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Active vs passive funds: the behavioral factors for individual investors.

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ABSTRACT:
The purpose of this bachelor's thesis is to investigate the behavioral factors that influence individual investors when choosing between actively and passively managed funds. The study focuses on whether the choices made by investors can be explained by traditional finance theories, such as costs, returns and risk. But also, are there other behavioral factors that play an important role when decisions are made.

The choice between active funds and passive funds has been a widely discussed topic. Traditional finance theories depict investors as rational decision-makers who choose the most efficient option given the available information. However, in reality, investors are not always rational when making investment decisions. Behavioral finance tendencies like herding, availability bias and loss aversion may shape the way individual investors act in the financial markets.

According to research, investing in passively managed funds is often seen as a stable, cost-efficient and low-cost option. Still, actively managed funds are widely invested in by individual investors. This thesis shows that the decision between these two fund types is not always simple. Behavioral factors, differences in market environments, financial literacy and investor experience all affect the choices that individual investors make. Because of this, behavioral finance gives this thesis a strong backbone for understanding individual investors' decision-making.

KEYWORDS: Active funds, passive funds, behavioural finance, individual investors, market efficiency, financial advisors, financial literacy,

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1 Introduction

Financial markets are often viewed as an environment where investors make decisions based on risk, expected returns, and costs. According to a traditional finance theory, investors are assumed to act rationally and choose the most efficient investment option based on the available information. At the same time, markets are expected to allocate capital towards fairly priced assets. (Fama,1970). From this perspective, choosing between active and passive funds should be straightforward, but that is not always the case.

In practice, investment decisions are rarely this simple. Individual investors don't always act fully rationally, and their decisions are often influenced by psychological factors that may not align with traditional financial theories. Studies in behavioral finance have shown that factors such as loss aversion, overconfidence, availability bias, and herding can shape how investors make decisions and understand financial markets (Kahneman & Tversky, 1979; Barber & Odean, 2013). Because of this, the choice between active and passive funds should not be understood only as a question of investment skill, returns, or costs, but also as a question of investor behavior.

It is important to understand the differences between active and passive funds. Actively managed funds have a portfolio manager who seeks to outperform the market through active decision-making. In passive funds, the main goal is not to beat the market but to track a benchmark index, typically with low transaction costs. It is important to understand what leads an investor to choose a particular type of fund. Not all investors choose passive funds even when the cost would be lower in comparison to an actively managed fund. Also, not all active investing aims to outperform the market. These decisions are usually driven by the need for control, a tendency to follow other investors, and confidence in one's own abilities.

This bachelor's thesis examines the decision-making process that individual investors use when choosing between actively managed and passively managed funds. The goal

is to understand the factors behind these decisions using behavioral finance theories. This is a timely topic because passive investing has grown in popularity in recent years, yet many investors still choose actively managed funds. Investors can often be reduced to numbers and ranked solely by their returns. This is why it is important to go beyond a surface-level analysis and examine how behavioral tendencies influence individual investors' decisions. The comparison between these two investment approaches provides this thesis with a solid platform for examining how economic rationality and actual behavior don't always align.

Even though the literature on performance of active and passive funds, investor behavior and behavioral finance is extensive, many of the studies are based on large developed markets such as the United States. This creates a gap in the literature, because investor behaviour may differ elsewhere. Investment culture, regulations, financial literacy and market participation may have differences across the world. Therefore, it is also relevant to consider the European context, where the structure of financial markets and individual investor behavior may differ from those in the United States.

1.1 Purpose of the study

The purpose of this study is to examine what explains individual investors' choice between actively managed funds and passively managed funds. More specifically, it seeks to understand the factors behind these decisions by exploring relevant behavioral finance theories and traditional finance theories such as modern portfolio theory, the random walk hypothesis and the efficient market theory.

The motivation for this thesis is that it may help individual investors make better financial decisions and recognize behavioral patterns that influence their investment choices. A better understanding of these patterns may also help fund managers, organisations and regulators to structure more transparent investment products. In addition, it may help improve financial literacy so that investment decisions are based

more on academic knowledge and less on impulse. Based on the purpose of the study, this thesis is guided by the following research questions.

Research question 1. How behavioral factors may influence individual investors when choosing between actively managed funds and passively managed funds?

Research question 2. Why do individual investors continue to choose actively managed funds even though passive funds in general are often presented as an efficient, low-cost alternative?

1.2 Structure of the study

This study is conducted as a literature review. First, this thesis discusses the theoretical framework of the research, such as modern portfolio theory, market efficiency, and other key perspectives in behavioral finance. The second part deals with the factors that shape individual investors' behavioral tendencies and the differences between active and passive funds. Finally, the last part concludes the key conclusions and answers to the research question.

2 Theoretical Foundations

To understand the background of individual investors' investment choices, it is necessary to examine why market returns, fund performance and stock prices behave as they do. This chapter examines two central theories: Eugene Fama's efficient market theory and the random walk theory. Both theories are relevant to this study because they help explain the behavior of stock prices and market returns.

2.1 Efficient Market Hypothesis and Market Anomalies

Eugene Fama (1970) introduced the term "efficient markets". Fama argued that in efficient markets, stock prices fully reflect all available information. This suggests that it is difficult for individual investors to outperform the market using publicly available information. Fama also pointed out in his hypothesis that investors are making rational decisions and maximizing their profits. The hypothesis also assumes that information is free and instantly available to all market participants and that transaction costs or other market frictions do not exist.

Fama (1970) categorized the efficiency into three different forms. The first form is weak-form efficiency. It suggests that current prices already reflect all past market information, such as historical prices and returns. This historical information can be used as technical analysis about historical market prices and returns. "Semi-strong efficiency" refers to all publicly available information. It can be used to analyze financial markets, but it does not offer investors a consistent advantage in outperforming the market. Lastly, "Strong efficiency" means access to all private and public information. This is problematic because strong-form efficiency rarely exists in reality. This is because private information, such as insider information, is generally inaccessible to ordinary investors and its use is often illegal.

2.2 Random Walk

The Random Walk hypothesis is closely related to the Efficient Market hypothesis. It suggests that stock prices are unpredictable and that price changes are random and independent. Meaning that past returns do not predict future stock returns reliably (Fama, 1965). In other words, the new information entering the markets is usually unpredictable and prices adjust accordingly. This theory emphasizes the challenges of active management when stock trading is based on historical returns.

The Random Walk hypothesis also provides important support for passive investing from a theoretical point of view. When the future price movements are consistently hard to predict from historical information, it challenges fund managers and investors to outperform the market through active trading strategies. This challenges the idea that it is systematically possible to achieve superior returns through market timing and active stock selection. Malkiel (2003) also argues that trying to outperform the market through predictions is often ineffective.

However, the random walk model also has its limitations. Financial markets may show anomalies and behavioral patterns that do not fully align with the theory. Also, like previously mentioned in this thesis, behavioral finance suggests that investors do not always make fully rational decisions. Even if passive investing may be more suitable for investors according to the random walk hypothesis, still many individual investors may prefer active management. This preference can be explained by behavioral factors such as the illusion of control and overconfidence.

2.3 Modern Portfolio Theory

Harry Markowitz introduced the modern portfolio theory (MPT) in 1952. This theory suggests that risks and returns of an investment portfolio can be improved by distributing funds across different asset classes (Markowitz, 1952). MPT assumes that investors are risk-averse and seek to maximize their expected returns according to their

level of risk. The efficient frontier is a fundamental element in MPT. The efficient frontier relates to a group of portfolios that offer the highest expected return for each level of risk. Also, this set provides the lowest risk for a given expected return. A Rational investor should choose a portfolio on the efficient frontier that offers the highest return for a given risk or the lowest risk for a given expected return. According to MPT, the risk is measured by the variance of investment returns. It also assumes that higher expected returns come with higher levels of risk.

The core principle of MPT is diversification. It is recommended that investors include different assets in their portfolios that have low correlation with each other. When a portfolio is built with assets that have low correlation with each other, it may bring balance to the portfolio and reduce the overall volatility of the portfolio's returns. Through diversification, unsystematic risk can be lowered while systematic risk cannot be eliminated. In modern portfolio theory, the connection between risk applies to all investors, but there are differences in how they perceive and accept this relationship based on their risk tolerance (Markowitz, 1952).

MPT assumes that investors act rationally. Behavioral finance suggests that investment decisions do not always follow the principles of MPT. Kahneman and Tversky's (1979) prospect theory shows that individual investors experience gains and losses differently. Investors tend to be more sensitive to losses than gains. This may lead to several behavioral biases when making investment decisions. Individual investors might panic-sell their investments when the stock market is experiencing losses or hold on to investments based on emotional expectations rather than rational ones. However, these kinds of over or underreactions to market changes are common (Kahneman & Tversky, 1979). Psychological tendencies like herding, overconfidence and loss aversion may lead investors away from the principles of modern portfolio theory. In this case, diversification, which is a core element of MPT, does not always become a reality in practise when investment decisions are made based on impulses and emotions (Markowitz, 1952).

2.4 Prospect Theory applied to investor behavior

The prospect theory was introduced by Daniel Kahneman and Amos Tversky in 1979. It is one of the central theories in behavioral economics. It studies decision-making under risk and explains how individuals systematically deviate from the predictions of expected utility theory. The theory is divided into four different elements, which are reference dependence, probability weighting, loss aversion and diminishing sensitivity (Barberis, 2013). Since its introduction in 1979, prospect theory is still highly influential. However, the original version of prospect theory also has limitations. Particularly in its approach to uncertain outcomes (Barberis,2013). The theory can only be applied to gambles with net zero outcomes. Kahneman and Tversky later developed the theory further in 1992 by introducing cumulative prospect theory. This newly modified version fixed some of the limitations of the original prospect theory.

The prospect theory provides a useful frame for understanding the behavioral tendencies and patterns that influence individual investors. Loss aversion helps explain why some investors are holding on to losing investments for too long and sell their winning investments too early. Kahneman and Tversky (1979) found that people are generally more affected by losses than gains of the same size. Even small losses tend to have a greater impact on people than gains of the same size. For example, losing 100€ usually has a stronger psychological impact than a 100€ gain. Individual investors may hold on to their stocks in the hope that they will return to their purchase price. In this case, they are basically gambling that the stock will break even and get their money back eventually. This suggests that individuals do not always choose the most financially rational outcome.

Grinblatt and Keloharju (2001) noticed the same behavior among investors not selling their losing investments. They analyzed the trading records for nearly all Finnish investors during 1995-1996. They also concluded that Finnish investors, among other investors in different countries, tend to hold on to their losing investments. Their findings

support the idea that loss aversion influences selling decisions. Additionally, if the stock is trading at an all-time high, these stocks have a high chance of being sold.

Another useful explanation that prospect theory offers regarding active and passive investing choices lies in the probability weighting. According to Kahneman and Tversky (1979), people may have tendencies to give too much weight to unlikely outcomes. They pointed out that people are often attracted to lotteries and insurance. In other words, individuals may seek risk in some situations but also have the need for security at the same time. Kahneman and Tversky gave an example that many might prefer a 0.001 chance of winning 5000$ over a safe profit of 5$. The theory also suggests that people may find it easier to lose 5$ rather than having a 0.001 chance of losing 5000$.

Kahneman and Tversky also wanted to point out that such decisions do not mean that individuals are irrational. They understand that the 0.001 probability is low, but still treat it as a big risk. Combining the results, loss aversion and probability weighing help explain why some individual investors may prefer actively managed funds. Active investing may be attractive to some investors because it creates the impression that some losses can be avoided. Also, at the same time, investors may have the impression that it is still possible to achieve superior returns through market timing and managerial skill.

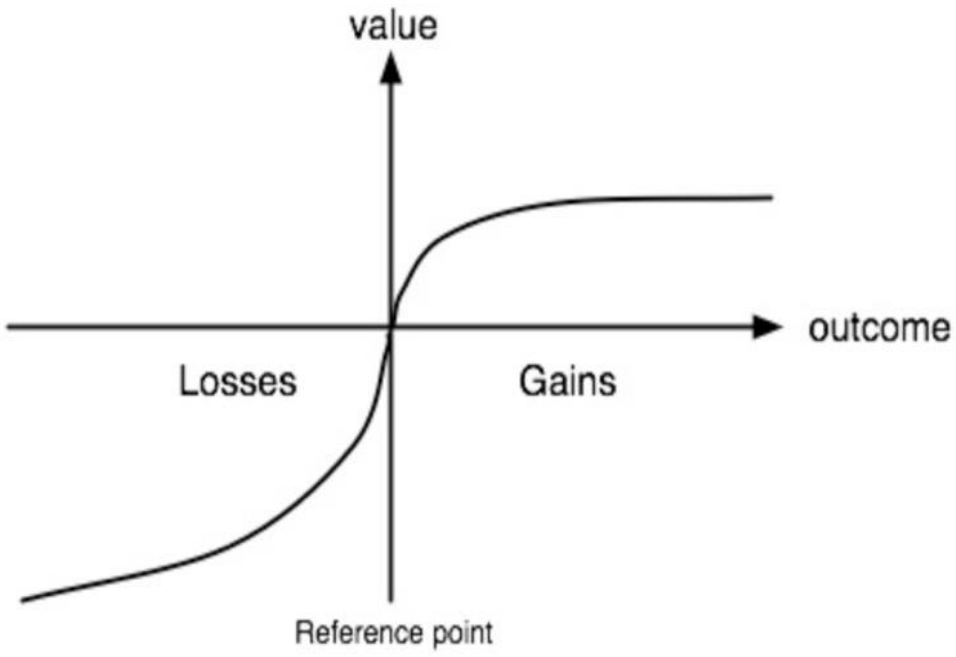

Figure 1. Kahneman's value-plot on prospect theory (Kahneman, 1979)

3 Empirical evidence on behavioral factors in active vs passive choices

This chapter examines active and passive investing by reviewing the fundamental differences between these strategies. This chapter focuses on fund returns after fees, costs, and as well their overall performance. Additionally, this chapter briefly examines how wider market conditions may impact active and passive investing. In addition, this chapter examines the factors that drive individual investors to make certain decisions and discusses the theories that help to explain these decisions.

3.1 Impact of Fees, Costs, and Performance Expectations

There is a noticeable difference between the fees charged by actively managed funds and passively managed funds. This raises the question of why investors still choose actively managed funds when passive funds often offer lower costs and may perform better on average after fees. The annual fees of actively managed funds can be around 2.0% or more annually. Compared to passively managed funds, where the fees can be as low as 0.20%. After high management fees and taxes, the net returns of active funds may be at a lower level compared to overall market performance. On average, passive funds or index-based benchmarks are often used as a reference point for actively managed funds when evaluating performance (Del Guercio & Reuter, 2014).

Crane & Crotty (2018) challenged the assumption that all passive funds are identical and offer no opportunities for skill differentiation. Their study showed that it makes a huge difference what is used as a benchmark when examining passive index fund performances. They also noticed that various tracking errors might occur when trying to compare fund performances. After comparing active and passive funds using several performance measures, Crane and Crotty found that passive funds in general outperformed active funds. They also found out that even highly skilled fund managers and top-performing active funds did not consistently outperform the best index funds. As noted earlier in this thesis, Kahneman and Tversky (1979) concluded that investors

are generally risk-averse. In a similar way, Crane and Crotty (2018) also argued that risk-averse investors would be better off choosing a passive index fund rather than an actively managed fund.

3.2 Overconfidence and perceived skill

There are differences in how investors perceive their knowledge and skills in the financial markets, from beginners to experienced market participants. Nowadays, investing in funds has become easier, and access to the internet has brought new investors to the markets. People can start investing in funds with as little as 10-15€ per month, and there is a wide range of information about investing strategies available. However, the difficult part is how to process the information correctly so that it supports a sensible investment strategy. Even skilled individual investors can become overconfident when making investment decisions. For example, people with higher education in finance may believe that they know how to build an effective portfolio. However, this is not always the case.

Overconfidence is an important concept in behavioral finance because it helps us better understand what may lead investors to overestimate the abilities of their investment decisions. Barber and Odean (2001) gathered data from more than 35 000 households and suggest that overconfident investors tend to trade more frequently, even though this might shrink their net returns. In conclusion, this may help explain why some investors might still prefer active investment funds over passive investment funds even when passive alternatives may offer more stable long-run outcomes and lower costs.

3.3 Availability Bias and Illusion of Control

This chapter examines two behavioral finance concepts, availability bias and the illusion of control. It also examines how they may impact individual investment strategies. Availability bias refers to the tendency to evaluate the probability or importance of a certain outcome based on how easy it is to remember information. For example, Individual investors may place too much weight on recent returns and easily available data, even when such information is not representative of long-term return probabilities. (Tversky & Kahneman, 1973). The illusion of control, on the other hand, refers to a behavioral tendency in which individuals overestimate their own ability to influence outcomes in random or partly controllable situations. This tendency may be strengthened by multiple factors such as active participation, familiarity and choice (Langer, 1975).

When it comes to fund choices, availability bias may lead individual investors to prefer actively managed funds when recent performance, good rankings, or media attention is positive. Such funds may become easier to remember for individual investors and might seem like a good-performing fund for them. As a result, investors may invest excessively in funds with strong recent performance, which is consistent with return chasing behavior (Sirri & Tufano, 1998).

The factors that may reinforce availability bias are usually simplified information, like fund ratings, which can reduce the need for more information gathering. Also, the comparison of fees and overall costs can be neglected at the same time and rely more on easily noticeable information. Event study evidence suggests that even a discrete change in Morningstar star ratings can influence investor fund flows. In other words, higher ratings are associated with positive fund flows, and lower ratings tend to reduce inflows. This suggests that the fund flows in this situation may be influenced by star ratings rather than other performance measures (Del Guercio & Tkac, 2008).

On the other hand, the illusion of control may psychologically reward individuals who choose active funds or frequently make changes between funds. The feeling of making independent decisions and analysis may increase self-confidence and create the illusion that investors can spot the best fund managers or time their investment changes successfully (Langer, 1975). Empirical evidence on the illusion of control, and especially on overconfidence, suggests that being too active may also have a negative effect on the net returns of individual investors. For example, frequent trading linked to overconfidence may lead to weaker investment performance. (Barber & Odean, 2001).

3.4 Herding and the impact on individual investors

Herding refers to a phenomenon in which investors make their investment decisions based on the actions of other investors rather than on their own information or analysis. Herding happens among individual investors when many investors buy or sell the same stocks or other investments within a short time span. For individual investors, herding is often noticed in situations when certain stocks, industries, or investment themes become popular in the financial markets. For example, the attention may come from the media or from investor forums. Studies show that individual investors are affected by herding during bull markets. During better market conditions, investors may rely on earlier market and price trends when forming expectations about future returns. (Nofsinger & Sias, 1999).

Devenow and Welch (1996) also highlighted a rational perspective regarding herding. They suggested that individuals who follow other investors may feel safer psychologically and socially, rather than going against most investors. From an individual investor's perspective, such behavior may be seen as more justified if their investment strategy aligns with the majority of investors. In this kind of situation, losses may appear less severe when other investors end up having the same outcome.

Empirical studies suggest that herding among individual investors, on average, is associated with weaker investment performance. Hsieh (2013) points out that in herding situations, individual investors often buy stocks after prices have already gone up and tend to sell after prices have fallen. Similar results have also been reported by Merli & Roger (2013) and Mavruk (2022). According to these studies, herding may increase the volatility of individual investors' portfolios. Also, another downside is that herding does not appear to generate systematic abnormal returns for individual investors.

Herding among individual investors can play a crucial role when comparing the differences between active and passive investment strategies. As previously discussed in this chapter, herding can lead investors to active investment strategies and following popular market trends. On the other hand, passive investment strategies such as index funds or ETFs may reduce exposure to short-term market anomalies. Herding also provides a useful platform to understand why individual investors may underperform compared to the market. By understanding the effects of herding on individual investors, it can be argued that passive investing may offer individual investors a more efficient alternative, particularly when the investing horizon is long-term.

3.5 Risk tolerance, investor experience and financial literacy

Risk tolerance measures an investor's willingness to accept fluctuations in returns and possible losses. Risk tolerance is typically measured using questionnaire scales, such as risk tolerance tests or taken from actual risk-taking behavior, such as stock weighting (Grable & Lytton, 1999). Investor experience can be understood as the result of previous investment decisions and through learning over time. It can be measured, for example, by analyzing trading history and the number of years an individual has been investing (D'Hondt et al., 2020). Financial literacy, on the other hand, is a combination of financial knowledge, skills, attitudes and behavior (OECD, 2020). It is often analyzed using short sets of knowledge questions, such as the "Big Three". It is also measured with multiple-choice questions used in international surveys (Lusardi & Mitchell, 2014; FINRA Foundation, 2025)

Empirical evidence suggests that financial literacy is often low at the population level, which may lead to underestimation of costs and risks (OECD,2023; FINRA Foundation, 2025). Individuals with higher financial experience and literacy are more likely to invest in passive low-cost index funds. On the other hand, high-cost active investment products are usually used by individuals who have a tendency for overconfidence and availability bias (Grinblatt et al., 2016). This is also supported by experimental evidence showing that more financially literate investors respond more positively to advice that emphasizes passive investing and are less likely to react to advice that emphasizes active investing (Schoar & Sun, 2024). Behavioral factors, such as loss aversion and framing effects, increase the urge for downside protection. For some investors, it also increases the attractiveness of active management. For example, ignoring costs and relying on past returns might reinforce the belief that it is possible to succeed in active investing. (Kahneman& Tversky, 1979; Choi & Robertson, 2020).

4 Comparing market types, geography, and Technology

When examining the decisions of individual investors, it is also important to consider the role of different market environments, geographical contexts, and technological developments. This chapter compares developed and emerging markets in relation to active and passive investing. It also discusses how investor behavior has changed during different market conditions. In addition, this chapter considers the growing role of technology and how it has already shaped or may shape investment decisions.

4.1 Investor behavior in developed vs emerging markets

There are noticeable differences between developed and emerging markets, especially when it comes to active and passive investing. In developed markets, especially in the United States, the popularity of passive investment products has grown significantly over time. According to ICI (2024) data, passive investment products like ETFs and index funds accounted for 48% of long-term fund assets in 2023, up from 19% from year 2010. This indicates that passive investing has become increasingly important in developed markets. However, actively managed funds still account for a slight majority of long-term fund assets (ICI,2024; Sushko & Turner,2018)

Investor behavior in emerging markets often differs from that in developed markets. For example, individual investors often play a more visible role in trading activity, whereas short-term trading behavior is more common than in institutionally dominated markets. Also, benchmark-driven investments and global capital flows may make emerging markets more sensitive to external changes (IMF,2020). The popularity of passive investing has also differed across developed markets. In the United States, passive investing has risen in popularity faster than in many other markets. In Europe, the growth has been slower. Before the financial crisis, ETFs and index funds were generally less popular than they are nowadays. In addition, many individual investors relied more

heavily on active stock picking than they do today. During strong bull markets, such behavior is also often reinforced by overconfidence (Barber & Odean, 2000).

The differences between market environments are easier to understand through behavioral finance. Herding, for example, is often more visible in markets where individual investors have a strong role and where information is not always processed evenly. Chiang and Zheng (2010) found evidence that herding is common in several international markets. These markets included Asian markets, although the pattern was not the same across all regions. This emphasizes the fact that herding does not only happen in emerging markets. It also becomes particularly visible in markets characterized by strong trends, uncertainty, and high retail participation.

Overall, the evidence suggests that passive investing has become more common in developed markets. This development is seen especially in the United States, whereas active investing and short-term trading may remain more visible in some emerging markets. These differences should not be exaggerated. In conclusion, herding and overconfidence often affect individual investors in developed and emerging markets. However, they appear more clearly in some markets depending on how the market works and who the investors are.

4.2 Active vs passive fund performances in emerging markets and developed markets

Several studies suggest that most actively managed funds underperform their benchmark index over the long term. According to SPIVA reports, most actively managed funds underperform their benchmarks over long time horizons. In addition, in many equity categories, the underperformance rate exceeds 80%. In several developed market categories, long-term underperformance has been even higher. SPIVA Europe reported a 10-year underperformance rate of 94% to 98% in major U.S. and global equity categories in its 2025 mid-year report (S&P Dow Jones Indices, 2025).

These findings also apply to Sharpe's (1991) Arithmetic of active management. According to Sharpe, the gross returns earned by active investors are equal to the market return before costs. However, after costs, the average active investor underperforms the market. This suggests that low-cost passive investment strategies, like index funds and ETFs, offer a better long-term outcome than high-cost actively managed funds in developed markets. According to Morningstar's active/passive barometer, only 42% of active funds survived or outperformed their passive peers in 2024. This percentage was even lower in some equity categories. In this case, only 37% of U.S. large-cap active funds both survived and outperformed their counterparts. This suggests that actively managed funds have had limited long-term success, especially after fees and fund closures are considered (Morningstar, 2025).

In emerging markets, inefficiencies, weaker market transparency and information asymmetries may, in some cases, benefit active investing relative to more efficient developed markets. (González, 2024; Schill, 2006). However, even in emerging markets, the broader long-term evidence remains challenging for active funds. SPIVA Latin America reported that, over the 10 years ending in 2025, active managers underperformed their benchmarks. This underperformance occurred in all reported Brazil equity categories, with underperformance rates above 80% in most cases (S&P Dow Jones Indices, 2025).

In conclusion, the long-term evidence regarding active management remains weak in developed and emerging markets. However, a small number of actively managed funds outperform their benchmarks, but identifying them is difficult. When fees, risks and fund survival are considered, passive investing is often a more reliable choice for individual investors (Sharpe, 1991; Morningstar, 2025).

4.3 Behavioral changes over time, the post-2008 crisis, and the fintech era

The global financial crisis of 2008-2009 was a turning point in individual investors' behavior and attitudes towards investing. During the financial crisis, many actively managed funds made huge losses for investors. Even the very best fund managers who previously had brought good returns to investors failed to protect investors from losses. As a result, many investors started to question the value of active investment strategies. This also had an impact on investor perception of risk and return. Hoffmann, Post and Pennings (2013) found that during the worst phases of the crisis, individual investors' risk tolerance and return expectations declined. This may have made individual investors more aware of risks hiding in the financial markets. Also, it may have raised awareness that stock prices do not increase continuously (Hoffmann, Post and Pennings, 2013). As a result, many investors started paying attention to transparency, diversification and lower-cost investment options.

After the Financial crisis, financial markets had a long bull market. Morningstar columnist John Rekenthaler (2024) points out that in the years following the financial crisis, investors increasingly chose passive index funds over actively managed funds. This reflected a change in investor preferences. After the crisis, investors' assets flowed towards passive investments, as many active strategies had failed to deliver protection during the crisis. The financial crisis can therefore be seen as a turning point in the rise of passive investing. In the United States, active funds began to see an increase in net outflows, while at the same time, passive funds started to become more popular among investors. In Europe, the shift has been slower, although passive investment products have also grown in importance in recent years.

In the aftermath of the global financial crisis, investors appeared more risk-averse and cautious. However, this did not last long. By the late 2010s and especially around the meme stock phenomenon of 2020-2021, investor behavior in some cases reflected

speculative tendencies and higher risk-taking. This suggests that changes in investor behavior over time may be influenced by broader market conditions. Also, technological developments and the availability of new investment instruments may intensify these kinds of tendencies. (Pedersen, 2022; Philander & Zheng, 2023).

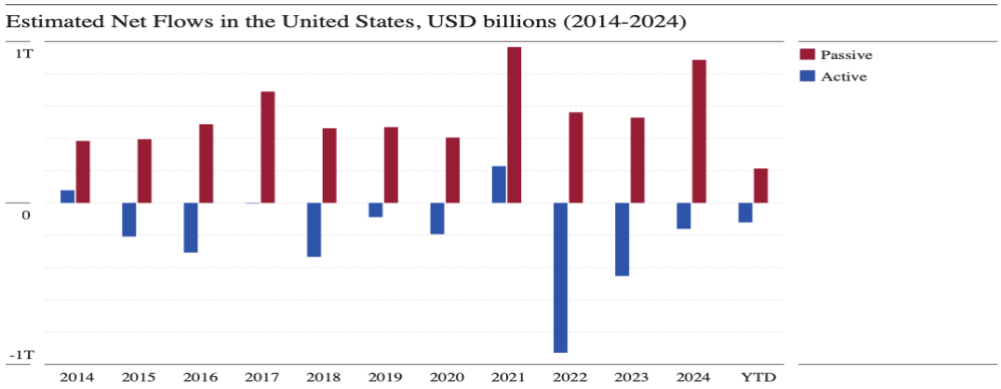

Figure 2. Estimated net flows in the United States to active and passive funds from 2014-2024 (Morningstar, 2026)

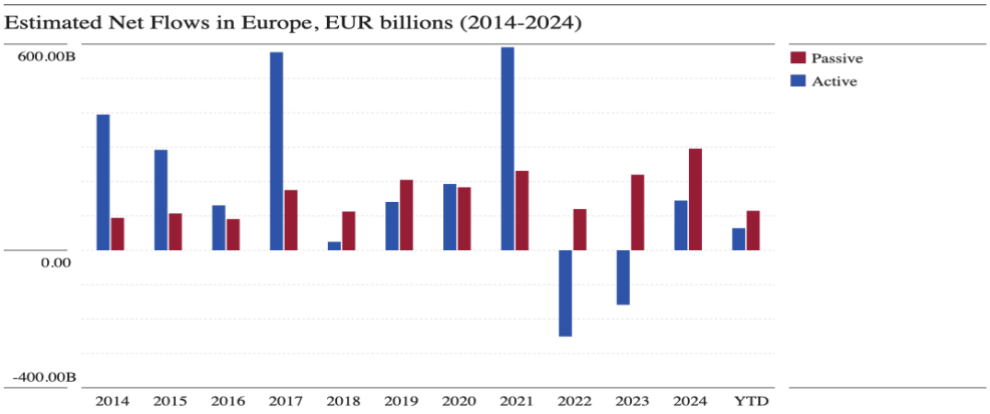

Figure 3. Estimated net flows in Europe to active and passive funds from 2014-2024 (Morningstar,2026)

4.4 The influence of AI platforms and information Availability

Artificial intelligence-based platforms and robo-advisory tools can help provide investment ideas to investors, such as market data, and provide access to digital investment tools. These platforms often use machine learning and algorithms to provide information to beginners or advanced investors. Research suggests that these kinds of tools can improve investment decision-making in some situations, and additionally, help reduce certain behavioral biases when investing (Back et al., 2023; Bhatia et al.,2020). Even though these AI tools may provide useful help for individual investors, relying heavily on them weakens independent judgment. Additionally, using these tools risks placing too much trust in artificially generated investment suggestions or ideas.

Nowadays, access to financial information is easier than ever. Additionally, the speed of data flow is faster than before. This allows investors to monitor markets and make investing decisions in real time. However, the amount of information is vast, and the question is how individual investors interpret the data they are given. A larger amount of financial information does not necessarily improve individual investors' chances of better returns. Studies suggest that individual investors have limited attention and can place too much weight on information that is easily available (Choi & Choi, 2019). The way financial information is shown also affects investor behavior. Hillenbrand et al. (2018) suggest that visual distractors in financial documents affect how investors see risk, make investment decisions and gather information.

5 Practical Implications for Financial Advisors

From a behavioral finance perspective, the choice between active and passive funds is not only a technical question of returns, costs, and risk but also a matter of managing the biases that affect decision-making. This is a key practical observation for financial advisors because there are several factors that may affect individual investors' decisions. For example, overconfidence, loss aversion, a desire for fast gains, and a need to feel in control of their investments. In these situations, the role of a financial advisor is not only to present the products but also to develop a decision-making process for the client that reduces the impact of harmful behavioral biases. (Mullainathan, Noeth, & Schoar, 2012).

Financial advisors do not always succeed in protecting their clients from being affected by harmful behavioral biases. Mullainathan et al. (2012) noticed in their audit study that financial advisors could even reinforce clients' biases. For instance, by recommending high-cost actively managed funds in situations where the client might already have a diversified low-cost index portfolio. This suggests that practical counseling work should pay special attention to the fact that the advice is based not on the client's emotions but on a long-term and systematic investment plan.

Hackethal, Haliassos and Jappelli (2012) found similar results to those previously stated in this chapter. Portfolios managed by a financial advisor had lower average returns, and trading volumes were higher than in self-managed accounts. This indicates that the added value of financial advisors lies not in favoring active investment products or frequent fund changes, but in guiding their clients to avoid harmful behavioral tendencies when investing. Hackethal et al. (2012) concluded that passive investing could be the most suitable option for individual investors. They also mentioned that Passive investing could be complemented with active investment choices if these actions are justified and have a proper cause.

Financial advisors might even invest themselves in the same way they advise their clients. If an advisor personally prefers high-cost active investment products, trades frequently,

and bases decisions on past returns, similar patterns can also be reflected in the advice they give to their clients. As a practical implication, financial advisors should also recognize their own behavioral biases. Therefore, successful financial advising requires that the advisor not only understands their own behavior as an investor but also has a critical awareness of their client's behavior (Linnainmaa, Melzer and Previtero, 2021).

6 Conclusion

This bachelor's thesis examines the behavioral factors that affect individuals' decision-making when choosing between actively managed and passively managed funds. This thesis combines research on behavioral finance, traditional finance theory and the performance differences between active and passive investment strategies. In addition, this thesis examines the different choices individual investors make between active and passive funds in different market environments. It also reviews what type of effects the financial crisis left on investors' behavior and how it has shaped modern-day individuals as investors. In addition, the technological change and how it may or may not help individual investors to make better investment decisions are also examined. The research questions are addressed using relevant studies and prior literature.

The first research question can be answered by concluding that individual investors' fund choices are affected by multiple factors. These factors include loss aversion, herding, overconfidence, availability bias, illusion of control, risk tolerance, and financial literacy. These factors shape the views on how investors interpret market information and their own investment skills. In addition, they affect how risks, costs and returns are interpreted. To conclude the first research question, the decision between actively or passively managed funds is not only a financial decision, but also a decision that is affected by behavioral biases.

Why do individual investors continue to choose actively managed funds when passive funds are usually presented as an efficient and low-cost alternative? The previous literature suggests that this decision cannot be explained by rational financial theories alone. This is due to the fact that many investors prefer active funds because they want to follow what other investors are doing, or they want a greater sense of control. Additionally, investors want to believe in managerial skills and react to strong market trends themselves. At the same time, investing in passively managed funds can be more stable in the long run and bring individual investors security regarding behavioral biases and sudden market events.

Future research regarding individual investors should examine the differences between active and passive fund choices made in the Nordics or on a smaller scale, such as in Finland. There is a need for more investor data regarding transactions, surveys and interviews. This data would help better understand how behavioral biases affect fund choices in real life. In addition, future research should further examine what kind of effects digitalization and, especially, artificial intelligence have had on the decision-making of individual investors.

This thesis shows that active investing remains attractive to certain individual investors with behavioral tendencies, such as overconfidence, herding, and the illusion of control. However, passive investing has risen in popularity due to its low costs and long-term stability. In conclusion, this thesis shows that the choice between active and passive investing cannot be understood through risk, returns, or costs alone. Furthermore, behavioral factors play an important role in shaping investors' preferences.

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