

Investor Sentiment and Mutual Fund Selection: A Behavioural Finance Analysis

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Abstract—The present study investigates the role of investor sentiment in mutual fund selection, highlighting its influence on decision-making, fund performance, and portfolio outcomes within the behavioural finance framework. Traditional finance models, including the Efficient Market Hypothesis, assume rational investor behaviour, yet empirical evidence demonstrates that psychological biases, emotions, and social dynamics frequently deviate decisions from purely analytical reasoning. This article examines the theoretical foundations of behavioural finance, exploring cognitive biases such as overconfidence, herding, loss aversion, and mental accounting, which shape fund selection and allocation. It further analyses the impact of emotions, market mood, media influence, and information asymmetry on investment timing and fund choice. The study underscores that investor sentiment not only drives fund flows but also affects long-term performance, highlighting the strategic implications for fund managers in mitigating volatility and enhancing portfolio stability. By integrating sentiment indicators, media analysis, and behavioural insights into investment frameworks, both individual and institutional investors can better anticipate market reactions, make informed fund selections, and achieve sustainable risk-adjusted returns. This analysis emphasises that recognising psychological and emotional drivers is critical for bridging the gap between classical rational models and the nuanced realities of mutual fund investment.

Index Terms—Investor Sentiment, Behavioural Finance, Mutual Fund Selection, Portfolio Performance

I. INTRODUCTION

Traditional financial theory has long assumed that investors are rational actors who make decisions based on complete information to maximise utility. The Efficient Market Hypothesis (EMH), a foundational principle of classical finance, posits that “financial

markets are efficient in reflecting information” and that asset prices fully incorporate all available data (Fama 383). Under this framework, mutual fund investors are expected to evaluate risk, return, and diversification analytically before making allocation decisions. However, empirical evidence increasingly challenges this assumption, revealing systematic deviations from rational behaviour that cannot be explained by classical models alone (Barberis and Thaler 1055). Such deviations have prompted the rise of behavioural finance, a discipline that integrates psychological and emotional factors into financial decision-making.

A central concept within behavioural finance is investor sentiment, defined as “the overall attitude of investors toward market conditions and expected future performance” (Baker and Wurgler 1227). Sentiment encapsulates optimism, pessimism, fear, and euphoria, influencing not only the timing of investments but also fund selection and asset allocation. Shiller observes that “market prices often move in ways inconsistent with purely rational expectations” (Shiller 31), highlighting that emotional and cognitive drivers play a critical role in financial markets. In mutual fund investment, sentiment can result in overconcentration in high-performing funds during bullish phases or mass withdrawals during pessimistic periods, reflecting the strong behavioural underpinnings of investor decisions.

Psychological biases such as overconfidence, herding, loss aversion, and mental accounting further shape investor behaviour in fund markets. Kahneman and Tversky note that “investors are systematically biased in their assessments, often overestimating their predictive abilities and underestimating risk” (Kahneman and Tversky 265). Such biases influence mutual fund selection by leading investors to chase

past performance, neglect diversification, or follow trends driven by peer behaviour rather than fundamentals. As Shefrin argues, “investors’ decisions are frequently guided by instinctive reactions and mental shortcuts rather than systematic analysis” (Shefrin 18), demonstrating that understanding cognitive tendencies is essential for analysing fund flows and investment outcomes.

The interplay of sentiment, emotions, and cognitive biases underscores the limitations of traditional rational models in explaining mutual fund investment behaviour. By incorporating behavioural insights, financial analysts and fund managers can better anticipate investor reactions, design more resilient portfolios, and improve long-term performance outcomes (Barberis and Thaler 1072). Recognising that “humans are not always the rational actors classical theories presume” (Shiller 45), this study seeks to examine the influence of investor sentiment on mutual fund selection, highlighting the theoretical foundations, psychological determinants, and practical implications for portfolio management.

Revisiting Rationality: The Emergence of Investor Sentiment in Financial Decision-Making

Traditional financial theory has long assumed that investors are rational decision-makers who analyse all available information to maximise their utility. The Efficient Market Hypothesis (EMH), a cornerstone of classical finance, asserts that “financial markets are efficient in reflecting information” and that prices always incorporate all relevant data (Fama 383). However, behavioural finance has challenged this premise, demonstrating that investor behaviour is frequently influenced by psychological and emotional factors that cause systematic deviations from rationality. As Barberis and Thaler argue, “investors often rely on heuristics, or mental shortcuts, which can lead to predictable errors in judgment” (Barberis and Thaler 1055). These insights have prompted a reconsideration of how financial decisions are made, particularly in contexts such as mutual fund investment where perceptions and emotions strongly affect choices.

One of the most influential concepts emerging from behavioural finance is investor sentiment, defined as “the overall attitude of investors toward market conditions and expected future performance” (Baker and Wurgler 1227). Rather than responding solely to

fundamental valuations, investor decisions often reflect optimism, pessimism, fear, or euphoria, leading to asset price fluctuations that classical theories cannot fully explain. Empirical research shows that markets can experience overvaluation during periods of excessive optimism and undervaluation during pessimistic downturns, demonstrating that “market prices often move in ways inconsistent with purely rational expectations” (Shiller 31). Such findings underscore the growing importance of psychological and emotional drivers in financial markets.

Investor sentiment can also be operationalised and measured through indices that capture bullishness, bearishness, or trading mood. For example, Baker and Wurgler note that “sentiment measures derived from surveys and trading data have predictive power over future stock returns” (Baker and Wurgler 1235). Positive sentiment typically encourages higher buying activity, whereas negative sentiment can trigger sell-offs, sometimes independent of the underlying economic fundamentals. These patterns illustrate how emotions and cognitive biases influence investor decisions, highlighting the limitations of traditional financial models that assume purely analytical behaviour.

In the specific context of mutual fund investment, sentiment plays a critical role in shaping fund selection, timing, and portfolio allocation. Investors swayed by optimism may chase high-performing funds, while pessimistic moods can prompt sudden withdrawals, producing market dynamics that deviate from rational expectations (Barberis and Thaler 1072). Recognising the influence of sentiment allows financial analysts and fund managers to better understand investor behaviour and develop strategies that account for both rational and psychological factors. As behavioural finance demonstrates, “humans are not always the rational actors classical theories presume,” and incorporating sentiment analysis is essential for more accurate, realistic models of investment decision-making (Shiller 45).

Behavioural Finance and Mutual Funds: Theoretical Foundations and Conceptual Framework

Behavioural finance integrates psychological insights with financial theory to explain why investors often deviate from traditional rational models. Classical finance assumes that investors act logically to maximise returns; however, empirical evidence shows

that biases, heuristics, and emotions frequently influence investment decisions (Barberis and Thaler 1053). As Shefrin observes, “investors are subject to cognitive illusions, overconfidence, and framing effects that affect how they interpret information” (Shefrin 12). These behavioural tendencies are particularly relevant in mutual fund markets, where decisions involve selecting among numerous funds with varying risk–return profiles, requiring judgement under uncertainty.

A core theoretical pillar in behavioural finance is the study of cognitive and emotional biases. Overconfidence, loss aversion, herding, and mental accounting are commonly observed phenomena that shape investor behaviour (Kahneman and Tversky 265). In mutual fund selection, overconfident investors may overestimate their ability to pick outperforming funds, while loss-averse individuals may avoid equity-based funds despite long-term growth potential. As Barberis and Thaler note, “systematic biases can lead to mispricing and inefficient allocation of capital, yet they also offer opportunities for informed investors and fund managers” (Barberis and Thaler 1070). Understanding these biases forms the foundation for designing frameworks that anticipate and mitigate irrational behaviour in fund investment.

The conceptual framework for analysing behavioural influences in mutual fund investment involves linking investor psychology with decision outcomes. Sentiment indicators, such as consumer confidence, fund inflows/outflows, and market mood indices, can act as proxies for investor optimism or pessimism (Baker and Wurgler 1235). This framework suggests that mutual fund flows are not driven solely by fundamentals like NAV or past returns but are also significantly shaped by investor perception and sentiment. Shiller emphasizes that “markets are influenced as much by human emotion as by economic fundamentals” (Shiller 31), underscoring the importance of incorporating behavioural variables into analytical models.

By integrating behavioural theory with mutual fund analysis, investors and fund managers can better understand market dynamics and improve portfolio strategies. Recognising biases, monitoring sentiment, and anticipating herd behaviour allows for more informed decision-making and risk management. As Shefrin concludes, “behavioural finance provides a

more realistic and human-centred approach to understanding financial markets, particularly in complex instruments such as mutual funds” (Shefrin 45). Consequently, this theoretical and conceptual framework serves as a critical tool for bridging the gap between classical financial assumptions and the nuanced realities of investor behaviour.

Psychological Biases Influencing Mutual Fund Selection

Investor behaviour in mutual fund selection is often shaped by psychological biases that diverge from traditional rational decision-making. Cognitive biases, emotional responses, and heuristics significantly influence the choice of funds, impacting both risk assessment and portfolio allocation (Kahneman and Tversky 274). As Shefrin observes, “investors’ decisions are frequently guided by instinctive reactions and mental shortcuts rather than systematic analysis” (Shefrin 18). Such tendencies challenge the assumption that investors always act in a utility-maximising manner, revealing the complex interplay between psychology and financial decision-making. Overconfidence is one of the most widely documented biases affecting mutual fund investors. Overconfident individuals tend to overestimate their knowledge and predictive abilities, often believing they can identify outperforming funds despite limited expertise (Barberis and Thaler 1061). This bias can lead to excessive trading, frequent fund switching, and underestimation of market risks. Shefrin notes, “overconfidence may inflate expectations of returns and diminish the perceived need for diversification, exposing investors to avoidable losses” (Shefrin 23). Recognising and mitigating overconfidence is therefore essential for prudent mutual fund investment strategies.

Herding behaviour and loss aversion also play pivotal roles in fund selection. Herding occurs when investors follow the actions of peers or market trends rather than conducting independent analysis, often exacerbating price fluctuations and market volatility (Baker and Wurgler 1240). Loss-averse investors, conversely, demonstrate a stronger preference to avoid losses than to achieve gains, which can lead to overly conservative fund choices or premature redemptions (Kahneman and Tversky 275). Shiller highlights that “markets are not solely guided by fundamentals but are profoundly shaped by collective emotion and fear” (Shiller 33),

emphasising the impact of these biases on investment behaviour.

Investors often segregate their investments into separate mental categories, treating gains and losses differently across funds rather than evaluating the overall portfolio objectively (Thaler 47). Anchoring, meanwhile, causes individuals to rely heavily on initial information—such as past fund performance or target NAV—when making future investment decisions (Barberis and Thaler 1068). Understanding these psychological tendencies enables both investors and fund managers to design strategies that account for irrational behaviour, fostering better risk management and more informed fund selection.

Role of Emotions and Market Mood in Investment Timing and Fund Choice

Emotions play a critical role in influencing investment timing and mutual fund selection, often overriding rational decision-making models. Investors' emotional responses to market fluctuations—such as fear during downturns or euphoria during bull runs—can trigger impulsive investment actions, leading to suboptimal fund choices (Lo 45). As Shiller notes, “investor psychology and social mood can amplify market cycles far beyond what fundamentals would suggest” (Shiller 56). Emotional decision-making can result in buying high during optimistic peaks and selling low during pessimistic troughs, highlighting the significance of understanding affective influences on fund selection.

Fear and greed, two dominant emotional drivers, significantly shape mutual fund investment behaviour. Fear often leads to defensive strategies, including withdrawing from equity-oriented funds or shifting towards low-risk debt instruments, particularly during periods of market volatility (Shefrin 89). Conversely, greed can encourage overexposure to high-risk funds with the expectation of outsized returns, despite the potential for significant losses (Barberis and Thaler 1065). Lo asserts that “emotions are inseparable from financial decision-making and can systematically bias timing and allocation choices” (Lo 46), demonstrating that emotional awareness is critical for mitigating reactive investment behaviour.

Market mood or collective investor sentiment further affects fund choice and timing. Positive sentiment—characterised by optimism and confidence—can drive a surge in inflows to growth or equity funds, whereas

negative sentiment often results in a flight to safety, favouring conservative or money market funds (Baker and Wurgler 1235). Herd behaviour is closely intertwined with market mood, as investors tend to mimic the prevailing trend, amplifying asset price movements and creating momentum effects (Shiller 61). Recognising the role of market mood allows investors and fund managers to anticipate periods of overreaction and strategically position portfolios.

Tools such as sentiment indices, behavioural tracking, and investor surveys help identify prevailing market moods and emotional drivers influencing fund flows (Barberis and Thaler 1070). Coupled with disciplined investment principles, these approaches enable investors to avoid impulsive reactions and make more informed choices regarding fund selection and timing. As Shefrin emphasises, “successful investing requires not only analytical skill but also the capacity to manage emotions and understand psychological drivers of market behaviour” (Shefrin 92), reinforcing the interconnection between affective factors and financial outcomes.

Information Asymmetry, Media Influence, and Herd Behaviour among Mutual Fund Investors

Information asymmetry, a situation where some investors have more or better information than others, plays a pivotal role in mutual fund investment decisions. When investors lack access to timely or accurate information regarding fund performance, portfolio composition, or market trends, they may rely on perceived signals from other market participants or media reports, often resulting in suboptimal choices (Akerlof 488). As Stiglitz observes, “asymmetric information creates incentives for agents to act on incomplete knowledge, often amplifying market inefficiencies” (Stiglitz 355). This imbalance contributes to reactive investment behaviour, highlighting the importance of transparency and effective information dissemination in mutual fund markets.

Media influence significantly shapes investor perceptions and, consequently, fund selection decisions. News coverage, analyst reports, social media commentary, and financial blogs can create narratives that disproportionately affect investor sentiment, irrespective of fundamental data (Tetlock 957). For instance, a positive media portrayal of a particular equity fund may lead to increased inflows,

while negative coverage can trigger panic redemptions (Shiller 112). As Tetlock notes, “media content can drive short-term market fluctuations by altering collective beliefs about risk and opportunity” (Tetlock 958). Such influence underscores the interplay between external information sources and investor behaviour in shaping fund flows.

Herd behaviour emerges when investors mimic the actions of others, often as a response to uncertainty or perceived expertise. In mutual fund markets, herding can manifest as mass inflows into popular funds or mass withdrawals during market downturns, driven less by individual analysis and more by observing peers (Bikhchandani, Hirshleifer, and Welch 999). Shiller emphasises that “herding is not merely irrational copying; it reflects the social dynamics of belief formation and risk perception under uncertainty” (Shiller 119). This collective behaviour can exaggerate price movements, create market inefficiencies, and increase volatility, demonstrating that investor psychology extends beyond individual biases to socially influenced patterns.

Mitigating the effects of information asymmetry, media influence, and herding requires a combination of education, regulation, and analytical discipline. Transparency in fund reporting, investor awareness programmes, and critical assessment of media sources enable investors to make informed choices and reduce reliance on herd cues (Statman 123). Additionally, incorporating behavioural insights into investment frameworks can help fund managers anticipate herd-driven flows and design strategies to buffer against extreme market reactions. As Bikhchandani et al. argue, “understanding social and informational dynamics is essential for both investors and policymakers to ensure more stable and efficient markets” (Bikhchandani, Hirshleifer, and Welch 1005). Recognising these interconnected influences underscores the necessity of integrating behavioural finance principles into mutual fund investment decision-making.

Impact of Investor Sentiment on Mutual Fund Performance and Portfolio Outcomes

Investor sentiment, defined as the overall attitude of market participants toward risk and investment opportunities, has a profound effect on mutual fund performance and portfolio outcomes. Positive sentiment can lead to increased inflows into popular

funds, driving up asset prices and sometimes creating temporary overvaluation, while negative sentiment can trigger mass redemptions and depress fund valuations (Baker and Wurgler 1201). As Baker and Wurgler assert, “investor sentiment influences asset prices not only in the short term but also shapes portfolio rebalancing and fund flow decisions” (1203). This sentiment-driven behaviour can amplify volatility and affect long-term performance, highlighting the need for fund managers to account for psychological factors in strategic decision-making.

The interaction between investor sentiment and mutual fund performance is particularly evident in equity-focused funds. High optimism often results in overinvestment in growth-oriented funds, inflating market multiples and potentially reducing subsequent returns (Barberis, Shleifer, and Vishny 1141). Conversely, pessimistic sentiment can lead to excessive selling, creating buying opportunities for contrarian investors. As De Bondt and Thaler note, “market overreactions driven by collective sentiment generate predictable patterns in returns that can be exploited through disciplined investment strategies” (De Bondt and Thaler 797). Therefore, sentiment not only affects fund inflows but also the realised portfolio outcomes, influencing risk-adjusted returns for both individual and institutional investors.

Investor sentiment also interacts with fund manager behaviour and strategic fund allocation. Funds experiencing heavy inflows during periods of high optimism may face liquidity constraints or be forced to adjust asset holdings to accommodate new investments, which can affect fund performance (Gao, Lin, and Zhang 45). Similarly, during pessimistic periods, forced redemptions may compel managers to liquidate holdings at suboptimal prices. Shleifer and Summers emphasise that “sentiment-induced flows can create persistent performance effects, with funds benefiting from positive sentiment often underperforming after initial inflows subside” (Shleifer and Summers 1166). This demonstrates that sentiment is a double-edged sword, influencing both the timing of investments and long-term portfolio results.

Understanding the impact of investor sentiment is essential for both investors and fund managers seeking to optimise portfolio outcomes. Incorporating behavioural insights into investment strategies, such as contrarian approaches or sentiment-adjusted

allocation models, can mitigate the adverse effects of herd behaviour and irrational exuberance (Statman 89). Additionally, monitoring sentiment indicators—such as fund flows, media coverage, and market surveys—enables investors to anticipate potential overreactions and make informed decisions. As Kahneman observes, “investment decisions are often swayed by intuitive judgment and prevailing moods, rather than by rigorous analysis” (Kahneman 42). Recognising and strategically responding to investor sentiment thus enhances the likelihood of achieving stable, long-term portfolio performance.

II. CONCLUSION

The analysis of investor sentiment in mutual fund investment reveals a fundamental shift in understanding financial decision-making beyond traditional rational models. While classical finance emphasises utility maximisation and information efficiency, behavioural finance demonstrates that psychological biases, emotions, and social influences profoundly shape investment choices. Investor sentiment, encompassing optimism, pessimism, and prevailing market moods, drives fund selection, inflows, and withdrawals, often creating deviations from fundamental valuations (Baker and Wurgler 1201). Recognising these factors is essential for both investors and fund managers seeking to navigate complex and emotionally driven market environments.

Overconfidence, herding, loss aversion, and other cognitive biases significantly influence investor behaviour, often leading to misallocation of capital or excessive trading (Barberis and Thaler 1061). Emotional responses such as fear and greed further exacerbate reactive fund decisions, highlighting the interplay between affective states and investment timing (Lo 46). Media narratives and information asymmetry amplify these effects, as investors rely on external signals in the absence of complete data (Tetlock 958). Understanding these behavioural patterns enables more effective risk management and informed fund selection strategies.

Investor sentiment not only affects short-term fund flows but also long-term portfolio performance and returns. Positive sentiment can create temporary overvaluation and liquidity pressures, while negative sentiment may force suboptimal liquidation of assets

(Shleifer and Summers 1166). By integrating sentiment indicators, behavioural analysis, and contrarian strategies, fund managers can anticipate market overreactions, stabilise portfolios, and enhance risk-adjusted performance. The study underscores that sentiment is a critical driver of mutual fund dynamics and cannot be ignored in contemporary investment practice.

In conclusion, incorporating behavioural insights into mutual fund investment provides a more realistic and human-centred approach to understanding markets. By recognising the influence of psychological biases, emotions, and social dynamics, investors can develop strategies that balance rational analysis with behavioural awareness (Shefrin 92). Conscious consideration of investor sentiment allows for improved fund selection, timing, and portfolio outcomes, bridging the gap between classical theory and real-world market behaviour. Ultimately, understanding and strategically responding to investor sentiment enhances the potential for sustainable, long-term investment success.

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