



“Impact of financial literacy and Risk Tolerance on Investment Decision”

Reema Sharma

Abstract – Researcher has followed a widespread approach for explain the relationship between financial literacy, risk tolerance and investment decision. Recently there has been increasing interest in studying the behaviors of investors and the factors which affecting the investment decisions of investors due to a synchronized approached followed by a large number of investors. A Study has been shown that a large number of investors look after the safety of their money not higher return.[1] Investment decision is a crucial decision which is influenced by various factors as financial literacy, income level, financial soundness and various other demographic and sociological factors. The choice of investment alternative of is broadly depends upon the risk tolerance level of investors.[2] On the basis of certain conclusion, cover from precious research, the researcher in this study defines the relationship between financial literacy, risk tolerance and financial decision making of investors through exploratory research tools. For explaining this relationship researcher gives a mediation model. By using this mediation model a direct relationship between Financial Literacy and Risk Tolerance and between Financial Literacy and Investment Decision via Risk Tolerance, can be explored.

Key words – Financial Literacy, Risk Tolerance, Investment Decision, financial modeling, factors affecting investment decision, investment pattern

Any decision taken by the investor without proper information or with misleading information may generate unexpected outcome. Financial literacy is considered as a base on which the investor can take rational decision. It helps the investor to match the requirement with all the alternatives available for investment that can strengthen to expected outcomes. The existing studies also shown that so many young and old age people remain unknown about very basic concept of economics which seriously affect the retirement planning, saving and other decisions. [6] The researchers also identified that the households that having high financial knowledge or rely on the professional or personal contacts for making investment achieve comparatively high returns or outcome in place of those households who are having less knowledge and take their financial decisions on their own. [7]. This study was done in the year 2015 in which the researcher investigative about the outcome of investor’s portfolio and identified the positive relationship between the financial literacy and investment portfolio outcome. There are also certain research which proves that the people who are financially knowledgeable can take more rational decisions in comparison to those who do not posses more sound financial knowledge.[8]

I. INTRODUCTION

New schemes of investment are coming in the market day by day for proving investment opportunity to the investor so that the investor can plan his current as well as future requirement and also can better utilize his savings by generating more returns. But according to the evidence from various researches very few investors move towards the new scheme of investment. A large part of investors still follow only few options like fixed deposits, recurring deposits and life insurance policies, mainly the less risky investment options. A very small segment of investors relay on high risky financial instrument. Investors generally follow a specific kind of investment pattern which is derived from the investment decisions taken by the investor or choosing the financial instrument with certain specific features like fixed rate of return. There are large number of factors affecting the financial like age, income, gender, qualification and risk tolerance level etc. [3]“Are individuals well-equipped to make financial decisions? Do they possess adequate financial literacy and knowledge?”[4]. There are very few researches related to the financial literacy and investment decisions of the individuals. Financial literacy is always considered as a very basic factor for taking the financial decision by the investors[5]

II. PROBLEM STATEMENT

In this research paper the researcher trying to discover the various factors affecting investment decision of the individuals. There are various factors which affect the financial decision of an individual like demographic factors, age, income, gender, qualification which affect the financial decision. So many studies has been done for finding the impact of these various factors on financial decision making but in this research paper the researcher will consider the impact of financial literacy on risk tolerance and investment decision.

III. LITERATURE REVIEW

a) Financial Literacy Risk Tolerance and Investment Decision

Financial Literacy can be defined through two dimensions as knowledge and application dimension. Knowledge dimension shows the acquisition of knowledge trough study of books, journals and other related material or it can be acquired through experience of doing investment in various types of financial assets. The other aspect application dimension can be explained as successfully apply the knowledge drown through various sources for generating profit.[9]

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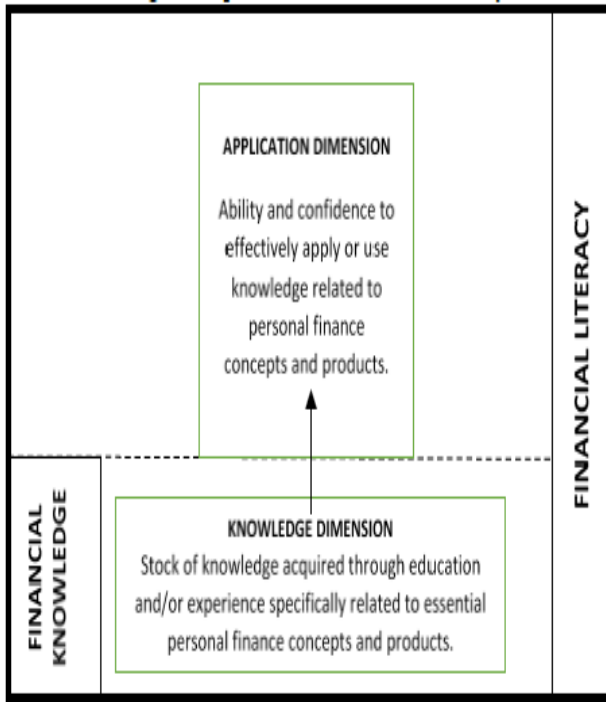


Figure 1 – Financial Literacy Concept

The Institute of financial literacy has also given certain standards which can be used to assess the financial knowledge and skills.[10]

1. Standard I- Money Management
2. Standard II- Credit
3. Standard III - Debt Management
4. Standard IV- Risk Management
5. Standard V- Retirement Planning

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| Money Management | Money Management is the first concept which under which the individual must know about budget and its component with the skill of making personal budget, his/her cash flow as well as about the constructing of realistic financial long term and short term goal as life circumstances change. |
| Credit standard | Credit standard says that a person who is financial literate must know about the sources of credit and implication of using credit. He/she must know suitability of type of credit according to the situation. Must know about credit application process. Must have knowledge about credit report and consumer’s right regarding credit report. |
| Debt Management | Under this standard the individual must know about good and bad debt. Must have skills to analyze the warning sign of excessive debt. |
| Risk Management | The individual must know about the strategies to cope up with risky situations for assets and life circumstances, must know his/her risk tolerance level, know about various type of insurance. |
| Retirement | Under this standard the investor must |

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| Planning | know about various type of investment & retirement schemes available and risk and reward related with, must recognize the importance of retirement planning. |
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There exists very less number of surveys that provide information on financial literacy and other variable which affect the financial decision making of individuals. Different researcher done different work related to financial literacy and investment decision. The researcher in their studies analyzed the relationship between financial literacy and retirement planning of investors at the age of their prime earning when they suppose to focus towards retirement planning as well as other investment. That has been examined by the researcher through detail questions related to financial literacy and retirement planning. In which he found that there is a strong relationship between financial literacy and retirement planning. The researcher also found that the respondent who was exposed to economics as a subject at their school level or attended company based financial education programs responded high level of financial literacy.[11]. Researcher also done the studies by focusing on women for the same and found that financial literacy is making very sound effect on retirement planning and also that those respondent who understand about risk diversification, much likely to plan their financial investment.[12] In another research the researcher also find out the impact of financial literacy on economic decision making. The researcher also says that the financial market is now assessable easily by all type of investors due to technology up gradation. Bank customer who have credit card are mostly unable to decide that how much amount they wanted to borrow and the easy availability of financial service like credit card, and all purpose loan leads to less savings and investment plans by the investors.[13] There are studies also for indentifying the factors affecting the investment decision. In the same way researcher tried to identified the various factor affecting the respondent behavior of the individuals and also the attitude of respondent towards making investment choice. The researcher considered the various factors as age, income, gender, qualification, occupation as independent variable and investment avenues as dependent variable. The researcher found that the investors who are less than 50 year of age, give more preference for investing in insurance, post office savings, public provident fund and bank deposit.[14] Researchers also focused on the concept of financial literacy for defining it clearly through their research. This research shows that financial literacy is financial awareness and knowledge about financial product and related simple terms like compound interest payment, money management and financial planning. In this research the researcher also identified that the customer access is different in low income and high income countries.[15] Risk tolerance level is also an important factor that needs to be analyzed while studying the investment pattern of individuals. In this regards a researcher studied the financial risk attitude 1,000 respondent by controlling the demographic and sociological factors.



This research shows that the respondent reduce their tolerance for risk over time although higher education, wealth and self employability increase the capacity of risk tolerance. Researcher also shows that macroeconomic conditions also affect the risk tolerance level of respondent in the same as demographic and socioeconomic characteristics.[16] The researcher also says that financial literacy can also be defined as the ability to understand the financial terms and also the mathematical ability of the individual. For doing the research the researcher consider some factors as age, occupation, gender, ethnicity, income saving and debt. The literature shows the two category of responded one with high financial literacy which include respondent between 50 to 60 year, professionals, businessman owners, university and college graduates on the other hand low person with low financial literacy include females, unemployed and low level educated persons.[17] Literature also shows the study related to the factors affecting the financial literacy and found certain factor which have significant impact on the level of financial literacy of respondent as level of education, personal income, knowledge from parents.[18] Some literature is also related with studying the investor's behavior in selecting the various investment alternatives available in the Indian Market. Researcher indentified the major factors behind the investment behaviors which were safety of principal amount, appreciation, income stability and liquidity. Investors invest on the basis of their risk taking attitude and most of the investors prefer bank deposits first and secondly they prefer investment in gold and silver.[19] Literature is also available related to the analysis of factors which affect the investment in stocks (high risk investment) and fixed deposits (low risk investment). This research found that high return worked as the most important variable influencing stocks investment and stability in income influenced the investment in the fixed deposit to the most.[20] Investors are tends to be momentum buy past winning stocks and sells past loosing stocks.[21] Investor behaves rationally while taking investment decision and react on available information only. [22] gender of investor also affect the investment pattern of an investor.[3] By investigating the factors we can hypothesis that-

Hypothesis 1a: Financial literacy is directly and positively related with Investor's high risk tolerance.

Hypothesis 1b: Financial Literacy is directly and negatively related with Investor's low risk tolerance.

Hypothesis 2a: Investor's low Risk Tolerance mediates a negative relationship between Financial Literacy and investment in high risk assets.

Hypothesis 2b: Investor's High Risk Tolerance mediates a positive relationship between Financial Literacy and investment in high risk assets

IV. METHODOLOGY

a) Empirical Model

A number of researcher examine the financial literacy, risk tolerance and investment decision at single level mediation approach, hence ignoring the possibility of Financial Literacy and Investment decision may operate at different analytical level at Risk Tolerance.[23] On the basis of above hypothesis we use this model to examine the study the indirect relationship between Financial Inclusion and

Investment Decision of investors via Risk Tolerance level of investors.

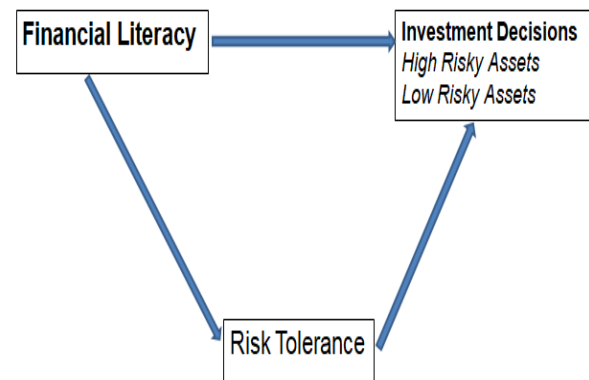


Figure 2: Mediation model involving Financial Literacy, Risk Tolerance and Investment Decision

b) Variables –

1. Financial Literacy (Predicting Variable)
2. Risk Tolerance (Mediating Variable)
3. Investment Decision (Decision Variable)

This model provides a demonstrated relationship between variables which conclude that Financial Literacy support the investment decision of investors which is also affected by risk tolerance level of investors.

V. CONCLUSION AND FUTURE IMPLICATIONS-

This paper gives a theoretical model which can be used to predict the investment decision of investors. There is so many couple of investment alternatives available in the financial market in India, which attribute with different level of risk or probability of outcome. The investor choose the alternatives based on various factors as income, age, gender, occupation, capital assets and other but the financial literacy and risk tolerance play major role in taking investment decision, which can be study by using the model given in this research paper. Higher level of financial literacy leads to higher risk tolerance. Which can helps the investors to make diversified portfolio. A diversified portfolio can generate higher return to investors in comparison to undiversified portfolio. With the deep knowledge of financial products investor can take relevant and correct decision on time. Also the investor can handle the risky situation easily. This study can help the future researchers while studying investor behavior with consideration of risk tolerance and financial inclusion. Moreover this research may also helpful for the investors in understanding the value of financial literacy in dealing with risky investment as well as generating more profit by the investment.

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