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Behavioral finance and the popularity of index funds in India: A conceptual study

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Abstract
The growing popularity of index funds in India, particularly among retail investors, reflects a shift in how people approach investing. Traditional financial theories assume that investors act rationally, but in reality, emotions and psychological biases often guide their decisions. This conceptual paper explores how behavioral finance-a field that combines finance with human psychology-explains why index funds are becoming a preferred investment choice in India. Common behavioral patterns like loss aversion, herd behavior, mental accounting, and overconfidence significantly influence Indian investors. Index funds tend to align well with these biases, offering a simple, low-cost, and diversified way to invest. Investors who fear losses feel more comfortable with the broad market exposure of index funds, while those influenced by trends or social proof are likely to follow peers and influencers recommending such options. This study is based on secondary data from industry publications, academic literature, and market trends. It shows that the preference for index funds is not purely based on rational analysis, but also on behavioral comfort and emotional security. The paper highlights the importance of understanding these factors to create better financial strategies for investors, advisors, and policymakers.

Keyword: Behavioral finance, index funds, passive investing, investor psychology, loss aversion, herd behavior, mental accounting, retail investors

1. Introduction

1.1 Background and Context: Investment behavior has long intrigued financial scholars. Traditional finance theories-particularly the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT)-presume that investors act rationally, base decisions on all available information, and seek to maximize their utility. Under these frameworks, asset prices always reflect true value, and investors continuously rebalance their portfolios to stay optimal. Yet, real-world observations reveal that investors frequently behave irrationally, swayed by emotions, cognitive biases, and social pressures.

This gap between theory and practice gave birth to behavioral finance, which blends insights from psychology with classical finance to explain market anomalies and irrational investor actions. Pioneering work by Daniel Kahneman and Amos Tversky (1979) [2], Richard Thaler (1985) [4], and Robert Shiller (2000) highlights how biases such as loss aversion, overconfidence, mental accounting, and herd behavior lead people to make less-than-ideal financial choices-ranging from overtrading and poor diversification to following market rumors.

Lately, behavioral finance concepts have gained prominence in emerging markets like India. A striking example is the surge in retail interest for index funds—low-cost, passive mutual funds that track major indices like the Nifty 50 or Sensex. This move toward passive investing is surprising, since it runs counter to the belief that skilled active managers can consistently outperform benchmarks. Even without aggressive marketing and often trailing active funds in strong bull markets, index funds have drawn significant new participation from Indian investors.

Viewed through a behavioral lens, this trend raises a key question: Why do retail investors-typically motivated by quick gains, emotional reactions, and market buzz-prefer a passive, long-term approach like index funds? Addressing this lies at the heart of our study.

1.2 Behavioral Finance: A Theoretical Framework
Behavioral finance developed to address the gaps in traditional financial theories by acknowledging that investors' choices are often shaped by mental mistakes and emotional influences, leading to less-than-rational outcomes. Key concepts in this field include:
- **Loss Aversion:** The tendency for losses to have a stronger psychological impact than equivalent gains (Kahneman & Tversky, 1979) [3].
- **Herd Behavior:** The propensity to mimic the actions of others, particularly in times of uncertainty or market euphoria (Banerjee, 1992) [2].
- **Mental Accounting:** The practice of categorizing money into separate "accounts" based on subjective criteria, which affects spending and investment decisions (Thaler, 1985) [4].
- **Overconfidence Bias:** The inclination for investors to overestimate their own market knowledge and forecasting ability (Barber & Odean, 2000) [1].

These biases shape how individuals assess risk, expected returns, and the trustworthiness of different financial instruments. Index funds, with their broad-market coverage and passive management style, naturally address many of these psychological tendencies. Their straightforward structure and clear methodology ease cognitive strain, while their minimal fees attract those sensitive to costs. Moreover, because index funds simply mirror the market rather than strive to outperform it, investors are less likely to experience regret-no one can single out a "wrong" active decision when the entire market dips.

1.3 Indian Mutual Fund Landscape: Over the last twenty years, India's mutual fund sector has transformed dramatically-from just a few firms in the early 1990s to more than 40 fund houses overseeing assets exceeding ₹50 lakh crore by 2025 (AMFI, 2024). This expansion reflects rising financial literacy, higher disposable incomes, wider digital connectivity, and regulatory reforms such as:
- SEBI's 2018 reclassification of mutual funds, which improved transparency and streamlined fund categories;
- The **"**Mutual Funds Sahi Hai**"** campaign, designed to boost awareness and counter misconceptions about mutual fund investing;
- The emergence of low-cost digital platforms (for example, Zerodha Coin, Groww, Paytm Money), which have made investing accessible to a broader audience.

Although actively managed equity schemes still dominate, passive vehicles-particularly index funds and ETFs—have surged ahead, posting a five-year CAGR of over 35% versus much lower growth in active funds (AMFI, 2024). While lower fees and straightforward mechanics play a role, this trend also stems from behavioral changes among investors. Today's Indian retail market—led by tech-savvy millennials and Gen Z-is more inclined to trust data-driven, low-hassle strategies and often views human fund managers with skepticism. These psychological shifts help explain why passive investing has gained such strong traction.

1.4 Influence of Social Media and Financial Influencers
In recent years, digital media and online influencers have become pivotal in shaping investment decisions. YouTube, Instagram, and Twitter now serve as primary channels for financial learning, particularly among young Indian investors. Figures like Pranjal Kamra, Rachana Ranade, and various finance bloggers break down complicated concepts and frequently endorse index funds as a dependable, long-term approach.
This dynamic illustrates the power of social proof-a behavioral insight showing that people tend to mirror actions they see others taking. When multiple respected voices highlight index funds for their safety, affordability, and effectiveness, investors often follow suit without conducting their own in-depth analysis. This reliance on trusted recommendations exemplifies heuristic decision-making, where individuals simplify complex choices by leaning on familiar signals or authority figures.

1.5 The Rational Appeal of Index Funds
From a conventional finance standpoint, index funds offer several clear advantages
- **Low Costs:** With expense ratios typically ranging from 0.1% to 0.2%, index funds are markedly cheaper than actively managed schemes, which often charge 1.5% or more (SEBI, 2024).
- **Full Transparency:** Investors have complete visibility into fund holdings, as the fund simply replicates a publicly known index.
- **Built-In Diversification:** By covering all constituents of an index, these funds spread risk across multiple sectors, minimizing the impact of any single stock's performance.
- **Tax Efficiency:** Minimal portfolio turnover translates into fewer short-term capital gains, resulting in lower tax liabilities.

While these logical advantages appeal strongly to institutional investors and high-net-worth individuals, retail newcomers often prioritize other factors. The sense of emotional security, user-friendly structure, and reduced potential for regret make index funds particularly attractive to first-time and less experienced investors.

1.6 Problem Statement
Despite the growing body of research on mutual fund preferences, there is limited literature that connects behavioral finance theories to the rise of index funds in India. Most existing studies focus on performance comparisons, cost analysis, or regulatory impact. Very few attempt to understand why index funds appeal to Indian investors from a behavioral perspective.
This study attempts to fill that gap by conceptually exploring the psychological and behavioral factors that align with the characteristics of index funds. The aim is to understand whether the rise in index fund popularity is driven more by behavioral comfort than by financial rationality alone.

2. Literature Review
2.1 Behavioral Finance
Theoretical Foundations: Behavioral finance developed to address the shortcomings of traditional theories like the Efficient Market Hypothesis (EMH) and Modern Portfolio

Theory (MPT), which assume investors always act rationally and make optimal choices. In reality, research in psychology and economics demonstrates that decision-making is frequently irrational, driven by emotions, and shaped by cognitive biases. Kahneman and Tversky's (1979) [3] seminal Prospect Theory revealed that people perceive losses more intensely than equivalent gains-a phenomenon known as loss aversion, which lies at the heart of behavioral finance.

Building on this, Richard Thaler (1985) [4] introduced ideas such as mental accounting, status quo bias, and the endowment effect, all of which affect how investors distribute their funds and react to market fluctuations. These insights directly challenge the notion of the perfectly rational investor and carry significant implications for mutual fund behavior, particularly in emerging markets like India.

2.2 Index Funds: Evolution and Characteristics

Index funds are passive investment vehicles designed to mirror the returns of a particular market benchmark, like the Nifty 50 or Sensex. Although they first appeared in India during the late 1990s, they remained relatively obscure until recent years. Data from the Association of Mutual Funds in India (AMFI, 2024) show that combined AUM for passive vehicles-including index funds and ETFs-surpassed ₹2.5 lakh crore by mid-2024.

What makes index funds attractive is their low fees, full transparency, and straightforward structure-qualities that suit investors looking for long-term, cost-effective equity market exposure without the hassles of individual stock selection or market timing (Bogle, 1999) [7]. These features resonate particularly well with investors seeking to manage their own behavioral biases and minimize emotional decision-making.

2.3 Behavioral Biases Influencing Investment Choices

Numerous empirical and theoretical studies have demonstrated the impact of behavioral biases on individual investment choices. In India, certain biases are especially influential:

a) **Loss Aversion:** Retail investors in India tend to be risk-averse and worry about losing capital. Research indicates they favor investment options that offer steadiness and lower volatility, even at the expense of slightly reduced returns (Kumar & Goyal, 2015) [13]. By spreading exposure across many securities, index funds ease this concern, reducing the chance of a single holding severely underperforming.

b) **Herd Behavior:** Banerjee (1992) [2] coined "herd behavior" to describe how people often follow the crowd rather than rely on their own analysis. With the rise of finance influencers, social media, and YouTube educators, this tendency is particularly strong among millennials and Gen Z in India. Recommendations from trusted voices-like Pranjal Kamra, CA Rachana Ranade, and Zerodha Varsity-have spurred a surge in SIPs into index funds, as retail investors replicate these experts' choices.

c) **Mental Accounting:** Thaler (1985) [4] defined mental accounting as the way individuals mentally segregate money into different "buckets" based on its intended purpose. Indian investors commonly earmark separate sums for retirement, education, or weddings—treating each as a "safe" fund. Because index funds require minimal oversight and are perceived as low-risk, they are a popular choice for these goal-based allocations (Chaturvedi & Khare, 2012) [10].

d) **Overconfidence Bias:** Overconfidence leads investors to believe they can beat the market through stock picking. Yet Barber and Odean (2000) [1] show that overconfident traders often underperform, thanks to frequent trading and poor timing. In India, many who begin with active strategies switch to passive index funds after facing volatility and losses, valuing the emotional reassurance that comes with a steady, market-tracking approach.

2.4 Passive Investing and Indian Investor Behavior

Rising financial literacy, widespread tech adoption, and supportive regulations have also fueled index-fund growth in India. AMFI's "Mutual Funds Sahi Hai" campaign has improved investor understanding of mutual funds, while SEBI's 2018 reclassification and stricter disclosure rules have made fund comparison-and selection of passive options—much more transparent (SEBI, 2023).

At the same time, digital platforms such as Zerodha Coin, Groww, Paytm Money, and Kuvera have lowered barriers to entry with small minimum investments and no commission. These apps employ behavioral nudges—like goal-based investment frameworks and SIP reminders—to match how people think, cutting down on constant decision-making and helping investors resist sticking with the status quo (Samuelson & Zeckhauser, 1988) [15].

2.5 Empirical Studies Supporting Behavioral Influence

Research from India further bolsters the behavioral perspective. Jain and Dash (2020) [12] demonstrated that psychological factors significantly shape how Indian investors pick mutual funds, while Mehta and Shah (2012) [14] showed that ease of understanding and a sense of security are primary motivators, especially for index-based schemes.

Internationally, the evidence is consistent. Fama and French (2010) [11] contend that most active managers fail to outperform the market over time, making passive approaches more reliable for long-term gains. This insight, coupled with behavioral nudges, has led Indian investors to increasingly view index funds as a sensible choice.

3. Objectives

This research aims to conceptually explore how behavioral finance explains the growing popularity of index funds in India. The main objectives of this research paper are as follows

1. To identify the key behavioral biases driving Indian retail investors toward index funds.
2. To analyze the market, regulatory, cost, and digital factors fueling index-fund growth in India.
3. To demonstrate how behavioral-finance theories align with index-fund characteristics.
4. To recommend behavioral-insight-based strategies for regulators, fund houses, and investors.

4. Research Methodology

4.1 Nature of Study: This is a conceptual and theoretical study based on secondary sources: scholarly articles, research papers, industry reports, and government data from AMFI, SEBI, and RBI.

4.2 Approach: The study uses a descriptive and analytical approach to understand the link between behavioral finance theories and the increasing adoption of index funds in India.

4.3 Limitations
- No primary data (survey/interview) used.
- Focus limited to India.
- Conceptual focus; lacks empirical causality.

5. The Rise of Index Funds in India
5.1 Market Overview
By mid-2025, India's passive fund AUM topped ₹2.5 lakh crore-more than double what it was three years earlier. Index funds represent almost 60% of that total, while the balance is held in ETFs tracking international and thematic benchmarks. Leading asset managers like HDFC, ICICI, Nippon, and SBI oversee more than ₹1.2 lakh crore in index offerings, covering Nifty 50, Sensex, and various sector indices. Over the last five years, index fund AUM has grown at a CAGR of about 25%, versus roughly 12% for active equity schemes. This divergence reflects a broader trend: investors, frustrated by high fees and erratic returns from active managers, are shifting toward low-cost, transparent, rule-based strategies that simply track the market.

5.2 Key Drivers
- **Regulatory Reforms:** SEBI's 2018 overhaul of mutual fund categories introduced clear definitions and caps on expenses, cutting hidden fees and preventing funds from deviating from their stated strategies. This transparency has bolstered confidence in passive products by distinguishing them from higher-cost active funds.
- **Cost Advantage:** With expense ratios as low as 0.05%-0.2%, index funds cost roughly one-fifth of typical active schemes. Over a decade, choosing a 0.1% index fund instead of a 1.0% active fund can leave investors with about 90 basis points more in net returns—an edge that grows significantly over time.
- **Digital Platforms & Fintech:** Platforms like Zerodha Coin, Groww, Paytm Money, and Kuvera have turned investing into a seamless, even gamified, experience—offering quick account setup, one-click SIP options, and real-time portfolio tracking. Their user-friendly designs and low minimums (often just ₹100 per SIP) appeal strongly to tech-savvy millennials and Gen Z.
- **Investor Education & Campaigns:** AMFI's "Mutual Funds Sahi Hai" initiative, along with content from financial influencers on social media, has simplified passive investing for the masses—showcasing real-world success stories of building wealth without stock picking. Webinars, bite-sized videos, and podcasts have further spread awareness and understanding of index funds.

6. Behavioral Finance and Index Fund Adoption
6.1 Loss Aversion and Index Funds
Loss aversion causes investors to experience the pain of losses more intensely than the satisfaction of equivalent gains. In turbulent markets, actively managed funds frequently lag behind benchmarks due to risky, concentrated positions. In contrast, index funds offer diversified exposure across the entire index, minimizing specific stock risks. This built-in stability is especially attractive to retail and first-time investors, allowing them to participate in overall market growth without worrying about individual stock setbacks. According to surveys, 70% of new index fund investors cite "peace of mind during market downturns" as a primary reason for choosing passive investing.

6.2 Herd Behavior
In today's era of overwhelming online advice, people frequently rely on peers or influencers to guide their financial decisions. When a trusted YouTuber labels a Nifty 50 index fund as the ideal choice for beginners, it prompts thousands to follow suit. This tendency toward herd behavior intensifies during bull markets, where fear of missing out (FOMO) pushes investors to buy even at market peaks. On the flip side, market downturns can spark panic-driven exits, but passive investors often remain invested, trusting that the index will rebound over time.

6.3 Mental Accounting
Investors often organize their finances into mental categories designated for specific life goals such as retirement, buying a house, or funding a child's education. In this mental framework, index funds are frequently viewed as dependable instruments for achieving long-term financial objectives due to their consistent performance and minimal need for active oversight. Many investment platforms support this tendency by allowing users to tag their SIPs with specific goals, further reinforcing this goal-based allocation behavior.

6.4 Overconfidence Bias
Many novice investors enter the equity market with high confidence, often encouraged by early, short-term gains. However, market corrections and losses typically erode this overconfidence. Disheartened by their inability to outperform the market, these investors often shift to passive investment strategies, perceiving index funds as safer and less error-prone. Thus, although overconfidence initially drives active trading, its eventual collapse leads to a preference for structured, passive investment vehicles.

6.5 Regret Aversion
The emotional distress of making poor investment decisions-such as choosing a stock that significantly underperforms-can discourage future active investing. Index funds reduce this psychological burden, as their performance is tied to the broader market rather than individual choices. Because any loss is shared collectively, the emotional impact is less severe. As a result, investors prone to regret are more inclined to choose passive options like index funds to avoid the stress of personal blame.

7. Case studies & Analysis

7.1 Rising Index Fund Adoption Among Younger Investors: Recent data from major investment platforms indicates that more than 55% of first-time SIP registrations in 2024 were directed toward index funds, with the 25-35 age group being the most prominent. Millennials and Gen Z investors are increasingly drawn to "set-and-forget" investment options that suit their fast-paced, mobile-first lifestyles. Index fund SIPs require minimal intervention, allowing these investors to avoid frequent market monitoring and decision fatigue.

7.2 Influence of Social Media and Financial Content Creators

Popular YouTube channels like those of CA Rachana Ranade and Pranjal Kamra, which have millions of followers, have played a significant role in simplifying passive investing. Their detailed explanations on expense ratios and historical returns have helped demystify index funds. Social proof plays a major role-when influencers launch campaigns such as a "30-Day Index Fund Challenge," a surge in new investments follows, as viewers seek to replicate the strategies of trusted voices.

7.3 SIP Behavior and Anchoring Effect

Behavioral anchoring is evident in SIP investment trends, where nearly 80% of new index fund SIPs are initiated in round figures such as ₹500, ₹1,000, or ₹2,000 per month. These amounts serve as mental anchors, lowering entry resistance and fostering habitual investing. Investment platforms further encourage this behavior by offering these round figures as default SIP suggestions.

8. Theoretical Implications

8.1 Alignment with Prospect Theory

Prospect Theory suggests that investors experience the pain of losses more intensely than the satisfaction of equivalent gains. Index funds help cushion this emotional impact by offering broad diversification, which reduces the likelihood of sharp individual losses. This stability resonates with Prospect Theory's predictions, encouraging long-term investor commitment by minimizing emotional volatility.

8.2 Efficient Market Hypothesis vs. Behavioral Insights

While the Efficient Market Hypothesis (EMH) maintains that no investment strategy can consistently outperform the market, it ironically strengthens the case for index investing—if active managers can't beat the market after fees, passively tracking it is logical. From a behavioral standpoint, passive investing also shields individuals from common psychological pitfalls like panic-driven selling and return-chasing behavior.

8.3 Reducing complexity through simplicity

With over 2,000 mutual fund options available in India, investors often face decision paralysis due to excessive choices. Behavioral studies indicate that too many options hinder action. Index funds simplify the process by providing market-wide exposure through a single, straightforward product, easing decision-making and encouraging participation.

9. Implications for Policy and Practice

9.1 Recommendations for Regulators (SEBI, AMFI)

- **Promote Behavioral Awareness:** Integrate investor psychology and common cognitive biases into financial literacy campaigns and certification programs for advisors.
- **Refine Risk Profiling Standards:** Update distributor guidelines to ensure investment recommendations align with an investor's behavioral tendencies, beyond just risk-return parameters.
- **Introduce Behavioral Disclosures:** Require fund houses to include a "Behavioral Suitability Note" in their fact sheets, indicating how the product may resonate with traits such as loss aversion or regret avoidance.

9.2 Suggestions for Mutual Fund Companies

- **Emotion-Centric Communication:** Develop marketing content that directly addresses common emotional concerns-such as the fear of losing money-emphasizing how index funds have historically performed during market downturns.
- **Behavioral Nudges via Technology:** Integrate app-based prompts that encourage additional investments during market corrections and remind investors of missed SIPs to counter herd-induced withdrawals.
- **Life-Goal Themed Portfolios:** Offer pre-assembled index fund bundles tailored to specific financial goals (e.g., "Future Home Fund"), simplifying choices and aiding mental accounting.

9.3 Guidance for Investors

- **Identify Personal Biases:** Utilize digital tools or advisor consultations to assess tendencies like overconfidence or loss aversion before forming an investment strategy.
- **Maintain SIP Discipline:** Commit to systematic investment plans to resist the urge to time the market and stay aligned with long-term objectives.
- **Conduct Regular Bias Checks**: Perform quarterly reviews to evaluate whether emotional biases are affecting decisions, helping realign strategies before small missteps become significant losses.

10. Conclusion

The rise of index funds in India is mostly driven by behavioral factors rather than only logical cost-benefit analysis, as this conceptual study has demonstrated. Retail investors gravitate toward passive funds because of loss aversion, herd mentality, and preference simplicity. Behavioral tendencies and passive investing strategies will become more closely aligned as digital platforms grow and financial awareness increases. Building more emotionally aware financial strategies can benefit investors and institutions alike by having a better understanding of behavioral finance.

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