

Impact of Psychological Factors on Investment Decisions in Nepalese Share Market: A Mediating Role of Financial Literacy

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ABSTRACT

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The Nepalese stock market is characterized by emerging market dynamics and significant volatility, influenced by regulatory developments, economic conditions, and investor sentiment. This study explores the impact of psychological factors on investment decisions within the Nepalese share market, emphasizing the mediating role of financial literacy. Data were collected from 410 individual investors in the Kathmandu Valley using a structured questionnaire and analyzed with SmartPLS 4.0. The findings indicate that psychological factors have a positive and significant effect on investment decisions, with psychological biases often leading to suboptimal investment choices. Investors with higher levels of financial literacy are better equipped to mitigate the adverse effects of these biases, resulting in more rational and informed investment decisions. The study highlights the critical need for enhanced financial education programs to empower investors and improve overall market efficiency. Recommendations include integrating financial literacy programs into the national curriculum and other public initiatives to equip investors with the necessary knowledge to understand financial products, market dynamics, and risk management strategies.



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INTRODUCTION

The influence of psychological factors on investment decisions in Nepal's stock market with the mediating role of financial literacy reflects a significant issue both globally and regionally. Globally, financial market volatility often triggers irrational investment decisions due to the influence of emotions and psychological biases, while the lack of financial literacy among investors can lead to poor decisions and threaten market stability. In addition, the use of technology and social media can exacerbate the phenomenon of herd behavior, potentially creating market bubbles. At the regional level, Nepal's fledgling stock market faces challenges such as limited access to financial education, which leaves many investors unaware of the risks and opportunities involved. Cultural influences and social norms can also encourage individuals to follow others' investment decisions, while inadequate regulation can

add uncertainty for investors. Regional or global economic crises can worsen investor confidence, increasing psychological biases such as fear of loss. This study aims to explore the relationship between psychological factors and financial literacy in investment decision-making, hoping to provide useful insights to improve investment practices in Nepal. Behavioral finance is a branch of finance that deals with emotional involvement in financial decision-making. It looks at how people's emotions and biases influence their financial decisions. It shows that investors don't always make rational choices because they can be influenced by things like fear, overconfidence, or even the way information is presented to them. By understanding these factors, we can better understand why markets sometimes behave unexpectedly and how to make better decisions when investing or managing money ([Osagie & Chijuka, 2021](#)). It talks about the biases of human nature that impact our investment choices and, how it leads to the deviation from traditional economic models. It explores how psychology, emotions, and cognitive biases influence financial decision-making. It seeks to understand and explain how human psychology and emotions influence financial decision-making ([Khurshid et al., 2021](#)).

Psychological factors of the individuals play a pivotal role in shaping investment decisions. It is concerned with the factors influencing how individuals perceive risks, interpret market information, and manage their portfolios. Risk perception varies widely among investors, influenced by factors such as personality traits, past experiences, and financial goals ([Dorn & Huberman, 2022](#)). For instance, individuals with higher risk tolerance may be more inclined to invest in volatile assets with potential for higher returns, whereas those with lower tolerance may choose for safer, less volatile investments despite potentially lower returns ([Kahneman and Tversky, 2021](#)). Behavioral biases, rooted in cognitive psychology, further impact decision-making processes. Loss aversion leads investors to strongly prefer avoiding losses over acquiring gains of similar magnitude ([Kahneman & Tversky, 2021](#)). This bias can result in risk-averse behavior, causing investors to sell assets prematurely during market downturns to avoid further losses, rather than holding on for potential recovery. Overconfidence is another common bias where investors overestimate their ability to predict market movements or the performance of specific investments ([Barber & Odean, 2021](#)).

Emotions play a pivotal role in investment decisions. Particularly, fear and greed can significantly influence market sentiment and individual behavior. In times of market volatility or downturns, fear often drives investors to hastily sell off assets, exacerbating market instability ([Shiller, 2023](#)). Conversely, greed can spur speculative behavior, prompting investors to pursue high-risk investments in pursuit of quick profits, often disregarding long-term consequences ([Kahneman & Lovallo, 1993](#)). To counteract these emotional biases and their impacts, investors can implement strategies like diversification. This approach spreads risk across various asset classes, reducing dependence on the performance of any single investment ([Markowitz, 2022](#)). Regular portfolio assessments and adherence to a well-defined investment plan also foster discipline and help deter impulsive decision-making during turbulent market phases ([Benartzi and Thaler, 2021](#)). Recognizing and addressing these psychological factors is crucial for investors striving to achieve long-term financial objectives. By

acknowledging their own biases and emotions, and by adopting evidence-based investment strategies, investors can enhance their ability to make rational, well-informed decisions aligned with their goals.

Financial literacy is now widely acknowledged as a vital skill in today's intricate economic environment, impacting how individuals make informed investment choices that match their long-term financial objectives. A survey conducted by the Global Financial Literacy Excellence Center reveals that a considerable number of adults globally lack fundamental financial knowledge, hindering their capacity to effectively manage personal finances and make prudent investment decisions ([Lusardi & Mitchell, 2019](#)). Research emphasizes the significance of financial education in enabling individuals to understand financial markets, assess investment risks, and maximize returns ([Fernandes, Lynch Jr, & Netemeyer, 2014](#)). Investment decisions involve more than just maximizing returns; they also require an understanding of risk tolerance, asset allocation, and how economic factors impact various asset classes. Research indicates that individuals with greater financial literacy are more inclined to plan for retirement and diversify their investment portfolios. This approach not only helps in managing risk but also supports long-term wealth accumulation ([Hastings & Mitchell, 2019](#)). Additionally, financial literacy is vital for promoting economic stability on both personal and societal fronts, contributing to overall financial well-being and resilience, particularly in times of economic downturn ([van Rooij, Lusardi, & Alessie, 2011](#)).

Investing in Nepal's stock market is fraught with challenges rooted in psychological factors, financial literacy, and decision-making processes. Paudel and Pant (2018), highlighted that investors lack experience and expertise, often leading to emotional decision-making and susceptibility to herd mentality. Financial literacy remains a significant barrier, as highlighted by the Nepal Rastra Bank (2020), with investors often having inadequate understanding of complex financial products and market risks. Moreover, the regulatory environment can be daunting, complicating compliance and accessibility to reliable information (Nepal Stock Exchange, 2021). These factors contribute to issues such as overtrading, lack of diversification, and vulnerability to market manipulation. Addressing these challenges requires concerted efforts to enhance financial education, improve access to information, and strengthen regulatory frameworks, thereby empowering investors to make more prudent and informed decisions in Nepal's evolving stock market landscape. Considering this fact, this study aims is to explore how psychological factors influences the investment decisions in Nepalese share market, considering the mediating influence of financial literacy. By examining these relationships, the study seeks to contribute to a deeper understanding of the factors shaping investment decision in Nepalese share market. This study aims to analyze the influence of psychological factors, such as emotions and cognitive biases, on investment decisions in the Nepal stock market, as well as assess the role of financial literacy as a mediating variable that can help investors overcome the negative impact of psychological factors. It is hoped that the results of this study can provide a better understanding of the psychological influences on investment decision-making, as well as demonstrate the importance of financial literacy in helping investors make more rational and informed decisions.

METHODS

Literature Review and Hypotheses Development

The Prospect Theory by Kahneman and Tversky (1979) led to studies on behavioral biases. The Efficient Market Hypothesis (EMH) says markets are perfectly efficient and investors are always rational ([Jiang & Li, 2020](#)). Similarly, the Expected Utility Theory states that investors make rational decisions based on available information ([McCarthy et al. 2020](#)). However, Prospect Theory challenged these ideas by showing the limits of rationality. Thaler and his team first applied Prospect Theory in 1980, arguing that investors often make irrational decisions due to various factors ([Barberis et al. 2021](#)). This work earned Thaler the title of the father of behavioral finance.

According to Niroomand et al. (2020), traditional finance theories such as the Efficient Market Hypothesis and the Expected Utility Theory fail to account for investors' behavior. Additionally, these theories do not pinpoint the factors that led investors to make less rational decisions. This gap in understanding prompted researchers to investigate other influences on investors' behavior.

Relationship between Psychological Factors and Financial Literacy

The relationship between psychological factors and financial literacy is increasingly recognized as crucial in understanding individual financial behavior and decision-making. Psychological factors such as cognitive biases, emotional regulation, and personality traits significantly influence financial literacy levels and subsequent financial outcomes. For instance, individuals prone to cognitive biases like overconfidence or loss aversion may make suboptimal financial decisions despite possessing adequate financial knowledge ([Lusardi & Mitchell, 2024](#)). Moreover, emotional factors such as anxiety or impulsiveness can impair financial decision-making even among individuals with high financial literacy ([Shim et al., 2019](#)). Personality traits such as conscientiousness and openness to experience have also been linked to higher levels of financial literacy, suggesting a nuanced interplay between individual psychological characteristics and financial knowledge acquisition ([Furnham & Cheng, 2024](#)). Effective financial education programs often incorporate behavioral economics principles to mitigate biases and enhance decision-making skills ([Fernandes et al., 2024](#)). Base upon these facts, the following hypothesis has been proposed.

H1: Psychological factors have a significant effect on financial literacy.

Relationship between Psychological Factors and Investment Decisions

Understanding the intricate relationship between psychological factors and investment decisions remains a critical area of study in contemporary behavioral finance. Recent research underscores how emotions, such as anxiety and euphoria, significantly influence investor behavior and market outcomes ([Garg et al., 2023](#)). Cognitive biases, such as the availability heuristic and confirmation bias, continue to distort risk assessment and investment choices, impacting portfolio diversification and performance ([Hirshleifer, 2021](#)). Moreover, individual psychological traits, including impulsivity and sensation-seeking, shape investor decision-making

processes and risk-taking behaviors ([Liang et al., 2022](#)). Integrative models that incorporate these psychological insights alongside traditional financial theories offer a more nuanced understanding of market dynamics and investor behavior, providing pathways to improve financial decision-making strategies ([Shefrin, 2016](#)). By addressing these psychological dimensions, financial advisors and policymakers can better support investors in navigating volatile markets and achieving long-term financial goals ([Malmendier & Nagel, 2011](#)). Based on these facts, the following hypothesis has been developed:

H2: Psychological factors have a positive significant effect on investment decisions.

Relationship between Financial Literacy and Investment Decisions

Financial literacy plays a crucial role in shaping individuals' investment decisions, influencing their ability to make informed choices and manage financial risks effectively. Recent studies underscore the significance of financial literacy in enhancing investment outcomes and reducing financial vulnerability. According to a report by the Organization for Economic Cooperation and Development (OECD), individuals with higher levels of financial literacy tend to exhibit more diversified investment portfolios, which can potentially mitigate risks associated with market volatility (OECD, 2023). Moreover, a study published in the *Journal of Economic Psychology* highlighted that financial literacy positively correlates with retirement savings behavior, indicating that well-informed individuals are more likely to engage in long-term financial planning and secure their future financial well-being ([Lusardi & Mitchell, 2011](#)). Furthermore, the Federal Reserve Board's Survey of Consumer Finances revealed that households with higher financial literacy scores are more inclined to invest in assets that yield higher returns over time, such as stocks and mutual funds, compared to those with lower literacy levels ([Federal Reserve Board, 2023](#)). These findings underscore the pivotal role of financial literacy in fostering confident and prudent investment decisions, thereby promoting economic stability and resilience at both individual and societal levels. Based on these facts, the following hypothesis has been proposed:

H3: Financial literacy has a positive significant effect on investment decisions.

Financial Literacy Mediates between University Psychological Factors and Investment Decisions

Financial literacy has become a key focus for many struggling economies aiming to boost financial inclusion. By increasing financial literacy, investors' understanding improves, helping to mitigate some of their behavioral biases. Financial literacy refers to the personal ability to make informed and effective decisions regarding the use and management of money. According to Takeda, Takemura, and Kozu (2013), individuals with high levels of financial literacy tend to be less overconfident. Research has demonstrated its mediating effect on the relationship between psychological factors and investment decisions ([Adil et al., 2022](#); [Ghasarma et al., 2017](#)). Various studies have examined the role of financial literacy, confirming that it

aids investors in better understanding the markets and performing adequate security analyses to make informed decisions. The mediating role of financial literacy has been highlighted in numerous recent studies ([Akhtar & Malik, 2023](#); [Fikriyah & Suhartini, 2023](#); [Khan et al., 2023](#)).

[Baker et al. \(2019\)](#) investigated the impact of financial literacy on behavioral biases. Their findings revealed a negative correlation between financial literacy and herd behavior, and a positive correlation with mental accounting, overconfidence, and loss aversion. Similarly, [Aren et al. \(2016\)](#) demonstrated that financial literacy influences investors' risk perception. Investors with high financial literacy levels tend to conduct thorough analyses before investing, thereby reducing their risk perception. This indicates that as financial literacy increases, risk perception decreases and rational investment increases. These facts support to propose the following hypothesis:

H4: Financial literacy mediates the relationship between psychological factors and investment decisions.

Theoretical Model

Figure 1 illustrates the theoretical mediation model used in this study. The model includes a sole mediating variable, financial literacy (FL), positioned between the independent variable, psychological factors (PF), and the dependent variable, investment decision (ID).

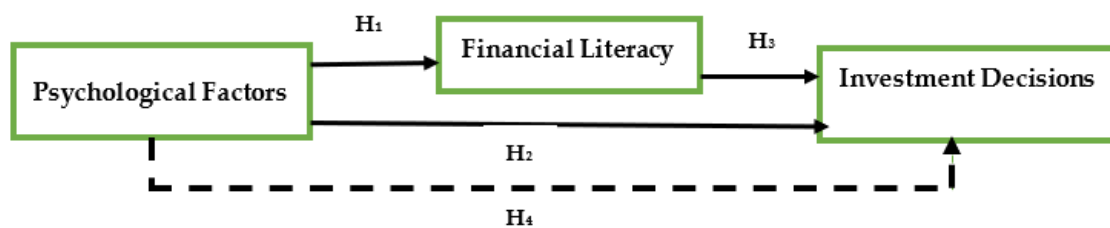


Figure 1. Hypothetical Mediation Model of the Study

This study is based on casual comparative research design. The population of the study includes all the investors of the Kathmandu valley who have traded on the Nepal Stock Exchange (NEPSE) and invested in the share capital of various companies. The sample size for this study was 410 respondents. The questionnaire was distributed via personal visits, email, and social media applications. Random sampling technique was used in this study. Altogether, 475 questionnaires were distributed, out of which 435 were returned (The response rate being 91.6 percent). Finally, 410 responses were used for data analysis, 20 were removed due to multiple non-responses. In this study, Smart PLS 4.0 (Partial least square equation modeling, PLS-SEM), was employed as the primary statistical tool for analyzing the structural relationships of the proposed theoretical model. To establish the internal reliability of the model, the Cronbach's alpha and composite reliability were used. This test helps determine whether the items within each dimension were internally consistent or not.

Convergent and discriminant validity were examined and validated using Structural Equation Modeling (SEM) using bootstrapping techniques.

RESULTS AND DISCUSSIONS

Demographic Profile of the Respondents

The study examines the mediating effect of financial literacy between psychological factors and investment decisions of individual investors in Nepalese share market. The sample size of the study was 410 individual investors within Kathmandu valley. Table 1 revealed the respondents' profile. Out of the total respondents, 69.52 percent respondents were male and 30.48 percent were female. Out of them, 79.27 percent were married and 20.73 percent were unmarried. Among the total respondents, approximately half are in the 36-50 age group, followed by those over 50 years old. Out of the total respondents, more than half (54.88 percent) were passed bachelor level, 39.51 percent passed above bachelor and 5.61 percent were passed school level. Out of them, 10.98 percent have monthly income below 30,000, 25.61 percent have 30,000-50,000, 47.8 percent have 50,000-70,000 and 15.61 percent respondents have monthly income more than 70,000. Similarly, 45.85 percent of the respondents invest their 11-20 percent of income in share market, 24.88 percent of respondents invest their 21-30 percent income, 19.76 percent respondents invest their up to 10 percent income and 9.51 percent respondents invest their more than 30 percent income in share market. It is also showed that 11.95 percent respondents make their transactions daily, 49.27 percent makes weekly transactions, 21.95 percent makes monthly transactions and 116.83 percent respondents their share related transactions occasionally.

Table 1. *Demographic Profile of Respondents*

Variables	Categories	Frequency	Percentage
Gender	Male	285	69.52
	Female	125	30.48
Marital Status	Married	325	79.27
	Unmarried	85	20.73
Age	Below 25	25	6.1
	25-35	82	20
	36-50	210	51.22
	Above 50	93	22.68
Academic Qualification	School Level	23	5.61
	Bachelor Level	225	54.88
	Above Bachelor Level	162	39.51
Monthly Income	Below 30,000	45	10.98
	30,000-50,000	105	25.61
	51,000-70,000	196	47.8
	Above 70,000	64	15.61

Income Used for Investment	Up to 10%	81	19.76
	11-20%	188	45.85
	21-30%	102	24.88
	Above 30%	39	9.51
Frequencies of Investment	Daily	49	11.95
	Weekly	202	49.27
	Monthly	90	21.95
	Occasionally	69	16.83

Source: Field survey, 2024

Measurement Model

The evaluation of the measurement model reveals robust reliability and validity across all constructs. For the psychological factors (PF) construct, Cronbach's alpha (CA) was 0.907, composite reliability (CR) was 0.908, and average variance extracted (AVE) was 0.682 above the threshold point of 0.5 (Fornell & Larcker, 1981), indicating excellent internal consistency and convergent validity. As per Hair et al. (2011), CA and CR values should exceed 0.70. The item loadings for the PF construct ranged from 0.801 to 0.866, all surpassing the 0.7 threshold (Tabachnick and Fidell, 2007), indicating strong indicator reliability. The variance inflation factor (VIF) values for the construct PF were all below 5, suggesting no multicollinearity issues among the indicators (Hair et al., 1995). Similarly, FL exhibited high reliability with CA of 0.919, CR of 0.920, and AVE of 0.756. The item loadings for this construct ranged from 0.840 to 0.902, all above the 0.7 threshold. The VIF values were also below 5, indicating no multicollinearity issues (Smith, 2020). The ID construct had CA of 0.912, CR of 0.918, and AVE of 0.657, further confirming excellent reliability and convergent validity. The item loadings for this construct ranged from 0.750 to 0.865, all exceeding the 0.7 threshold, with VIF values below 5 indicating that there is no issues of multicollinearity (Hair et. al, 1995).

Table 2. Measurement Model

Construct	Item Code	Loading	Outer Weight	CA	CR	AVE	VIF
Psychological Factors (PF)				0.907	0.908	0.682	
	PF1	0.866	0.220				3.017
	PF2	0.841	0.201				2.686
	PF3	0.820	0.185				2.730
	PF4	0.809	0.194				2.254
	PF5	0.816	0.207				2.785
	PF6	0.801	0.203				2.637
Financial Literacy (FL)				0.919	0.920	0.756	
	FL1	0.840	0.240				2.354
	FL2	0.872	0.229				2.794

	FL3	0.906	0.224		3.701	
	FL4	0.876	0.245		2.859	
	FL5	0.852	0.212		2.674	
Investment Decision (ID)				0.912	0.918	0.657
	ID1	0.829	0.174		3.465	
	ID2	0.865	0.196		3.612	
	ID3	0.846	0.182		2.812	
	ID4	0.778	0.160		2.085	
	ID5	0.843	0.201		2.548	
	ID6	0.754	0.156		2.583	
	ID7	0.750	0.162		2.286	

Note: Average variance extracted (AVE); Cronbach's alpha (CA); Composite reliability (CR).

Discriminant Validity

The Fornell-Larcker (1981) criterion confirmed discriminant validity, as the square roots of the AVE values for constructs FL, ID, and PF were 0.869, 0.810, and 0.826, respectively, each greater than the correlations between the constructs. The HTMT values were below the threshold of 0.9, further confirming discriminant validity.

Table 3. Discriminant Validity (latent variable correlation and square root of AVE)

	Fornell Larcker Criterion			HTMT Results	
	FL	ID	PF	FL	PF
FL	0.869				
ID	0.647	0.810		0.702	
PF	0.609	0.742	0.826	0.664	0.811

Note: PF- Psychological Factors, FL - Financial Literacy, ID- Investment Decision

In conclusion, the measurement model exhibits strong reliability and validity, with high internal consistency and good convergent validity for all constructs.

Structural Model

The structural model analysis showed substantial explanatory power for the endogenous constructs. The coefficient of determination (R^2) for construct FL was 0.365, indicating that 36.5% of the variance in FL is explained by PF. The predictive relevance (Q^2) for FL was 0.0343. For construct ID, the R^2 was 0.604, indicating that 60.4% of the variance in ID is explained by PF and FL, with a Q^2 of 0.538. According to Hair (2013), Q^2 of above 0.35 shows a strong degree of predictive relevance. The

model fit indices were satisfactory, with an SRMR of 0.066 and an NFI of 0.801, indicating a moderate fit (Hu & Bentler, 1999, Schumacker, & Lomax, 2010).

Table 4. Coefficient of determination (R²) and (Q²) and model fit (SRMR-NFI)

Endogenous Latent Factors	R ²	Q ²
FL	0.365	0.343
ID	0.604	0.538
	SRMR	NFI
Model fit indices	0.066	0.801

The structural model demonstrates substantial explanatory power, with high R² and Q² values for both endogenous constructs. Model fit indices suggest a good overall fit.

Hypothesis Testing

The results indicated that PF had a significant positive effect on FL ($\beta = 0.609$, $t = 7.285$, $p < 0.001$), supporting H1. Furthermore, PF also had a significant positive effect on ID ($\beta = 0.553$, $t = 5.897$, $p < 0.001$), supporting H2. Likewise, a significant positive effect of FL on ID ($\beta = 0.310$, $t = 3.227$, $p = 0.001$) was revealed, supporting H3. The analysis also revealed a significant indirect effect of PF on ID through FL ($\beta = 0.189$, $t = 2.604$, $p = 0.009$), supporting H4.

Table 5. Hypotheses Constructs

Hypotheses	Relationship	Path coefficient	T Stat.	Remark
<i>Direct relations</i>				
H1	PF → FL	0.609	7.285**	Significant
H2	PF → ID	0.553	5.897**	Significant
H3	FL → ID	0.310	3.277**	Significant
<i>Indirect relations</i>				
H4	PF → FL → ID	0.189	2.604**	Significant
	VAF	34 percent		

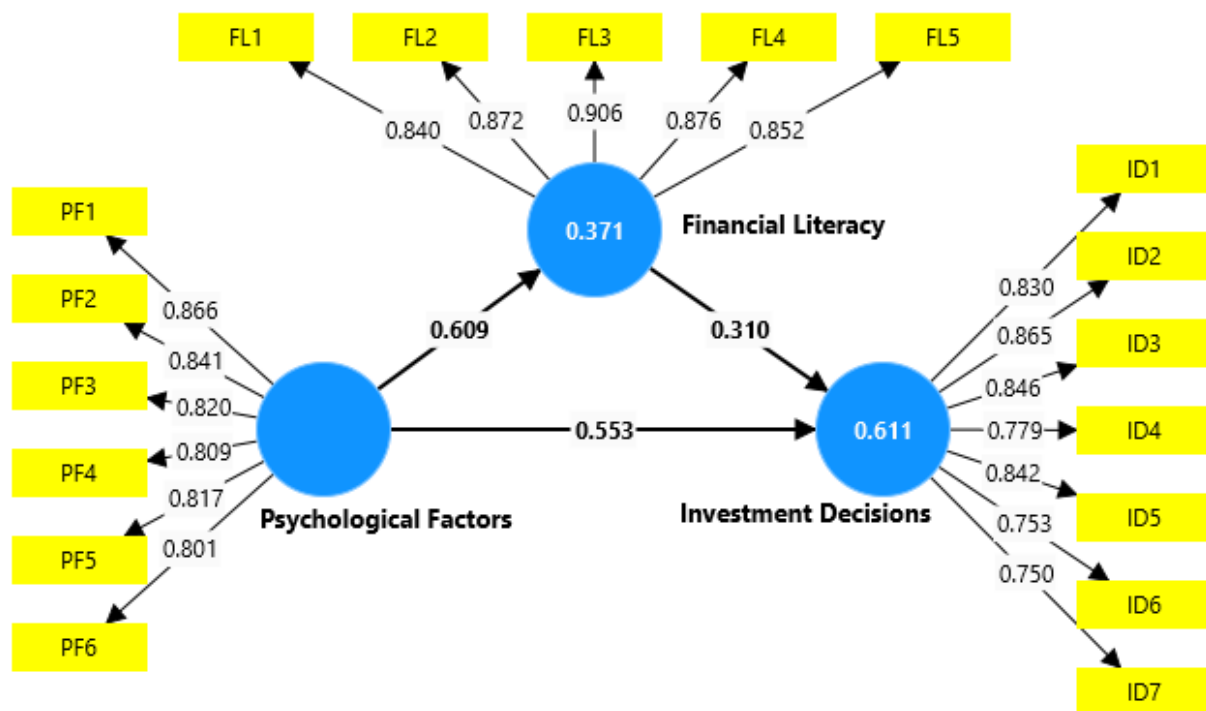


Figure 2. PLS-SEM showing positive relationships in variables

Discussion

The impact of psychological factors on investment decisions in the Nepalese share market is substantial, particularly when mediated by financial literacy. In Nepal, investors often make decisions driven by emotional and cognitive biases, such as overconfidence, herd behavior, and risk aversion. These psychological tendencies can lead to irrational investment choices, significantly affecting market outcomes. Financial literacy serves as a crucial mediator in this context, enhancing investors' ability to make informed and rational decisions.

The findings of the study underscore the significant influence of psychological factors on investment decisions within the Nepalese share market, emphasizing the pivotal role of financial literacy as a mediating variable. Investors often exhibit cognitive biases which can lead to suboptimal investment choices. These biases are not unique to Nepal but are consistent with global patterns observed in behavioral finance research. However, the unique socio-economic context of Nepal, characterized by limited access to financial education and resources, exacerbates these psychological influences, making the role of financial literacy even more crucial. Higher financial literacy has been shown to reduce the adverse effects of psychological biases by enabling investors to better understand financial products, market dynamics, and risk management strategies.

This finding aligns with previous research suggesting that financial literacy improves investment outcomes by promoting more rational decision-making processes (Lusardi & Mitchell, 2014). In Nepal, where the majority of investors lack formal financial education, targeted financial literacy programs could serve as a powerful tool to enhance market efficiency and investor welfare. Such programs could

include educational initiatives, workshops, and the integration of financial education into the national curriculum, aiming to build a foundation of knowledge that can mitigate the impact of psychological biases.

Contrarily, some studies argue that even financially literate individuals are not entirely immune to psychological biases ([Ackert & Deaves, 2010](#)). This suggests that while financial literacy is a crucial factor, it is not a panacea. Emotional and psychological aspects are deeply ingrained in human behavior and can still influence decision-making, despite a high level of financial understanding. Therefore, alongside financial literacy, other interventions such as behavioral training and the use of decision aids could be beneficial. Moreover, the nascent stage of the Nepalese share market, characterized by its volatility and the relatively low participation of institutional investors, presents both a challenge and an opportunity. The challenge lies in the heightened impact of psychological factors due to market inefficiencies and limited regulatory oversight. Conversely, the opportunity lies in the potential for substantial improvement through education and regulatory reforms aimed at enhancing market transparency and investor protection. This study highlights the dual importance of addressing psychological biases and improving financial literacy to foster a more rational and efficient investment environment in Nepal.

CONCLUSION

This study reveals that psychological factors have a significant influence on investment decisions in Nepal's stock market, where investors are often influenced by emotions and cognitive biases such as overconfidence and fear of loss. Financial literacy serves as an important mediating variable, as higher levels of literacy help investors understand financial products and risk management strategies, allowing them to control their psychological biases. Improved financial literacy not only supports more rational decisions, but also contributes to market stability. However, there are still areas that need further research, such as the influence of cultural and technological factors on investment behavior, as well as the importance of longitudinal research to understand changes in investor behavior over time. More in-depth research in these areas will provide a more comprehensive understanding of the factors that influence investment decisions and how financial education strategies can be tailored to meet the evolving needs of investors.

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