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Influence of Financial Literacy and Risk Perception on Choice of Investment

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Abstract

During recent years, variables affecting the investment preferences of individual investors are an issue attracting the attention of financial researchers. In this research, we investigate variables which are affecting investment preferences of individual investors. Personality trait is not an important variable, but on the other hand our evidence shows that level of financial literacy and risk perception are important. Besides, risk perception is also affected by financial literacy and gender, but marital status is not effective at the same level.

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1. Introduction

Preferences of individual investors are not based on rational basis as conventional finance foreseen. There are many psychological, socio- cultural and environmental factors which affect investment behavior. Within this scope, Bondt et al. (2008) state that investors can not be rational, they can only have bounded rationality.

Standard finance contextualizes investors as individuals who are never confused by cognitive errors and never averse to regret and who have an excellent self-control. On the other hand, according to Statman (1995), regard to behavioral finance, people are irrational, in other words they are normal. According to Baker and Nofsinger (2002) standard finance focuses on investor behavior outcomes rather than the consequences of this behavior. In place of this, behavioral finance is an emphasis on the importance of psychology in financial behavior and tries to explain the irrationality of investors.

According to Statman's description, behavioral finance is an area which is established under standard finance but offers a new perspective for standard finance's descriptive theory. Statman (1995) states that, behavioral finance

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reflects different model of human behavior and is built by many variables like prospect theory, cognitive errors, problem of self-control ext.

In Prospect Theory, Kahnemann and Tversky (1979) assert that people do not always act according to standard finance theory under risk and uncertainty and they added psychological factors and random behaviors to rational choices.

'Prospect Theory" is a kind of revolution that brings a better description of how decisions are made under risk and it opens up new horizon in behavioral finance like Naughton said (2002). Ricciardi (2004) states that, people care about avoiding possible loss more than possible gain and under specific circumstances, sentimental and cognitive factors, which are put in action by prejudices, affect investment choices of individuals.

Financial researches often investigated and tried foreseen factors that affect investment choices and risk perception. As has been stated, decision process is complicated and can not be explained by only risk-return relationship. For this reason, variables affecting the investment preferences and risk perceptions of individual investors have been investigated in this research. It is determined that investment preferences varied according to the level of financial literacy and perception of risk, on the other side personality trait is not effective. Investors who are willing to take risk are turning to equities unlike investors who prefer bank deposits. Similar results were obtained for financial literacy. Investors with a high level of financial literacy prefer equities while investors with low level of financial literacy prefer bank deposits. Besides, in consistent with the literature, advanced financial literacy is higher in man than in women. Man have a willingness to take risks more than women but marital status does not affect risk appetite.

2. Literature Review

Risk is a function of profit and loss (Elmiger and Kim, 2003; Finucane et al., 2000) and contains both of them. However human perception of risk is often equated with loss. Renn (1998) highlighted the importance of the human factor in the concept of risk and he asserted that, risk is associated with how much investors are care about likely result of events occurring in the future. In this context, according to Garland (2002) risk is subjective. Hillson and Webster (2005) claimed that perception of risk is influenced by many factors, including cognitive and emotional. In a similar vein, Henrich referring to the risk perception is cognitive bias and Olsen and Cox (2001) refer to the emotional dimension of risk perception.

Garling et al. (2009) indicate that the perception of risk is an important part of financial decision-making process and it is affected by many variables such as demographics and personality. However, different and conflicting results have been obtained by studies on risk perception. According to Slovic (1999), demographics is one of the most fundamental determinants of risk perception. Barber and Odean (2001) identified that men take more risks than women and similarly single men take more risk than those who are married. Regardless of the fact that men take more risks than women (Grable, 2000; Bernasek and Shwiff, 2001; Weber et al., 2002; Grable and Roszkowski, 2007; Yao et al., 2011), Hanna et al. (1998) and Friedberg and Webb (2006) could not reach the evidence of gender differences in risk perception.

Chen and Volpe (2002) dealt with this issue in the framework of financial information. They state that, women have less information than man and for this reason their confidence is low and they could not take the risk. But results are also contradictory for these findings. According to Wagland's (2009) research on Australian university students, gender is not a significant factor in financial literacy and risk-taking. Similarly kindle (2010), Joe and Grable (2004) stated that there is no connection between the genders and financial literacy.

Some researchers associated investment decisions with the level of education instead of financial literacy. However, these findings also have stayed away from taking the absolute results. While Gutter and Fontes (2006), Brown and Taylor (2007) and Gilliam (2011) emphasize the importance of education factor on risky investment decisions, Masters (1989) and Yao et al. (2011) conclude that the general education level of investors is not always an effective factor.

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