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Behavioral Biases and Investment Decision-Making in Emerging Markets: A Moderated Mediation Model of Risk Tolerance and Financial Literacy

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Abstract

The study aims to examine the influence of behavioral biases on individual investors' decisions, and it further assess the mediating role of risk tolerance and the moderating effect of financial literacy. Drawing on behavioral finance theory, six key biases, namely overconfidence, risk aversion, herding, disposition effect, representativeness, and anchoring, were taken. Analyzing data obtained from a structured questionnaire survey among 385 individual investors in Nepal Stock Exchange, the study revealed that overconfidence, risk aversion, representativeness, and anchoring significantly affect investment decisions, whereas herding and disposition biases do not. Contrary to expectations, neither risk tolerance nor financial literacy showed significant mediating or moderating effects, indicating their limited influence in relationship between behavioral biases and investment decision. The study concludes that cognitive biases remain powerful drivers of investment choices, particularly within emerging market contexts. The findings highlight the need for policymakers to design investor education programs that directly address specific behavioral biases.

Keywords: Behavioral biases, financial literacy, individual investors, investment decision, Nepal Stock Exchange, risk tolerance

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Introduction

Investment decision-making is a critical component of personal financial management and plays a broader role in economic growth by influencing the allocation of capital within financial markets. Traditional finance theories, rooted in the Efficient Market Hypothesis (Fama, 1970), assume that investors act rationally, processing all available information to maximize utility. However, this assumption has been persistently challenged by a substantial body of behavioral finance research demonstrating that cognitive biases and emotional heuristics systematically distort investor judgment and produce deviations from normative rationality (Kahneman & Tversky, 1979; Shefrin & Statman, 1985; Barberis, 2013).

The studies on behavioral biases and their effect on investment decision-making are largely concentrated around themes like overconfidence, regret aversion, disposition effect, representativeness, anchoring, and herding (Dhingra et al., 2024; Safaie et al., 2024). Overconfidence can drive excessive trading, regret aversion may lead investors to avoid high-risk opportunities, the disposition effect encourages selling winners too soon while holding onto losers too long, representativeness can lead to erroneous probability judgments based on past experiences, anchoring results in overreliance on initial information, and herding can fuel market bubbles or crashes. While the directional effects of these biases on investor behavior are broadly well-documented, their relative magnitudes and boundary conditions remain contested across contexts. However, there is a disproportional effect of various types of biases. For example, Thakkar et al. (2025) found that heuristic behaviors influence more than prospects and personality factors in investing decision-making. Crucially, these studies predominantly examine behavioral biases in isolation, offering limited theoretical insight into how internal psychological constructs condition the relationship between bias and investment decision.

In addition to psychological factors, existing literature highlights the role of financial literacy and risk tolerance in investment decisions and outcomes (Bajtelsmit & Coats, 2023). Financial literacy is broadly defined as the competence to critically understand and apply financial knowledge, which can impair cognitive biases and improve investment decision quality (Khan et al., 2023). Risk tolerance, reflecting an investor's willingness to bear return variability, similarly shapes how biases translate into actual investment choices (Mahmood et al., 2024). Research suggests that risk tolerance acts as a psychological buffer, influencing how behavioral biases affect investment choices (Mahmood et al., 2024). However, the precise theoretical roles of these constructs, whether as formal mediators, moderators, or boundary conditions of the bias–behavior relationship, remain largely ambiguous and empirically underexplored, limiting the development of coherent and testable theoretical models of investor behavior.

Against this backdrop, three critical gaps persist in the extant literature. First, the pathway through which behavioral biases translate into investment choices via risk tolerance remains largely unexamined as a formal mediation mechanism. Second, the boundary-setting role of financial literacy in moderating the bias–investment behavior relationship is theoretically

underdeveloped and empirically sparse. Third, integrative empirical models from frontier and emerging capital markets, where investor profiles, institutional structures, and regulatory environments differ markedly from those of developed markets, remain disproportionately limited. Nepal Stock Exchange (NEPSE), established in 1993 and regulated by the Securities Board of Nepal (SEBON), exemplifies this gap, operating as a frontier market with low institutional participation and a predominantly retail investor base vulnerable to behavioral distortions. Post-pandemic investor surge has raised concerns over herd-driven speculation, yet systematic behavioral finance evidence from Nepal remains scarce. Financial literacy in Nepal is comparatively low, amplifying cognitive vulnerabilities (World Bank, 2025).

Addressing this gap, the present study aims to examine the impact of key behavioral biases on investment choices while analyzing the mediating role of risk tolerance and the moderating effect of financial literacy. By focusing on individual investors in the NEPSE, who rely largely on informal networks rather than fundamental analysis, the study addresses an important empirical void in South Asian behavioral finance research and offers practical insights for improving investor decision-making and policy interventions.

Literature Review

Behavioral Biases and Investment Decision-Making

Grounded in Prospect Theory (Kahneman & Tversky, 1979) and the broader behavioral finance tradition (Thaler, 1985; Shiller, 2000), a well-established body of literature demonstrates that cognitive biases and emotional heuristics systematically divert investors from utility-maximizing behavior. Among the many biases studied, overconfidence, risk aversion, herding, disposition effect, representativeness, and anchoring have consistently been identified as major influencers on investment decision-making (Baker et al., 2018; Ahmad & Shah, 2020).

Various studies reinforce the findings that support the arguments of behavioral finance. Madaan and Singh (2019) identified overconfidence and herding as significant predictors of investment behavior among Indian investors, noting that psychological predispositions often override rational analysis. Similarly, Safaie et al. (2024), through a structural equation model, revealed that loss aversion, regret aversion, anchoring, and shifting risk preference were the most dominant and interlinked biases among investors in the Tehran Stock Exchange. The interconnectedness of these biases indicates a compounded effect on investment choices, where the presence of one bias can intensify others. Adding a broader perspective, Dhingra et al. (2024) conducted a bibliometric visualization of 518 scholarly articles and found that the influence of behavioral biases on investment decisions remains the most dominant research theme in the field. However, they also noted that research is disproportionately focused on equity markets, with limited attention to other asset classes such as bonds, real estate, or mutual funds. This indicates both the robustness of behavioral finance findings and the need for further diversification in research focus.

Risk aversion significantly impacts investment decisions as investors tend to prioritize loss avoidance over potential gains, thereby favoring conservative investment strategies

(Sharma et al., 2024). Likewise, disposition bias influences financial decisions by causing investors to prematurely sell profitable assets while retaining loss-making investments due to emotional regret avoidance (Zahera & Bansal, 2018). Similarly, representativeness bias impacts investment decisions as investors tend to evaluate outcomes based on stereotypes or recent patterns rather than objective probability assessments (Shah et al., 2018). Furthermore, anchoring bias affects decisions by causing investors to rely heavily on initial reference points or prior price information when evaluating financial assets (Sharma et al., 2024).

Kanapickienė et al. (2024) cross-contextually confirmed that these biases influence both asset pricing and individual trading behavior, with their relative magnitude varying across market settings. Importantly, Thakkar et al. (2025) found that heuristic biases, which correspond to the cognitive-processing cluster identified above, show stronger directional influence on investment decisions than prospect-related or personality-driven biases, suggesting that the mechanisms driving these two clusters warrant disaggregated empirical investigation rather than pooled modeling. Given the strong theoretical and empirical backing, it is hypothesized that each of these behavioral biases has a significant impact on individual investment decisions.

H1: Overconfidence has a significant impact on investment decisions.

H2: Risk Aversion has a significant impact on investment decisions.

H3: Herding has a significant impact on investment decisions.

H4: Disposition has a significant impact on investment decisions.

H5: Representativeness has a significant impact on investment decisions.

H6: Anchoring has a significant impact on investment decisions.

Role of Risk Tolerance

Risk tolerance, defined as an individual's willingness to endure variability in investment returns, is widely recognized as a central construct in behavioral finance that shapes both investment preferences and decision-making behavior. Grable (2008) conceptualized risk tolerance as a foundational determinant of individual investment strategy, influencing the extent to which investors engage in risky financial choices. Empirical evidence further suggests that investors with lower risk tolerance tend to exhibit stronger aversion to uncertainty and prefer low-volatility financial instruments over equity-based investments (Islam et al., 2024). For instance, Shaji and Uma (2023), in their study of IT professionals in Bangalore, found that highly risk-averse investors consistently avoided equity markets and favored safer financial instruments, often driven by loss aversion and psychological discomfort with uncertainty.

Risk tolerance is further understood as a dynamic psychological mechanism rather than a stable trait, as it may fluctuate under conditions of market uncertainty and financial stress, thereby affecting the consistency of investor behavior (Safaie et al., 2024). This dynamic nature provides a theoretical basis for its mediating role in behavioral finance models, wherein cognitive biases influence investment outcomes through variations in individual risk-bearing capacity.

Moreover, other studies demonstrate that shifting risk preferences can alter under conditions of stress or market volatility, further complicating the predictive power of traditional risk profiles (Safaie et al., 2024). Raheja and Dhiman (2019) showed that risk tolerance significantly mediates the relationship between overconfidence and investment decisions. In particular, investors with high risk tolerance are more likely to act on their overconfident beliefs. However, the mediating role is less consistent for herding bias, indicating variation in its influence. Likewise, Soraya et al. (2023) observed that risk tolerance significantly mediates overconfidence and representativeness, but not herding behavior. Taken together, the literature indicates that risk tolerance functions as a critical psychological conduit linking cognitive biases with investment behavior, although its mediating strength may vary across different behavioral dimensions. Accordingly, this study proposes the following hypotheses:

H7: Risk tolerance has a significant impact on investment decisions.

H8: Risk tolerance mediates the relationship between overconfidence and investment decisions.

H9: Risk tolerance mediates the relationship between risk aversion and investment decisions.

H10: Risk tolerance mediates the relationship between herding and investment decisions.

H11: Risk tolerance mediates the relationship between disposition and investment decisions.

H12: Risk tolerance mediates the relationship between representativeness and investment decisions.

H13: Risk tolerance mediates the relationship between anchoring and investment decisions.

Role of Financial Literacy

Financial literacy is increasingly recognized as a crucial moderating factor in investment behavior, particularly in mitigating the effects of cognitive biases. It enhances individuals' ability to evaluate financial risks, understand market mechanisms, and apply rational judgment in investment contexts (Thapa & Paudel, 2025). Prior research suggests that financially literate investors are better equipped to identify inconsistencies in their own cognitive judgments, thereby reducing the influence of systematic biases on risk perception and investment behavior (Adil et al., 2022; Rehmat et al., 2023). Mitra and Bhanawat (2025) demonstrated that structured financial education programs reduce the intensity of overconfidence and herding biases among Indo-Arabian investors, confirming financial literacy as an active attenuating force. Adil et al. (2021) found that financial literacy moderated the relationship between overconfidence and investment decisions, especially among male investors, while for female investors, it also significantly moderated the effects of risk aversion, herding, and disposition bias.

Similarly, Rehmat et al. (2023) confirmed that financial literacy helps investors better assess and manage risks, thereby reducing the distortive influence of behavioral biases. Ahuja and Kumar (2025), in a qualitative study on Indian millennials, revealed that despite being relatively well-educated and digitally literate, investors still demonstrated susceptibility to emotional triggers and cognitive biases during equity investment decisions.

Studies focusing on the Nepalese context further reinforce this perspective. Poudel et al. (2024) and Khan et al. (2023) highlighted that financial literacy negatively moderates the influence of common biases such as overconfidence, herding, and risk aversion on investment choices. Subedi and Bhandari (2024) and Nepal et al. (2023) affirm that low financial literacy in Nepal systematically amplifies the distortive influence of emotional biases on investor behavior, while Dangol and Shakya (2017) established that higher financial literacy correlates with more differentiated and information-driven investment strategies. Specifically, higher levels of financial literacy are likely to weaken the adverse effects of biases such as overconfidence, risk aversion, herding, disposition, representativeness, and anchoring by promoting more analytical and informed decision-making.

Conversely, lower levels of financial literacy may intensify the impact of these biases, as limited financial understanding increases reliance on heuristics, emotional responses, and socially driven investment behavior. Collectively, these findings position financial literacy as a theoretically grounded and empirically motivated moderator of the bias, risk tolerance pathway in the Nepalese investor context, a relationship whose testing constitutes one of the primary theoretical contributions of this study. Drawing from prior studies, financial literacy is anticipated to moderate the relationship between behavioral biases and risk tolerance, which leads to the formulation of the following hypotheses:

H14: Financial literacy moderates the relationship between overconfidence and risk tolerance.

H15: Financial literacy moderates the relationship between risk aversion and risk tolerance.

H16: Financial literacy moderates the relationship between herding and risk tolerance.

H17: Financial literacy moderates the relationship between disposition and risk tolerance.

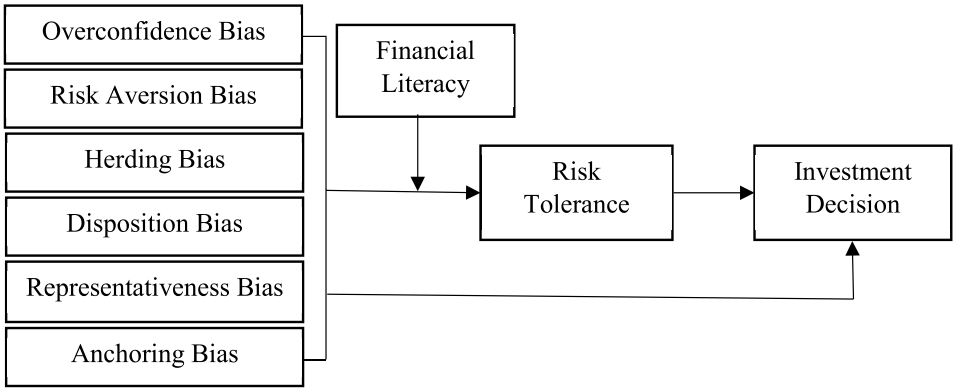
H18: Financial literacy moderates the relationship between representativeness and risk tolerance.

H19: Financial literacy moderates the relationship between anchoring and risk tolerance.

The conceptual framework, grounded in Behavioral Finance Theory, illustrates how specific behavioral biases such as overconfidence, risk aversion, herding, disposition effect, representativeness, and anchoring influence investment decisions among individual investors. Risk tolerance is incorporated as a mediating construct to explain the psychological mechanism through which these biases translate into investment behavior. Financial literacy is introduced as a moderating variable that conditions the strength of the relationship between behavioral biases and risk tolerance. Together, these theoretically grounded relationships form an integrated moderated-mediation framework that enables the simultaneous examination of direct, mediated, and moderated pathways, as shown in Figure 1.

Figure 1

Conceptual Framework



Research Methods

This study adopts explanatory research designs to capture patterns of investor behavior and examine the relationships among the variables. The research targets individual investors actively engaged in trading within the NEPSE. A total of 385 investors were surveyed using a purposive sampling technique. Purposive sampling was guided by pre-defined inclusion and exclusion criteria to ensure the sample was both relevant and representative of the target population. Inclusion criteria required participants to: (i) be individual retail investors holding a valid DMAT account; and (ii) have executed at least one buy or sell transaction on NEPSE within the preceding 12 months. Investors were excluded if they were institutional investors, fund managers, or licensed market intermediaries. The minimum sample size was determined using Cochran's (1997) formula to ensure adequate representation and statistical power.

Data were collected through a structured questionnaire, distributed in both online and offline formats to enhance outreach and inclusion. Eligible respondents were reached through multiple channels to maximize diversity and response rates. Offline access was facilitated through direct visits to registered brokerage houses in Kathmandu, where investors were approached during active trading sessions. Online respondents were reached via NEPSE-affiliated investor communities, Facebook groups dedicated to Nepalese stock market discussions. The questionnaire consisted of items measuring demographic characteristics, behavioral biases (overconfidence- 5 items, risk aversion – 5 items, herding – 5 items, disposition effect – 5 items, representativeness – 5 items, and anchoring- 4 items), risk tolerance – 5 items, financial literacy- 5 items, and investment decisions – 5 items. These items were adapted from Adil et al. (2021), Jain et al. (2001), and Grable and Joo (2004). All constructs were measured using a five-point Likert scale ranging from 1 (strongly disagree) to 5 (strongly agree).

The instrument was pre-tested with 30 respondents to refine clarity and reliability, and expert reviews were conducted to ensure content validity. Linguistically, seven items with technical financial terminology were simplified or paraphrased to ensure comprehension among Nepalese retail investors with varying financial literacy levels; three items were translated into Nepali and back-translated to verify semantic equivalence. Statistically, four items that yielded item-total correlation values below the .30 threshold during pre-testing were removed. Cronbach's alpha values for each construct exceeded the .70 threshold, confirming internal consistency.

After data cleaning, descriptive statistics such as means, frequencies, and standard deviations were analyzed using SPSS version 30 to summarize the demographic profile and overall trends. To test the hypothesized relationships among the variables, Structural Equation Modeling (SEM) was conducted using SmartPLS version 4.1. This variance-based approach is well-suited for exploring complex models and is particularly effective for smaller sample sizes. The analysis followed a two-step procedure. First, the measurement model was assessed through composite reliability, average variance extracted (AVE), and discriminant validity using the Fornell-Larcker criterion, Heterotrait-Monotrait (HTMT) ratios, and cross-loadings. Second, the structural model was evaluated by estimating path coefficients and significance levels using a bootstrapping procedure. The indirect effects of risk tolerance were assessed through bias-corrected bootstrapping with 10,000 subsamples to test the proposed mediation pathways (H8–H13), and the moderating effects of financial literacy were examined by introducing product-indicator interaction terms into the structural model (H14–H19), following the two-stage interaction approach recommended by Hair et al. (2022).

Consistent with the theoretical framework underpinning this study, the six behavioral biases (i.e., overconfidence, risk aversion, herding, disposition effect, representativeness, and anchoring) are conceptualized as distinct first-order reflective constructs rather than as dimensions of a single higher-order behavioral bias construct. Although these biases belong to the broader domain of deviations from rational investor behavior, they are theoretically and functionally distinct, arising from different cognitive and emotional mechanisms, influencing risk tolerance through diverse pathways (Hair et al., 2022).

Results and Analysis

Respondents Profile

Table 1 presents the demographic characteristics of the 385 respondents who participated in the study, covering aspects such as gender, age group, educational qualifications, and investment experience. The socio-demographic profile reveals that the majority of respondents are male (54.5%) and are between 25 and 34 years old (44.7%). Furthermore, most respondents hold a Bachelor's degree (47.8%) and have between 1 and 3 years of investment experience (30.6%). These findings suggest that the investor sample is largely composed of young, well-educated individuals with moderate investment experience.

Table 1

Socio-Demographic Profile of Respondents

Factors	Demographic Variables	Frequencies	Percentage (%)
Gender	Male	210	54.5
	Female	174	45.2
	Prefer not to say	1	0.3
Age Group	18-24	96	24.9
	25-34	172	44.7
	35-44	65	16.9
	45 and above	52	13.5
Academic Qualifications	SLC/SEE	14	3.6
	Intermediate (+2)	55	14.3
	Bachelor's level	184	47.8
	Master's level and above	132	34.3
Investment Experience	0-1 year	90	23.4
	1- 3 years	118	30.6
	3- 5 years	94	24.4
	5 years and above	83	21.6

Note. Survey data, 2025

Descriptive Analysis

The descriptive statistics indicate that all latent variables are measured on a 5-point scale, with observed minimum and maximum values ranging from 1 to 5. The mean scores suggest that respondents exhibit relatively higher levels of risk aversion, financial literacy, and representativeness (M = 3.626), whereas risk tolerance and herding behavior are comparatively lower. This implies that investors in the sample tend to be more risk-averse and moderately financially literate, while showing lower inclination toward risk-taking and herding tendencies. Likewise, the skewness values for most variables are negative, indicating a left-skewed distribution where responses are concentrated toward the higher end of the scale, and Kurtosis values fall within an acceptable range (approximately ±2), indicating no severe deviation from normality.

Table 2

Descriptive Statistics

Latent Variables	Minimum	Maximum	Mean	SD	Skewness	Kurtosis
Overconfidence	1	5	3.296	1.012	-.349	-.733
Risk Aversion	1	5	3.703	1.154	-.923	1.378
Herding	1	5	2.950	0.987	-.136	-1.101
Disposition	1	5	3.574	1.701	-.539	-.236
Representativeness	1	5	3.626	1.510	-1.014	1.454
Anchoring	1	5	3.371	1.092	-.612	-.099
Financial Literacy	1	5	3.644	1.084	-.761	.528
Risk Tolerance	1	5	2.744	.870	.272	-.789
Investment Decision	1	5	3.575	1.029	-.862	.925

Note. Survey data, 2025

Measurement Model

This model ensures that the selected indicators accurately represent the intended constructs, facilitating the assessment of reliability and validity and enhancing the overall credibility and robustness of the research findings, as illustrated by the measurement model presented in Figure 2.

Table 3 presents the results of the measurement model assessment, including indicator reliability, internal consistency reliability, convergent validity, and collinearity diagnostics. The outer loadings of all indicators exceeded the acceptable threshold of .50, while Cronbach's alpha and composite reliability values were above the recommended value of .60, confirming satisfactory internal consistency (Hair et al., 2019). Furthermore, the AVE values ranged from .501 to .728, exceeding the minimum threshold of .50 and thereby establishing convergent validity. The VIF values for all indicators were below the recommended threshold of 3.3, indicating the absence of multicollinearity concerns (Diamantopoulos & Siguaw, 2006). Thus, the measurement model demonstrated adequate reliability and validity.

Figure 2

Measurement Model

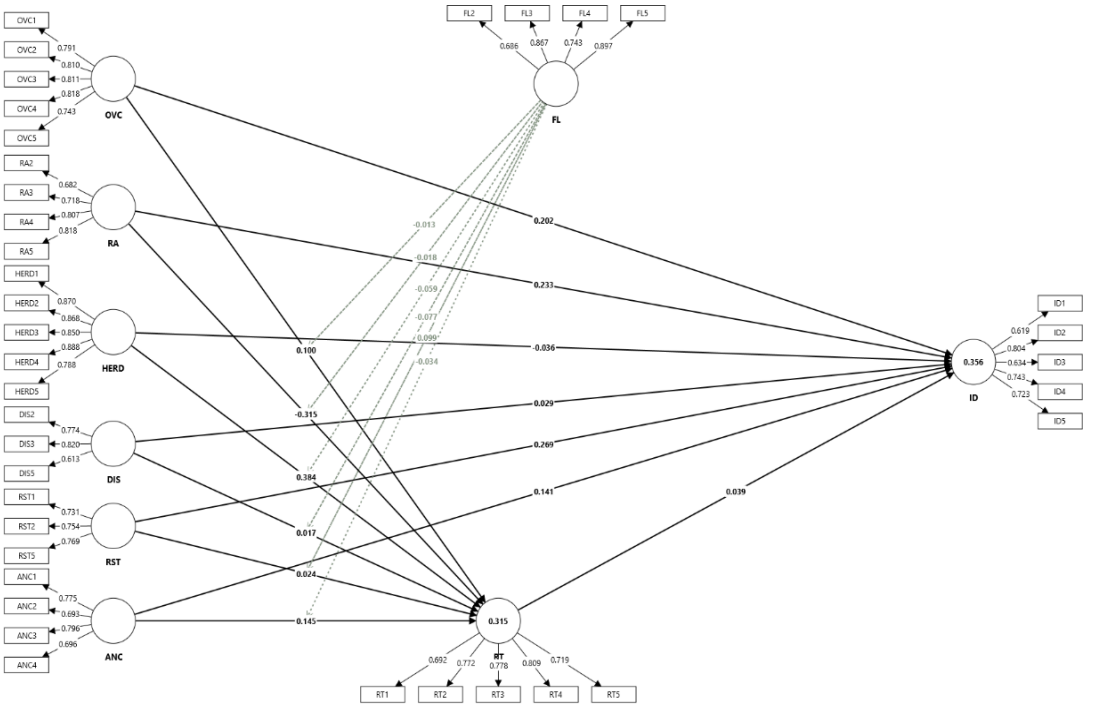


Table 3
Construct Reliability and Validity

Factors and Items	VIF	Loadings	Cronbach's alpha	CR (rho_a)	CR (rho_c)	AVE
Overconfidence						
OVC1	1.890	.791	.855	.863	.896	.632
OVC2	2.013	.810				
OVC3	1.870	.811				
OVC4	2.034	.818				
OVC5	1.835	.743				
Risk Aversion						
RA2	1.256	.682	.752	.761	.843	.575
RA3	1.395	.718				
RA4	1.608	.807				
RA5	1.695	.818				

Herding						
HERD1	2.962	.870	.906	.908	.930	.728
HERD2	3.181	.868				
HERD3	2.425	.850				
HERD4	2.969	.888				
HERD5	1.842	.788				
Disposition						
DIS2	1.212	.774	.612	.646	.783	.549
DIS3	1.209	.820				
DIS5	1.222	.613				
Representativeness						
RST1	1.222	.731	.619	.621	.796	.565
RST2	1.342	.754				
RST5	1.191	.769				
Anchoring						
ANC1	1.324	.775	.730	.749	.829	.549
ANC2	1.335	.693				
ANC3	1.535	.796				
ANC4	1.378	.696				
Financial Literacy						
FL2	1.667	.686	.821	.968	.878	.645
FL3	2.82	.867				
FL4	2.131	.743				
FL5	1.879	.897				
Risk Tolerance						
RT1	1.495	.692	.812	.823	.869	.571
RT2	1.602	.772				
RT3	1.777	.778				
RT4	1.762	.809				
RT5	1.570	.719				
Investment Decision						
ID1	1.333	.619	.751	.770	.833	.501
ID2	1.632	.804				
ID3	1.355	.634				
ID4	1.418	.743				
ID5	1.443	.723				

Note. Survey data, 2025

To ensure discriminant validity, the Fornell-Larcker criterion, HTMT, and cross-loadings values were examined, as suggested by Franke and Sarstedt (2019) and Hair et al. (2019). Table 4 presents the correlations between all variables, with the diagonal values indicating the square roots of the AVE for each construct. The highlighted values correspond to the square roots of the AVE for overconfidence, risk aversion, herding, disposition, representativeness, anchoring, risk tolerance, financial literacy, and investment decisions. These square roots exceed the corresponding correlation values, meeting the criteria established by Fornell and Larcker (1981) for discriminant validity.

This result is further confirmed by HTMT ratios. The value of the HTMT ratio should be less than .85 for discriminant validity to be established (Hiar et al., 2019). From Table 5, it is evident that the HTMT ratio values for each variable with respect to the others are all less than .85. This indicates that there are significant differences between constructs. Therefore, it can be concluded that the measurement model utilized in this research meets the criterion for discriminant validity.

Furthermore, it is important to satisfy cross-loading principles, which state that an item should exhibit the strongest association with the construct it is intended to measure rather than with other constructs (Farrell, 2009). The findings revealed that all the items belonging to a particular construct loaded strongly into its own parent construct instead of other constructs. Therefore, the current study does not have any discriminant validity issues.

Table 4

Discriminant Validity - Fornell-Larcker Criterion

Factors	ANC	DIS	FL	HERD	ID	OVC	RA	RST	RT
ANC	**.741**								
DIS	.224	**.741**							
FL	-.098	.014	**.803**						
HERD	.331	-.02	-.041	**.853**					
ID	.349	.342	-.008	.085	**.708**				
OVC	.17	.207	-.064	.182	.332	**.795**			
RA	.281	.513	.036	-.104	.46	.286	**.758**		
RST	.388	.458	.014	.161	.465	.133	.453	**.751**	
RT	.221	-.091	-.03	.478	.016	.103	-.264	.026	**.755**

Note. Survey data, 2025

Table 5

Heterotrait-Monotrait Ratio (HTMT)

Factors	ANC	DIS	FL	HERD	ID	OVC	RA	RST	RT
ANC									
DIS	.398								
FL	.119	.088							
HERD	.380	.165	.061						
ID	.464	.453	.141	.166					
OVC	.219	.333	.085	.211	.419				
RA	.39	.744	.090	.133	.581	.359			
RST	.567	.709	.109	.223	.653	.178	.658		
RT	.266	.170	.075	.549	.193	.137	.322	.177	

Note. Survey data, 2025

Structural Model

The structural model was assessed using the bootstrapping procedure with 10,000 resamples. The evaluation involved examining the coefficient of determination (R^2) and the significance of the hypothesized relationships.

The coefficients of determination (R^2) for the structural models. Hair et al. (2011) suggest that R^2 values of .75, .50, and .25 indicate substantial, moderate, and weak explanatory power, respectively, for endogenous latent variables. R^2 value of .356 for Investment Decision (ID) and .315 for Risk Tolerance (RT) signifies moderate explanatory power of both models (see Table 7). The associated t-statistics are significant ($p = .000$) for both ID (7.443) and RT (8.289), confirming strong relationships between the latent and observed variables.

Table 6 presents the path coefficients within the structural model, illustrating the strength and direction of statistically significant associations among the variables. Among the direct paths from behavioral biases to investment decisions, four are statistically significant. Overconfidence exerts a positive and significant effect on investment decisions ($\beta = .202$, $p < .001$), supporting H1. Risk aversion similarly demonstrates a significant positive association with investment decisions ($\beta = .233$, $p < .001$), supporting H2. Representativeness shows the strongest significant positive effect among the biases ($\beta = .269$, $p < .001$), supporting H5. Anchoring also exhibits a significant positive association with investment decisions ($\beta = .141$, $p < .001$), supporting H6.

In contrast, the effects of herding ($\beta = -.036$, $p = .562$) and disposition effect ($\beta = .029$, $p = .535$) on the investment decision were not statistically significant; therefore, H3 and H4 were not supported. Similarly, risk tolerance did not exhibit a significant direct effect on investment decisions ($\beta = .039$, $p = .532$), leading to the rejection of H7.

Regarding the moderating role of financial literacy, none of the six interaction effects *(FL × OVC, FL × RA, FL × HERD, FL × DIS, FL × RST, and FL × ANC)* on risk tolerance were statistically significant (all $p > .05$, with 95% confidence intervals including zero). Therefore, H14 through H19 were not supported, suggesting that financial literacy did not significantly moderate the relationships between behavioral biases and risk tolerance. The interaction terms are reported in Table 6.

Table 6

Path Coefficients

Path	Beta Coefficient(β)	Sample Mean	STDEV	*t-value*	*p-values*	CI (2.5%)	CI (97.5%)
OVC -> ID	.202	.204	.049	4.131	.00	.107	.299
RA -> ID	.233	.233	.065	3.584	.00	.106	.360
HERD -> ID	-.036	-.039	.061	.580	.562	-.158	.081
DIS -> ID	.029	.033	.046	.621	.535	-.059	.122
RST -> ID	.269	.270	.054	4.966	.00	.163	.375
ANC -> ID	.141	.144	.051	2.765	.006	.042	.243
RT -> ID	.039	.040	.062	.624	.532	-.080	.160
FL x OVC -> RT	-.013	.000	.065	.206	.837	-.126	.131
FL x RA -> RT	-.018	.000	.068	.262	.793	-.132	.136
FL x HERD -> RT	-.059	-.040	.071	.826	.409	-.172	.104
FL x DIS -> RT	-.077	-.069	.071	1.089	.276	-.195	.082
FL x RST -> RT	.099	.066	.084	1.185	.236	-.116	.214
FL x ANC -> RT	-.034	-.040	.077	.437	.066	-.178	.131

Note. Survey data, 2025

Table 7

Model Predictive Capacity

	R-squared	Sample Mean	STDEV	*t-value*	*p-values*	CI (2.5%)	CI (97.5%)
ID	.356	.377	.048	7.443	.000	.284	.471
RT	.315	.351	.038	8.289	.000	.278	.427

Note. Survey data, 2025

Mediating Hypothesis

Table 8 presents the mediation analysis of risk tolerance in the relationship between behavioral biases and investment decisions. The results show that none of the mediation paths are statistically significant, as all p-values exceed .05. Specifically, the beta coefficients and p-values for overconfidence (*β = .019, p = .575*), risk aversion *(β = -.0557, p = .544*), herding (*β = -.7113, p = .544),* disposition effect (*β = .0224, p = .886*), representativeness (*β = .004, p = .859),* and anchoring (*β = .039, p = .575*) indicate no significant mediation effect of risk tolerance on the relationship between these behavioral biases and investment decisions. Hence, in all six cases, the 95% bias-corrected confidence intervals include zero, confirming the absence of statistically significant mediation. Accordingly, Hypotheses H8 to H13 are not supported by the empirical findings.

Table 8

Mediation Analysis

Path	Beta Coefficient	*t-value*	*p-values*	(CI) 2.5%	(CI) 97.5%
OVC -> RT -> ID	.019	.561	.575	-.009	.019
RA -> RT -> ID	-.056	.607	.544	-.053	.027
HERD -> RT -> ID	-.711	.607	.544	-.027	.067
DIS -> RT -> ID	.022	.143	.886	-.008	.011
RST -> RT -> ID	.004	.178	.859	-.009	.014
ANC -> RT -> ID	.039	.560	.575	-.014	.028

Note. Survey data, 2025

Discussion

This study aimed to examine the influence of behavioral biases on investment decisions while also assessing the mediating role of risk tolerance and the moderating effect of financial literacy. The results partially validate the theoretical foundations established in prior behavioral finance research. Importantly, the pattern of findings, including both the significant and non-significant paths, shows a contextually grounded reflection of the structural, institutional, and socio-cultural characteristics of the Nepalese investment environment. As discussed below, the absence of significant moderating and mediating effects is interpreted as substantively meaningful evidence that behavioral mechanisms established in developed markets may function differently within the context of emerging markets.

The findings confirm that overconfidence, risk aversion, representativeness, and anchoring significantly influence investment decisions. These results are in strong alignment with the literature. For instance, Adil et al. (2021) and Ahmad and Shah (2020) reported that overconfidence biases investors into taking excessive risks and overestimating market knowledge. Similarly, Rasool and Ullah (2020) and Tversky and Kahneman (1974) highlighted that risk-averse investors often avoid higher-return opportunities due to fear of loss. The

significance of representativeness bias echoes findings by Khan et al. (2023), who noted that investors commonly extrapolate from limited past trends. Anchoring bias, too, aligns with earlier studies (Jain et al., 2019; Mahmood et al., 2024), which demonstrated how initial or irrelevant reference points distort investors' valuation of assets. Theoretically, these findings align with two foundational frameworks: Prospect Theory (Kahneman & Tversky, 1979), which explains risk aversion through the asymmetric weighting of losses over equivalent gains, and the Heuristics and Biases program (Tversky & Kahneman, 1974), which accounts for overconfidence, representativeness, and anchoring as outcomes of fast, automatic System 1 processing (Kahneman, 2011). These cognitive mechanisms operate largely below the level of institutional mediation, suggesting their persistence across different stages of market development.

The persistence of these four biases in the Nepalese context is theoretically coherent: overconfidence, risk aversion, representativeness, and anchoring are cognitive heuristics that operate at the individual level and require minimal institutional infrastructure or financial sophistication to manifest. Their significance suggests that individual-level psychological tendencies are robust across market development stages, a finding consistent with cross-cultural behavioral finance research (Thaler, 2016).

In contrast, herding and disposition effects did not show significant relationships with investment decisions, diverging from the findings of Fogel and Berry (2006), Gavrilakis and Floros (2021), and Bett (2024), who emphasized the role of social influence and emotional biases in trading behavior. This discrepancy may reflect contextual differences, particularly in the Nepalese stock market, where evolving financial education and market maturity may reduce the effect of these biases. It also suggests a shift toward more informed and independent decision-making, as suggested by Poudel et al. (2024) and Dangol and Shakya (2017).

The absence of statistically significant mediation by risk tolerance across all six behavioral bias pathways is one of the study's most theoretically consequential findings and warrants substantive rather than dismissive interpretation. In behavioral finance models developed primarily in Western and East Asian markets, risk tolerance functions as a deliberative psychological intermediary: investors are assumed to consciously appraise their risk preferences before acting on a behavioral bias, such that tolerance modulates the bias-to-decision pathway (Raheja & Dhiman, 2019; Kasoga, 2021; Soraya et al., 2023). However, this mediation mechanism presupposes a degree of reflective self-awareness, financial self-concept, and institutional scaffolding, such as advisory services, risk profiling tools, and structured product menus, that may be largely absent in the Nepalese context.

NEPSE is characterized by limited market depth, a retail-dominated investor base, and an absence of widespread formal financial advisory infrastructure (Dangol & Shakya, 2017). Under these conditions, investors may not consciously engage risk tolerance as an intervening psychological construct; rather, behavioral biases appear to operate as relatively direct inputs into investment decisions, bypassing the reflective risk-appraisal layer that the mediation model assumes. This finding is consistent with research on informal investment decision-making in frontier markets, where behavioral responses are more likely to be governed

by social norms, habitual heuristics, and experiential intuition than by deliberate risk calibration (Thaler, 2016). The null mediation results, therefore, do not simply indicate a model misspecification; they provide empirically grounded evidence that the psychological architecture of investment behavior in Nepal operates through pathways distinct from those documented in more institutionally developed environments.

Likewise, financial literacy did not significantly moderate the relationship between behavioral biases and risk tolerance, despite the wide recognition of its importance in the literature. Theoretically, the moderating role of financial literacy rests on the assumption that acquired financial knowledge translates into bias-attenuating decision behavior, a premise embedded in the Knowledge-Action Gap framework (Lusardi & Mitchell, 2014), which stipulates that cognitive capacity requires enabling institutional structures to convert into behaviorally meaningful outcomes. This result contrasts with the findings of Adil et al. (2021), Khan et al. (2023), and Rehmat et al. (2023), who demonstrated that financial literacy reduces the impact of overconfidence, herding, and disposition biases. This finding thus offers an important boundary condition to extant theory: financial literacy's moderating function may be contingent upon the institutional environment in which it is exercised, and its influence may be substantially weaker in frontier and emerging markets where structural enablers of rational decision-making remain underdeveloped.

Thus, this study reinforces the importance of individual-level cognitive biases in investment decision-making across market contexts, while providing contextually grounded evidence that the intermediary mechanisms of risk tolerance and financial literacy, as theorized in developed market settings, may operate differently under the institutional and structural conditions of an emerging market such as Nepal.

Conclusion and Implications

This study examined the impact of behavioral biases, including overconfidence, risk aversion, herding, disposition effect, representativeness, and anchoring, on investment decisions, with a focus on the mediating role of risk tolerance and the moderating effect of financial literacy. The findings reveal that overconfidence, risk aversion, representativeness, and anchoring significantly influence investment decisions, while herding and disposition biases do not. Risk tolerance did not mediate, and financial literacy did not moderate the relationship between biases and risk tolerance. These findings indicate that in Nepal, behavioral biases translate directly into investment decisions through immediate affective-heuristic pathways, bypassing the deliberative risk-appraisal and knowledge-mediated mechanisms documented in developed markets. This is evidence of the failure of behavioral finance mechanisms documented in developed markets, in frontier markets like Nepal. In such markets, behavioral biases translate directly into investment decisions through more immediate affective-heuristic pathways.

The findings advance a context-contingent theoretical model of investor behavior: cognitive biases rooted in Prospect Theory and the Heuristics and Biases program remain relevant across market stages, while socially contingent biases and psychological intermediaries

(risk tolerance, financial literacy) require institutional preconditions that are largely absent in frontier markets. Investors should adopt bias-specific self-checks, such as verifying base rates before extrapolating trends. Financial education programs must shift from information delivery to cognitive debiasing strategies. SEBON should mandate bias-specific investor education modules addressing overconfidence, anchoring, and representativeness. National financial inclusion strategies must integrate behavioral finance literacy as a complementary objective to capital market development.

Limitations and Future Research

This study is subject to certain limitations. First, the use of cross-sectional data restricts the ability to establish causal relationships between behavioral biases and investment decisions over time. Second, the reliance on self-reported questionnaire responses may introduce response bias, common method bias, and limit the accuracy of measuring actual investor behavior. Finally, the study considers only individual investors in the NEPSE, which may limit the generalizability of the findings to other market contexts or institutional investor settings. Future researchers, therefore, could use the longitudinal research by incorporating institutional investors and market factors that influence investment behavior. Similarly, future studies should replicate this model across alternative frontier markets to validate whether the null mediation and moderation effects are generalizable or Nepal-specific.

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Conflict of Interest

The authors declare that there is no conflict of interest.

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