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An Empirical Analysis of Financial Risk Tolerance and Demographic Features of Individual Investors

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Abstract

Financial risk tolerance is the level of risk that a client believes they are willing to accept. Risk Tolerance must be measured simply because it is an aspect of utility for any investment decision and maximizing the expected utility is considered to be the ultimate goal in any financial activity. The paper reports the results of the study that was designed to examine the association /relationship between the risk tolerance of individual investors and their demographic features. Most of the anticipated relationship between financial risk tolerance and each of the demographic features from the literature were found to be relevant.

Keywords- Financial Risk Tolerance; Demographic Features; Finametrica Score

1. Introduction

Financial risk tolerance is commonly defined as the maximum amount of volatility one is willing to accept when making a financial decision. It is important to note that risk tolerance is a complex attitude. It has four facets - financial, physical, social and ethical. Whether in the context of professional practice or empirical research, risk tolerance is acknowledged as an important factor in savings and investments choices for retirement or other household goals. Choices regarding investment products, asset allocation plans, and portfolio accumulation strategies have been attributed to risk tolerance. Individual risk tolerance may also be taken into account as a part of "risk management" or insurance choices. Risk tolerance plays an important role in each household's optimal portfolio decisions. An investor's ability to handle risks may be related to

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demographic features such as age, gender, marital status, occupation, income, time horizon, liquidity needs, portfolio size, investment knowledge, and attitude toward price fluctuations. The demographic features of individual investors could be used to distinguish between levels of financial risk tolerance and an association of these variables could be developed to predict a person's risk-tolerance.

2. Review of literature

Empirical studies on financial risk tolerance of individual investors in relation to their demographic, socioeconomic, and attitudinal factors are limited. Some of the related studies on various determinants of financial risk tolerance are as follows:-

MacCrimmon, and Wehrung (1986) provided the seminal literature and research review concerning risk tolerance which examines research associated with the relationships among demographic, socioeconomic, and attitudinal factors, and financial risk tolerance. Wallach and Kogan (1961) began studying relationship between risk tolerance and age. They found that older individuals tended to be less risk tolerant than younger persons. Slovic(1966) concluded, after an extensive review of the literature, that a "prevalent belief in our culture is that men should and do take greater risks than women" In general, there is consensus among researchers that women tend to be less risk tolerant than men. It is widely assumed by practitioners that marital status is a factor that significantly influences risk and return preferences; and an individual's satisfaction with finance (Lazzarone, 1996).

According to Roszkowski, M.j; Snelbecker, G.E; and Leimberg, S.R (1993), other things being equal, different occupations of individual investors can be used to differentiate between their levels of financial risk tolerance. Over the years a positive pattern between income of individual investors and their financial risk tolerance has been observed (Cohn, RA; Lewellen, WG; Lease, R.C; and Schlarbaum, G.G, 1975; Cicchetti and Dubin, 1994; and Shaw, 1996). A person's level of formal education has been found to influence risk tolerance (Baker and Haslem, 1974; and Grable and Lytton, 1998). Researchers such as Grable and Joo (1997); Grable and Lytton (1997); and Sung and Hanna (1996) have suggested that a person's knowledge of personal finance and economic expectations may play a role in shaping risk preferences.

As a whole, there is a persistent belief among practitioners and researchers that (a) males are more risk tolerant than females, (b)younger individuals are more risk tolerant than older individuals, (c) single individuals are more risk tolerant than married individuals,(d) individuals employed in professional occupations are more risk tolerant than those employed in non-professional occupations, (e) self-employed individuals are more risk tolerant than those employed by others, (f) high income earners are more risk tolerant than lower income earners,(g) Whites are more risk tolerant than non-whites, and (h) individuals with higher attained educational levels are more risk tolerant than those with lower levels of attained education. However, there are research data not supporting these beliefs. Therefore, more research is needed to test these assumed relationship.