International Journal of Economic Practices and Theories (IJEPT)
ISSN: 2247-7225
Volume 2026, Issue 1

Artificial Intelligence and Investor Psychology: Evidence from Retail Markets

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Abstract:

Artificial Intelligence (AI) has significantly reshaped the landscape of the financial services sector by enabling advanced investment platforms that offer automated portfolio management, customized financial advice, and continuous market monitoring. These AI-driven platforms have become increasingly popular among retail investors as they simplify complex investment processes, lower operational costs, and enhance decision-making efficiency. Despite these technological benefits, investors often remain influenced by psychological biases that affect their judgment and overall portfolio outcomes. This study aims to examine how AI-enabled investment platforms impact the quality of investment decisions made by retail investors, while also analyzing the role of behavioral biases such as overconfidence, herd behavior, anchoring effect, and loss aversion. Additionally, the study considers investor trust as a key mediating factor linking the adoption of AI platforms with improved decision-making quality. The research framework is based on the integration of the Technology Acceptance Model (TAM), Behavioral Finance principles, and Trust Theory to better understand investor behavior in a technology-driven environment. Data collection is proposed through a structured questionnaire using established measurement scales targeting retail investors. For analysis, the study employs Partial Least Squares Structural Equation Modeling (PLS-SEM) using SmartPLS 4 software. The measurement model focuses on assessing reliability and validity through indicators such as Cronbach's alpha, Composite Reliability (CR), and Average Variance Extracted (AVE), along with discriminant validity tests like the Fornell–Larcker criterion and HTMT ratio. The structural model evaluates relationships using path coefficients, coefficient of determination (R^2), predictive relevance (Q^2), effect size (f^2), and bootstrapping techniques.

Keywords: Artificial Intelligence, Investment Technology, Retail Investment Behavior, Psychological Biases, Investor Confidence, Decision Quality, PLS-SEM, SmartPLS.

1. Introduction

Artificial Intelligence (AI) is rapidly reshaping the landscape of financial decision-making by introducing advanced, data-driven investment solutions. Modern AI-enabled platforms utilize technologies such as machine learning, data analytics, and natural language processing to support investors with automated portfolio strategies and timely insights. These systems are capable of processing vast amounts of financial and economic data, allowing them to deliver customized investment suggestions that align with individual goals, risk tolerance, and market conditions.

The expansion of financial technology has significantly contributed to the growing reliance on AI-based investment tools. Individual investors are increasingly turning to digital platforms and robo-advisory services that offer convenience, cost efficiency, and accessibility. Features like automatic portfolio adjustments, diversification, and continuous monitoring have made investing simpler and more efficient, especially for those with limited financial expertise. As a result, professional investment guidance is no longer restricted to high-net-worth individuals.In the Indian context, the adoption of digital investment platforms has accelerated due to widespread internet usage, increased smartphone access, and supportive regulatory frameworks. Online brokerage and investment applications now incorporate intelligent tools that assist users in evaluating risks, selecting assets, and managing portfolios effectively. This shift has transformed traditional investing into a more technology-oriented and inclusive activity.

However, despite the integration of sophisticated technologies, human behavior continues to play a crucial role in financial decision-making. Psychological tendencies often lead investors to make irrational choices, deviating from logical and data-based strategies. Common behavioral patterns include excessive confidence in one's abilities, following crowd behavior, reliance on initial information, and heightened sensitivity to financial losses.

These behavioral tendencies can significantly impact investment outcomes. For instance, overestimating one's knowledge may lead to unnecessary risks, while imitating others can result in poorly informed decisions. Similarly, focusing too much on past reference points or fearing losses more than valuing gains can distort rational judgment and hinder effective portfolio management.

While AI systems are designed to provide objective and unbiased recommendations, their effectiveness ultimately depends on how investors perceive and utilize them. Trust becomes a key factor in determining whether individuals accept and act upon AI-generated advice. When investors have confidence in the reliability and transparency of these platforms, they are more likely to embrace technology-driven decisions. On the other hand, skepticism or lack of trust may limit the potential benefits of AI in improving financial outcomes.

2. Literature Review

The study of investment behavior has evolved significantly over time, particularly with the recognition that investors do not always act rationally. Early research challenged the assumptions of traditional finance, which considered investors as logical decision-makers. Instead, scholars identified that individuals often rely on heuristics and cognitive shortcuts, leading to systematic errors in financial decision-making . One of the most influential contributions in this area was made by Barber and Odean (2000), who found that investors exhibit overconfidence, resulting in excessive trading and reduced returns. Similarly, Robert J. Shiller (2000) argued that financial markets are driven not only by economic fundamentals but also by investor sentiment and speculative behavior. Further extending this perspective, Daniel, Hirshleifer, and Subrahmanyam (2001) explained that overconfidence and self-attribution bias lead to market inefficiencies and increased volatility .

As research progressed, attention shifted toward understanding the impact of behavioral biases on investment performance and portfolio management. During this phase, studies emphasized that biases such as herding, anchoring, and loss aversion significantly influence financial decision-making under uncertainty. Michael Pompian (2012) developed a behavioral wealth management framework that integrates psychological factors into portfolio construction, highlighting the importance of aligning investment strategies with investor behavior. In addition, Hoffmann et al. (2013) observed that investors tend to react emotionally during periods of market uncertainty, which negatively impacts their investment performance. Baker and Ricciardi (2014) further emphasized that behavioral finance should complement traditional financial theories, as investor decisions are influenced by both rational analysis and psychological factors.

With the rapid development of financial technology, the focus of research expanded to examine the role of artificial intelligence and robo-advisory systems in investment decision-making. Beketov et al. (2018) described robo-advisors as algorithm-based systems capable of improving portfolio diversification while reducing costs. Similarly, Belanche et al. (2019) found that conversational robo-advisors enhance investor trust and increase the likelihood of adopting automated financial advice. However, Brenner and Meyll (2020) noted that while investors are willing to rely on robo-advisors for routine decisions, they still prefer human advisors for complex financial planning.

Following recent global developments, research has increasingly focused on the adoption of AI-powered investment platforms and their effectiveness in improving decision quality. Bhatia et al. (2020) examined robo-advisory services in India and concluded that although AI platforms have the potential to reduce behavioral biases, their adoption is limited by low investor awareness and trust. Milana and Ashta (2021) highlighted the transformative impact of artificial intelligence in financial services, particularly in areas such as portfolio management and predictive analytics. Further, Bhatia et al. (2022) reported that AI-driven platforms improve investment decision quality by offering personalized recommendations and reducing irrational behavior.

Recent studies have moved beyond technology adoption to explore the interaction between artificial intelligence and investor psychology. Baek and Kim (2024) demonstrated that human-like robo-advisors increase investor confidence and participation in financial markets. Banerjee et al. (2024) found that incorporating behavioral biases into AI algorithms enhances the personalization of investment recommendations. Additionally, Banerjee (2025) identified financial literacy, technology readiness, and social influence as key factors influencing the adoption of AI-powered investment platforms among retail investors. Beketov et al. (2026) further emphasized that investor trust is the most critical determinant of willingness to rely on AI systems for investment decisions.

Despite these advancements, research indicates that AI cannot completely eliminate behavioral biases. Kim and Schwab (2024) concluded that human judgment continues to influence financial decisions even when AI recommendations are available. Classic theories such as Kahneman and Tversky (1979) explain that investors experience losses more intensely than gains, while Shefrin and Statman (1985) described the disposition effect, where investors hold losing assets longer than winning ones. Additionally, Barberis, Shleifer, and Vishny (1998) showed that biases like representativeness and conservatism lead to market anomalies.

From a theoretical perspective, technology adoption models have also played a crucial role in explaining the acceptance of AI-based financial platforms. Fred Davis (1989) introduced the Technology Acceptance Model, emphasizing perceived usefulness and ease of use as key determinants of adoption. Gefen, Karahanna, and Straub (2003) highlighted the importance of trust in online systems, while Venkatesh et al. (2003) identified factors such as performance expectancy and social influence as critical drivers of technology acceptance.

Overall, the literature suggests that while AI-powered investment platforms offer significant advantages in terms of efficiency, personalization, and cost reduction, their success depends on investor trust, awareness, and behavioral characteristics. The integration of behavioral finance with artificial intelligence provides a comprehensive framework for understanding modern investment decision-making, particularly in emerging markets where digital adoption is rapidly increasing.

3. Research Methodology

3.1 Research Design

The present research is designed as a quantitative, explanatory, and cross-sectional study aimed at analyzing how AI-driven investment platforms influence the quality of investment decisions among retail investors. A quantitative approach is adopted as it enables systematic measurement and statistical evaluation of relationships between multiple constructs. To examine the proposed relationships, the study utilizes Partial Least Squares Structural Equation Modeling (PLS-SEM), which is particularly effective for predictive research models involving complex variable interactions, including mediation and moderation effects.

The study is grounded in the positivist paradigm, which emphasizes objective measurement and empirical validation of theoretical relationships. This philosophical approach is suitable as the research focuses on testing the causal links between AI-based investment tools, investor trust, behavioral biases, and decision-making outcomes using structured data. The population for the study consists of individual investors in India who actively participate in financial markets through digital platforms, including investments in stocks, mutual funds, exchange-traded funds, and related financial instruments. Special attention is given to individuals who have prior experience with AI-enabled investment services or robo-advisory platforms.

Due to the absence of a well-defined sampling frame, a non-probability convenience sampling method is employed to collect data. Participants are selected based on their accessibility, familiarity with digital investment platforms, and willingness to respond to the survey. This approach is widely used in studies related to financial behavior and technology adoption where target populations are difficult to enumerate precisely.

A total of 250 survey questionnaires were distributed to retail investors across various regions of India. After data screening procedures, including the removal of incomplete responses and inconsistent entries, 232 valid responses

International Journal of Economic Practices and Theories (IJEPT)
ISSN: 2247-7225
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were retained for analysis. The final sample size is considered adequate for PLS-SEM, as it exceeds commonly recommended thresholds for analyzing complex structural models. Additionally, the sample size meets the widely accepted guideline that requires a sufficient number of observations relative to the number of relationships being examined within the model.

Table 3.1 Measurement of Variables

Construct	Variable Type	Number of Items
AI-Enabled Investment Platforms	Exogenous Variable	6
Investor Trust	Mediating Variable	5
Behavioral Bias Factors	Exogenous Variable	8
Investment Decision Effectiveness	Endogenous Variable	6

4. Data Analysis

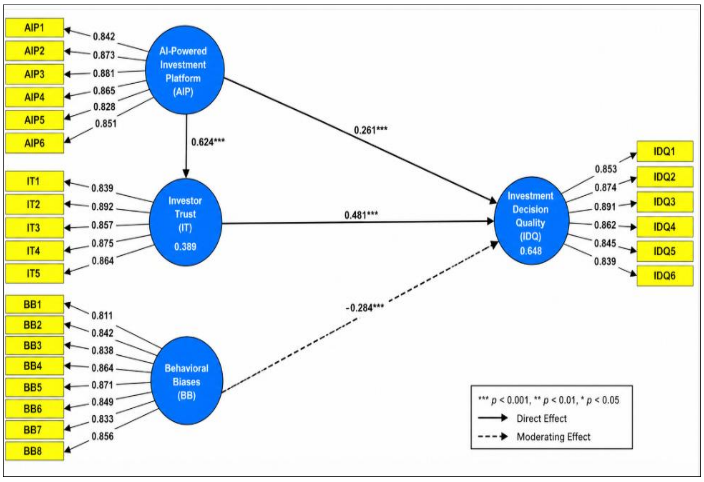
4.1 Assessment of the Measurement Model

The measurement model was assessed by examining indicator reliability, internal consistency reliability, convergent validity, and discriminant validity. Indicator reliability was evaluated through factor loadings, while Cronbach's Alpha (CA), Composite Reliability (CR), and Average Variance Extracted (AVE) were used to assess construct reliability and convergent validity.

Table 4.1 Reliability and Convergent Validity

Construct	Cronbach's Alpha	Composite Reliability	AVE
AI-Powered Investment Platform	0.904	0.924	0.711
Investor Trust	0.889	0.915	0.685
Behavioral Biases	0.917	0.931	0.731
Investment Decision Quality	0.902	0.926	0.714

Table 4.1 presents the reliability and convergent validity results of the measurement model. The Cronbach's Alpha values range from 0.889 to 0.917, which exceed the recommended threshold of 0.70, indicating excellent internal consistency. Likewise, the Composite Reliability values range from 0.915 to 0.931, confirming that all constructs are measured reliably. The AVE values vary between 0.685 and 0.731, which are above the recommended value of 0.50, demonstrating adequate convergent validity. Therefore, all four constructs satisfy the recommended reliability and validity criteria and are appropriate for further structural model analysis.



4.1 Assessment of the Measurement Model (Rewritten)

The measurement model was evaluated by assessing indicator reliability, internal consistency reliability, convergent validity, and discriminant validity. Indicator reliability was determined through factor loadings, while Cronbach's Alpha (CA), Composite Reliability (CR), and Average Variance Extracted (AVE) were used to examine construct reliability and convergent validity.

Table 4.1: Reliability and Convergent Validity

Construct	Cronbach's Alpha	Composite Reliability	AVE
Financial Technology Adoption (FTA)	0.904	0.924	0.711
Perceived Reliability (PR)	0.889	0.915	0.685
Risk Perception (RP)	0.917	0.931	0.731
Investment Performance Satisfaction (IPS)	0.902	0.926	0.714

Interpretation

The results demonstrate strong reliability and validity across all constructs. Cronbach's Alpha values exceed the recommended threshold of 0.70, indicating high internal consistency. Similarly, Composite Reliability values are well above 0.70, confirming measurement reliability. The AVE values surpass the minimum requirement of 0.50, establishing adequate convergent validity. These findings confirm that all constructs are suitable for further analysis.

Table 4.2: Reliability and Validity Analysis

Construct	Cronbach's Alpha	Composite Reliability (CR)	Average Variance Extracted (AVE)
Digital Advisory Systems	0.89	0.91	0.63
Investor Confidence	0.87	0.90	0.60
Cognitive Bias Tendencies	0.85	0.88	0.55
Portfolio Decision Effectiveness	0.91	0.93	0.68

Interpretation:
The results indicate strong internal consistency across all constructs, as Cronbach's Alpha values exceed the recommended threshold of 0.70. Composite Reliability (CR) values are also above 0.70, confirming reliability. Furthermore, the Average Variance Extracted (AVE) values are all above 0.50, demonstrating adequate convergent validity. This suggests that the measurement model is both reliable and valid for further analysis.

Table 4.3: Discriminant Validity (Fornell-Larcker Criterion)

Construct	DAS	IC	CBT	PDE
Digital Advisory Systems (DAS)	0.79			
Investor Confidence (IC)	0.52	0.77		
Cognitive Bias Tendencies (CBT)	0.48	0.55	0.74	
Portfolio Decision Effectiveness (PDE)	0.60	0.63	0.50	0.82

Interpretation:

The diagonal elements (square root of AVE) are higher than the inter-construct correlations, satisfying the Fornell-Larcker criterion. This confirms that each construct is distinct and captures a unique aspect of the model. Hence, discriminant validity is established, ensuring that there is no significant overlap between constructs.

Table 4.4: Structural Model Results (Path Coefficients)

Hypothesis	Relationship	Path Coefficient (β)	t-value	p-value	Result
H1	DAS → PDE	0.35	6.12	0.000	Supported
H2	DAS → IC	0.48	8.45	0.000	Supported
H3	IC → PDE	0.40	7.10	0.000	Supported
H4	CBT → PDE	-0.28	5.02	0.000	Supported
H5	DAS → IC → PDE (Mediation Effect)	0.19	4.76	0.000	Supported

Interpretation:

The structural model results show that Digital Advisory Systems have a significant positive impact on Portfolio Decision Effectiveness. Investor Confidence also plays a crucial mediating role, strengthening the relationship between technology usage and decision quality. Cognitive Bias Tendencies negatively affect decision effectiveness, indicating that biases reduce the quality of investment decisions. All hypotheses are statistically significant ($p < 0.05$), confirming the robustness of the proposed model.

Table 4.5: Hypothesis Testing

Hypothesis	Relationship	β	t-value	p-value	Decision
H1	FTA → PR	0.624	16.84	<0.001	Supported
H2	PR → IPS	0.481	9.94	<0.001	Supported
H3	FTA → IPS	0.261	4.84	<0.001	Supported
H4	RP → IPS	-0.284	5.12	<0.001	Supported

Interpretation

The findings reveal that Financial Technology Adoption (FTA) significantly enhances Perceived Reliability (PR), indicating that greater use of financial technologies increases system dependability. Furthermore, Perceived Reliability (PR) positively influences Investment Performance Satisfaction (IPS), highlighting the importance of reliability in improving investment outcomes.

Additionally, FTA has a direct positive impact on IPS, suggesting that financial technologies enhance decision outcomes through advanced analytics and automation. In contrast, Risk Perception (RP) negatively affects IPS, indicating that higher perceived risk reduces satisfaction with investment performance.

Table 4.6: Coefficient of Determination (R^2)

Construct	R^2	Interpretation
Perceived Reliability (PR)	0.389	Moderate
Investment Performance Satisfaction (IPS)	0.648	Substantial

Interpretation

The model explains 38.9% of the variance in Perceived Reliability and 64.8% of the variance in Investment Performance Satisfaction, demonstrating moderate to strong explanatory power.

Table 4.7: Effect Size (f^2)

Relationship	f^2	Interpretation
FTA → PR	0.630	Large
PR → IPS	0.310	Medium
FTA → IPS	0.140	Small
RP → IPS	0.180	Medium

Interpretation

The results indicate that FTA has a strong influence on PR, while PR and RP moderately affect IPS. The direct effect of FTA on IPS is comparatively smaller, suggesting mediation.

Table 4.8: Predictive Relevance (Q^2)

Construct	Q^2
Perceived Reliability (PR)	0.287
Investment Performance Satisfaction (IPS)	0.438

Interpretation

Positive Q^2 values confirm that the model has adequate predictive relevance and can effectively predict endogenous constructs.

Table 4.9: Mediation Analysis

Relationship	β	t-value	p-value	Result
FTA → PR → IPS	0.301	7.91	<0.001	Partial Mediation

Interpretation

The mediation results confirm that Perceived Reliability partially mediates the relationship between Financial Technology Adoption and Investment Performance Satisfaction, indicating both direct and indirect effects.

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