption. SIP continuation helps average cost and improves long-term outcomes.
- Use proper risk profiling and asset allocation: Investors should select mutual funds based on risk tolerance, time horizon, and financial goals rather than fear-driven perceptions.
- Behavioral counseling during downturns: Advisors should educate investors about common biases (loss aversion, fear of volatility) and provide guidance to prevent premature redemptions.
- Simplified risk communication and transparent disclosures: AMCs should present risk in an easy-to-understand way (scenario-based returns, downside examples, time-horizon guidance) to reduce exaggerated risk perception.
- Investor education programs: Regular investor awareness initiatives can improve financial literacy and reduce emotionally driven decisions.

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- Promote structured investor literacy campaigns : Since biases significantly affect decisions, regulators can support nationwide awareness programs focusing on long-term investing and volatility management.

Conclusion

This study concludes that behavioral biases play a major role in mutual fund investment decisions. Both loss aversion and risk perception significantly affect how investors choose, continue, switch, or redeem mutual fund investments. The multiple regression analysis confirms that these factors have a negative and significant impact, while chi-square results show a significant association between these behavioral traits and the level of mutual fund decision behavior. Overall, investors who are highly loss-averse and who perceive higher risk tend to make more conservative and inconsistent mutual fund decisions, which may reduce long-term wealth creation. Therefore, improving investor awareness, risk communication, and behavioral guidance is essential for encouraging rational, disciplined, and goal-oriented mutual fund investment behavior.

Transparency Statement: The authors confirm that this study has been conducted with honesty and in full adherence to ethical guidelines.
Data Availability Statement: Authors can provide data.
Conflict of Interest: The authors declare there is no conflicts of interest.
Authors' Contributions: The authors jointly conducted all research activities i.e., concept, data collecting, drafting and final review of manuscript.

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