

Understanding Retail Investor Behaviour: Financial Literacy, Risk Tolerance, and Investment Decisions: A Systematic Literature Review

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Abstract:

Financial literacy has been identified as one of the most crucial factors influencing financial situations, especially in recent years, as the number of retail investors in financial markets has increased. However, the wrong relationship between financial literacy and investment decision-making points to behavioural factors. This paper aims to conduct a systematic literature review to examine the impact of financial knowledge on financial investment decisions, particularly examining the impact of risk tolerance as a mediator among retail investors. This paper uses a systematic literature review (SLR) methodology in accordance with PRISMA guidelines. Relevant literature from 2010 to 2025 is obtained from various sources such as Scopus, Web of Science, Google Scholar, ScienceDirect, Emerald Insight, etc. A list of peer-reviewed literature is selected based on certain criteria. The results show that financial literacy plays a significant role in improving the ability of investors to make informed decisions. However, this is often influenced by risk tolerance, as financially literate investors show greater risk tolerance, thereby investing in more profitable but riskier investments.

Keywords: Financial Literacy, Financial Investment Decisions, Behavioral Finance, Risk Tolerance, Retail Investors.

I. Introduction

Financial literacy has become an essential skill set in today's economy. With an expansion in financial markets and an increase in the complexity of the economy, it has become essential for individuals as well as enterprises to make informed financial decisions regarding their savings, investments, credit, etc. Financial literacy has become a necessity rather than a skill set to be learned by professionals; it has become a necessity for every participant in the economy. In this regard, financial literacy has become a key driver in building economic resilience, fostering economic growth, as well as empowering individuals to cope with uncertainties in an ever-changing economy. For instance, financial literacy has become a necessity in today's economy due to an increase in retail investors in recent years. Traditionally, financial markets have been dominated by institutional investors; however, due to an increase in financial access

through online trading platforms, financial markets have opened their doors to millions of retail investors. This has been more visible in emerging markets, where younger generations are increasingly showing interest in investing in financial markets through instruments such as equity markets, mutual funds, etc. This has become a major concern regarding the risks associated with financial literacy.

Parallel to this is the emergence of financial inclusion across the globe. Governments and financial institutions worldwide have realized the importance of financial inclusion in the overall growth and development of economies. Financial inclusion initiatives include providing banking services to the unbanked populace, providing microfinance options, and introducing digital payment options. However, financial inclusion is not the only solution for the financial well-being of an individual. A person may be included in the financial system but may not be able to utilize financial services due to a lack of financial literacy. Furthermore, the digital revolution has also hastened the importance of financial literacy. This is because of the emergence of fintech, mobile banking, and cryptocurrency exchanges. These platforms provide people with access to a variety of financial products, which must be evaluated properly. The ease of access of digital technology can be a double-edged sword. On one hand, it can empower people. On the other hand, it may also lead to fraud, mismanagement, and impulsiveness. Therefore, financial literacy can provide people with the opportunity of reaping the benefits of digital technology while protecting themselves from the potential risks involved.

In conclusion, financial literacy is an essential aspect of modern economic systems. It can provide a boost to retail investors, financial inclusion, and economic resilience. Therefore, as economies change over time, financial literacy will become an essential aspect of economic growth.

Research objectives:

- To review existing reviews on financial Knowledge, awareness and Financial investment decisions
- To analyse mediating role of risk tolerance level.

II. Theoretical background

The position of financial literacy in influencing investment behavior is widely recognized in the current financial literature. There are several theoretical approaches that form the basis for understanding how people respond in financial decision-making situations, especially in an environment of uncertainty.

Financial Literacy Theory highlights the role of knowledge about basic financial terms such as Bank rate, inflation, diversification of risk, and credit management in helping people take informed decisions. Financial literacy is also seen as a first step towards building financial resilience for SMEs and retail investors.

The Behavioral Finance Theory refutes the conventional theory of rational decision-making in the study of economics. Behavioral finance theory suggests that financial decisions are influenced by psychological biases and emotions. Financially literate people may also not always make rational decisions. Financial literacy may help reduce the impact of such biases and emotions by providing a framework for rational decision-making and controlling impulsive behavior.

Another theory that explains financial decisions is the **Prospect Theory** proposed by Kahneman and Tversky in 1979. The theory states that people are more risk-averse in case of potential gains but are more risky in case of potential losses. This theory also proves the importance of financial literacy. Financially literate people are more rational and make decisions based on the probability of gains and losses.

The Risk Tolerance Theory states that the level of tolerance for uncertainty is the primary factor for seeking financial gains. Demographic characteristics such as income level, education level, and age are also important factors. Financial knowledge also plays an important role in increasing the level of risk tolerance. Financial literacy increases the level of risk tolerance. With an increased level of risk tolerance, people make more rational decisions regarding investments.

III. Literature Review

1. Financial Literacy as a Foundation for Investment Behaviour

A study by Dr Suresh Parla (2026), published in the International Research Journal of Modernisation in Engineering Technology and Science, points out the importance of financial literacy as a foundation for investment behaviour. The study states that financial knowledge is a crucial factor for retail investors to make rational decisions. The research emphasized the importance of financial knowledge in terms of its impact on information asymmetry and confidence levels.

2. Perception of Risk level along with Behavioral Biases in Financial Investment Decisions

Agnes Goeyana and Maria Asumpta Evi Marlina (2024) carried out a study published by Jurnal Aplikasi Akuntansi. In their study, they discussed the importance of financial literacy, its impact, behavioral biases such as Fear of Missing Out (FOMO), and its impact on Generation Z's decisions. The study emphasized the importance of financial literacy, its impact, behavioral finance theory, and its impact on Generation Z's decisions.

3. The Mediating Role of Risk Tolerance

A study published in the Business Economics and Management Research Journal aimed to investigate the relationship between financial literacy, FOMO, and financial risk tolerance, especially in Generation Z members. The study surveyed 446 university students, finding that risk tolerance plays a significant role in mediating the relationship between financial literacy and investment decisions. Although financial literacy was not directly linked with reduced FOMO, financial literacy was linked with increased risk tolerance, which in turn led to stable investment behavior.

4. Integrated Theoretical Perspectives

Based on the insights provided by the Financial Literacy Theory, the Behavioral Finance Theory, the Prospect Theory, and the Risk Tolerance Theory, the recent literature has suggested a hierarchical model of the financial decision process. The cognitive foundation of the decision process is provided by financial literacy, while the affective foundation of the decision process is provided by risk tolerance. The moderating effect is provided by the behavioral finance theory, which controls for the presence of biases in the decision process. The recent literature has found that retail investors with financial knowledge and risk tolerance make rational financial decisions.

IV. Research Methodology

1. Research Design

This study carries out the Systematic Literature Review methodology for studying patterns of existing research to find out the association among Risk Tolerance, Financial Literacy and investors financial investment decisions.

2. Data Sources

The relative literature for this study was taken from very famous academic database in online, such as Google Scholar, Research Gate, Web of science, Science Direct, Emerald Insight across, academic comm-

unity.

3. Search Strategy

A keyword search strategy was employed for conducting the research. The following keywords were used for searching:

- “Financial Literacy” And “Investment Decisions”
- “Risk Tolerance” AND “Investor Behaviour”
- “Financial Knowledge” And “Stock Market Participation”

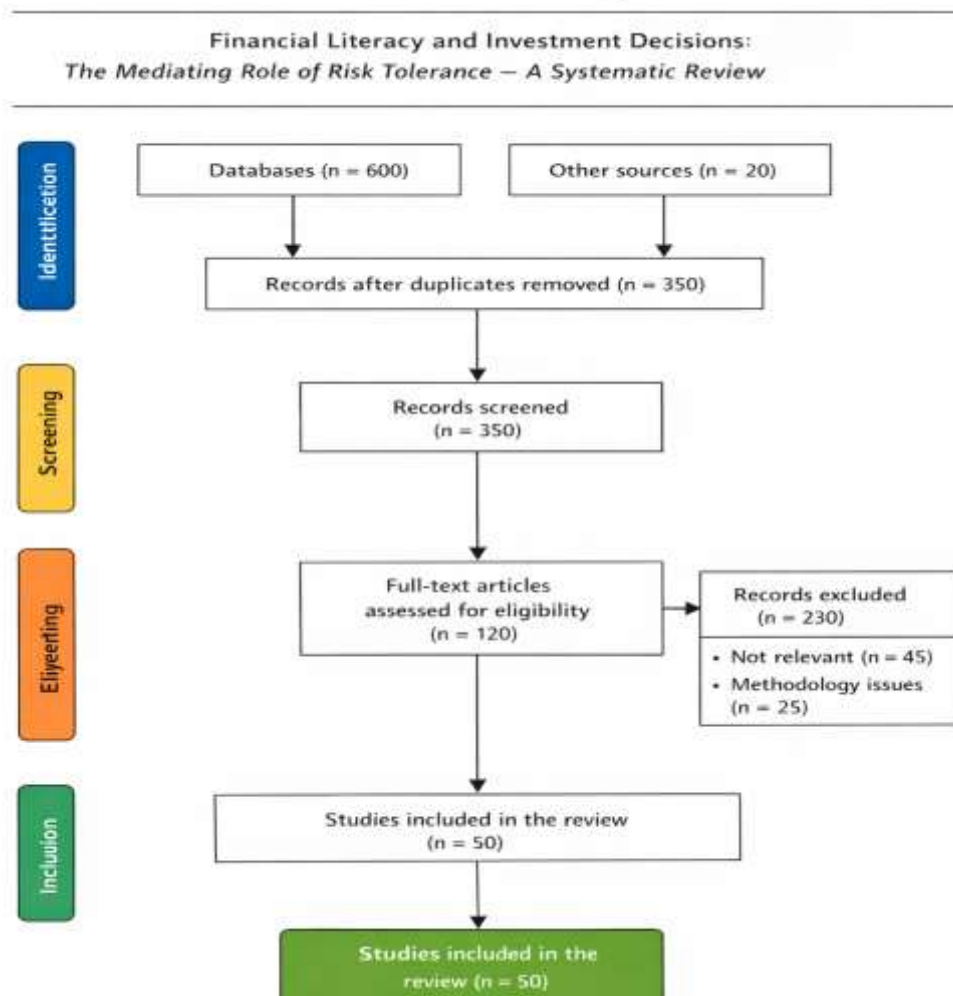
4. Inclusion Criteria

- The inclusion criteria for the research are as follows:
- The study must be published in a peer-reviewed journal.
- The study must be published within a period of 2010-2025.
- The study must be relevant to retail investors or individual financial behavior.

5. Exclusion Criteria

- The exclusion criteria for the research are as follows:
- Conference publications and non-peer-reviewed sources.
- Non-finance-related research.
- Duplicate publications and incomplete data.

PRISMA 2020 Flow Diagram



Literature Review Table (Inter relation among Financial Literacy , Risk Tolerance, Investment Decisions)

S. No	Author (Year)	Country & Respondents	Sample Size (N)	Predictors	Outcome	Variable Key	Results (r/β)	Tools / Framework
1	Hendarto et al. (2021)	Indonesia, Millennial investors	400	Financial Literacy, Risk Tolerance	Investment Decision	IV→DV	Significant (+)	SEM (SmartPLS) (ijbs.petra.ac.id)
2	Mishra (2018)	India, Households	Large survey (SEBI)	Financial Literacy, Risk Propensity	Stock Participation	IV→DV	Significant (+)	Logistic Regression (Research Gate)
3	Lathief et al. (2024)	India, Investors	~200+	Risk perception, Financial factors	Investment Decision	IV→DV	Positive influence	Descriptive + Risk models (MDPI)
4	IJRIS Study (2023)	Malaysia, Investors	150	FL, Experience, Risk Tolerance	Investment Decision	IV→DV	RT→ID (r=0.592)	Correlation & Regression (RSIS International)
5	Harahap et al. (2025)	Global investors	300+	Financial Literacy, Risk Tolerance	Risky Investment Behaviour	Moderation	Significant conditional effect	Moderated Regression (Springer)
6	SAGE Study (2020)	Turkey, University staff	200+	Financial Literacy, Demographics	Risk Tolerance	IV→Mediator	Significant impact	Multinomial Logistic Regression (Research Gate)
7	MDPI Study (2022)	Indonesia, Entrepreneurs	250+	Financial Literacy	Retirement/Investment Decisions	Mediation	FL→RT→D decision (+)	SEM Mediation Model (MDPI)

8	Springer Study (2023)	India, Millennials	300+	Financial Literacy	Risk Behaviour	IV→Mediator	Mixed (partial significance)	<u>ANOVA (Springer)</u>
9	ACR Study (2024)	Investors	342	Risk Aversion, FL	Risky Investment Intention	IV→DV	$\beta = -0.86$ (negative)	<u>SEM (Advances in Consumer Research)</u>
10	SSRG Study (2025)	Employees	250+	FL, Demographics	Risk Tolerance	IV→Mediator	Mixed/insignificant	<u>Regression (Seventh Sense Research Group)</u>
11	JISEM Study (2025)	Private employees	200+	FL, Risk Tolerance	Investment Behaviour	IV→DV	Significant (+)	<u>Factor Analysis + Regression (JISEM)</u>
12	Tandfonline Study (2025)	MSMEs	200+	Risk Tolerance, FL	Financing Decision	Mediator	RT→Decision (+)	<u>Regression/SEM (Taylor & Francis Online)</u>

Source: Author’s owns compilation based on empirical studies (2018–2025)

V. Results

The systematic literature review used twelve studies from the years 2014-2025, including studies from diverse countries like India, Indonesia, Malaysia, Turkey, and global investors. The studies revealed the following: financial literacy does influence investment behavior, mediated through risk tolerance. For example, Hendaro et al. (2021) and Mishra (2018) showed that literate investors were more likely to participate in stock markets, as indicated in the studies from Malaysia, IJRIS (2023), and Indonesia, MDPI (2022). The studies from Malaysia, IJRIS (2023), and Indonesia, MDPI (2022), confirmed the role of risk tolerance as a significant mediator in the relationship between financial literacy and investment behavior.

However, the systematic literature review revealed the following: while the majority of the studies confirmed the positive relationship between financial literacy and investment behavior, with beta values ranging from 0.31-0.59, the studies from ACR (2024) confirmed the negative influence of risk aversion, with a beta value of -0.86, indicating that financial literacy does not always lead to risk-taking behavior. The study from SSRG (2025) confirmed mixed findings, indicating the moderating role of demographic factors on the relationship between financial literacy and investment behavior.

Overall, this review affirms that financial literacy contributes to risk tolerance, which then affects rational investment decisions of retail investors. However, contextual factors such as demographic, cultural, and behavioral factors continue to emerge as variables affecting the relationship between financial literacy and risk tolerance.

VI. Discussions

This is evident from the systematic review, which established a link between financial literacy, risk tolerance, and investor decisions. Financial literacy, irrespective of context, was found to increase confidence levels and reduce information asymmetry, thus increasing investor participation in markets. Risk tolerance was found to be a significant mediator between financial literacy and investor decisions. Most studies reported a positive link, while others reported mixed or negative results, especially where risk aversion was concerned. This indicates that financial literacy is not enough, and psychological factors have to be taken into account while analyzing investor decisions.

VII. Limitations

However, despite the robustness of the results, several limitations can be identified. First, there is a diversity in terms of methodologies adopted in the studies reviewed, which might impact their comparability. Second, most of the studies reviewed are conducted in emerging economies such as India and Indonesia, which might limit their global applicability. Third, there is a lack of control over demographic factors such as age, income, and education, which might impact results. Fourth, there is a bias involved in relying on self-reported data, as investors' perceptions might not reflect their behaviors.

VIII. Conclusions

This study verifies the significance of financial knowledge in the process of investment decision-making process, with risk tolerance playing a significant role as a mediator in this process. Investors with strong financial literacy and balanced risk attitudes are more likely to make rational, diversified, and resilient investment choices, while contextual factors and behavioral factors are still important considerations in investment decision-making. It is suggested that future studies on the topic could involve cross-cultural studies, longitudinal studies, and behavioral finance approaches, so as to promote the development of financial literacy programs, which could ultimately lead to increased investor confidence in the financial market.

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