

A Study on Financial Risk Tolerance and Preferred Investment Avenues of Investor

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ABSTRACT

Financial Risk Tolerance is an important factor that influences investors' decision while selecting investment avenues. The objective of study was to assess the financial risk tolerance of Investors in present scenario and then analyzing their preferred investment avenues. The result of study found that most of the investors belong to average risk tolerance category which means that they were neither risk taker nor risk averse in nature. Study also found that Insurance as an investment avenue was the most preferred investment alternatives.

Keywords: Financial Risk Tolerance, Preferred Investment Avenues, Investment Preference, Investment Alternatives, Investment Decision, Risk Taking Capacity

1. INTRODUCTION

Financial risk tolerance can be defined as the willingness of individual investors to take investment decision where there is a desirable goal but achievement of the goal is uncertain along with the possibility of losses (Kogan & Wallach, 1964). Financial risk tolerance has an effect on the decision of investors who invest their savings for short- and long-term goals. Investors with varying levels of risk tolerance behave differently when making investment decisions regarding various investment avenues. Understanding Financial Risk Tolerance is an essential part of financial planning of an investor as financial planners usually devote their most of the time to assess investors' preferences and their risk perceptions in order to increase client satisfaction and retention.

Financial Risk Tolerance assessment is a crucial element of investment management process. Generally many financial planners use inputs like investment goal, time duration, financial stability and financial risk tolerance (German and Fogue, 1997). Hence, Financial Risk Tolerance is one of the key factors of investment planning of investors and must be assessed before taking any investment decision. As there are number of investment alternatives emerged in recent times investors are in dilemma where to put their investible surplus. These varied classes of investment has diverted investors mind from traditional investment like Gold and real estate. Not only an individual investors but also financial service provider are also thinking how to mobilize the individual saving into investment. In this situation it very necessary to understand the importance of Financial Tolerance and preferred investment alternatives. The purpose of this paper was to present a framework of financial risk tolerance instruments developed by Grable and Lytton (1999). Based upon the result obtained investors were classified in five categories of risk tolerance level ranging from High Risk Tolerance to Low risk Tolerance and then identifying their preferred investment avenue

2. OBJECTIVES

1. To study the financial risk tolerance of Investors
2. To study the preferred investment avenues of investors
3. To study the inter-relationship of financial risk tolerance and Preferred investment Avenues

3. LITERATURE REVIEW

Anbar and Eker (2010) investigated the relation between personal financial risk tolerance and demographic characteristics of investors. They found that gender, department and working in a job significantly predicted the financial risk tolerance. They also concluded that gender, department, working in a job, monthly personal income and total net assets were significantly different among investors' risk tolerance levels while age, marital status and number of children had not significantly different among investors' risk tolerance levels.

Prabha (2016) investigated the financial risk tolerance and the influence of socio-demographic characteristics of retail investors then classify the investors according to their risk profiles. He also studied relationship between various socio demographics factors like gender, age income etc. on the basis of their risk tolerance profiles. H found that maximum investors whose age lying under 25 years falls under average risk profile and investors between 26 years to 30 years of age were lying between high risk tolerance profiles. He also found that there is significant association between gender and risk tolerance level and further concluded that females were more risk averse in nature than male investors. His study also revealed that high income investors take more risk than low income group of investors married investors take less risky asset investment as compared to single investors. H finally concluded that maximum respondents fall under average risk tolerance category.

Rahmawati et. al. (2015) studied the determinants of the risk tolerance of individual investors with an objective to evaluate various factors which were responsible related to financial risk tolerance and affects investment decisions. They have taken gender, education, age, wealth as independent factor. They found that all these factors have significant impact on financial risk tolerance of investors and it affects investment decision also. Their main findings includes that male investors were more risk taker than female hence they posses higher risk tolerance level than female investors. Age of investors was also identified as main factor and financial risk tolerance decreases as the age of investor increases. Highly educated and financially literate investors take more risk as compared to uneducated investors and also it was concluded that education has direct impact on risk tolerance level as awareness about financial market and products develop confidence among investors. Lastly they found that higher income investors takes more risk and have high risk tolerance as compared to low income group investors.

Chavali and Mohanraj (2016) investigated the impact of risk tolerance on investment decision by considering scale developed by Grable and Lytton. They found that investors are by default risk averse in nature and do not want to take risk and always try to avoid risk while doing investment. The risk perception of investors depends on various demographic characteristics like age, gender and income etc. They found that it is the investors' tendency to think for losses first than gaining from investment and these behavioral characteristics sometimes leads the investors to take biased decision which actually lead to loss and therefore risk tolerance of investors affects the investment decision of investors.

Chattopadhyay and Dasgupta (2015) studied the demographic and socio economic impact on risk attitude of Indian investors. The main aim of their study was to investigate the role of various factors like age, gender, number of dependents, marital status, income, employment, educations, saving patterns, investment amount, monetary planning and returns on risk tolerance of investors. They found a significant relationship of age, gender, marital status and income of investors with financial risk tolerance. They concluded that age was an important factor and as it increases investors tend to take positions in less risky asset while income as another factors has same reason that if income of any investors increases the risk taking ability also increases. As far as gender is concerned both male and female were found average risk tolerance and have same tendency to take risk while investing. Lastly they concluded that education and awareness affects positively and more educated investors take more risk as compared to less educated investors therefore in order to increases investors risk tolerance education can be considered as an important tool.

4.RESEARCH METHODOLOGY

The Study: The study descriptive in nature in which Financial Risk Tolerance of investors was measured through a scale which consisted of 13 item scale developed by Grable and Lytton (1999) to measure risk tolerance level of investors. The scale measured the Financial Risk Tolerance of investors and on the basis of score obtained from result, investors were classified into five categories i.e., Low risk tolerance (i.e., conservative investor), Below-average risk tolerance, Average/moderate risk tolerance, Above-average risk tolerance, High risk tolerance (i.e., aggressive investor).

According to authors of the scale, the score received on the *Financial Risk Tolerance* can be interpreted as follows:

18 or below = Low risk tolerance (i.e., conservative investor)

19 to 22 = Below-average risk tolerance

23 to 28 = Average/moderate risk tolerance

29 to 32 = Above-average risk tolerance

33 and above = High risk tolerance (i.e., aggressive investor)

Preferred investment avenues were identified for each class of investors. Preferred Investment avenues were taken according to two categories i.e., negotiable investment alternatives and non negotiable investment alternatives. Further

negotiable securities were sub divided as variable income securities like equity shares etc., fixed income securities like bonds and debentures. Non negotiable securities include deposits, tax sheltered saving schemes, life insurance, mutual fund and the last category contains Real Asset which includes real estate, gold and silver etc.

Sample Size: The study was conducted on 1000 individual investors

Sampling: Convenient Sampling was used in the study.

Data Collection Tools: Data was collected through survey method through a self designed questionnaire. Questionnaire was divided in three parts A, B and C. Part A contains the information related to demographic characteristics of respondents like Age, Income, Gender, Occupations and Education. Part B contains the Financial Risk Tolerance Scale developed by Grable and Lytton (1999) to assess the Risk tolerance level of respondents. Part C consist of Investment Avenues namely Variable Income Securities, Fixed Income Securities, Deposits, Tax Sheltered Alternatives, Mutual Funds, Insurance and Real Assets. The questionnaire was presented to 1000 individual investors out which 974 appropriate responses were considered for the study. The response rate was 97.4%.

Analysis Tools: Arithmetic Mean, Percentage Analysis and Graphical Representation

RESULTS

Table 01: Showing the Result of Financial Risk Tolerance

S.No.	Scores	Risk tolerance category	No. of Respondents	No. of Respondents (%)
1	18 or below	Low risk tolerance (i.e., conservative investor)	66	6.78%
2	19 to 22	Below-average risk tolerance	125	12.83%
3	23 to 28	Average/moderate risk tolerance	488	50.10%
4	29 to 32	Above-average risk tolerance	225	23.10%
5	33 and above	High risk tolerance (i.e., aggressive investor)	70	7.19%

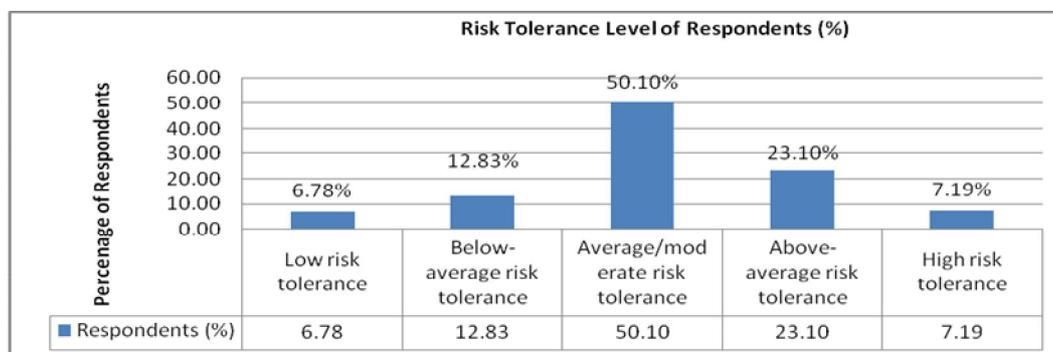


Figure 1: Showing the Number of Respondents Belongs to Respective Categories of Financial Risk Tolerance level

On the basis of score respondents were classified in five categories namely Low risk tolerance (i.e., conservative investor), Below-average risk tolerance, Average/moderate risk tolerance, Above-average risk tolerance, High risk tolerance (i.e., aggressive investor). It was found that majority of investors belong to average or moderate risk tolerance i.e., 50.10% followed by Above Average Risk Tolerance Level i.e. 23.10%, Below Average Risk Tolerance were 12.83%, High Risk Tolerance were 7.19% and Low Risk Tolerance were only 6.78.

5.Risk Tolerance level and Preferred Investment Avenues

In order to identify the most preferred Investment Avenue, total scores of respondents was calculated in each category of Risk Tolerance level (Table 4.3.2) and then Arithmetic Mean of all the preferred investment avenues respective to each category was taken (Table 4.3.3). Respondents were asked to rate preferred avenues i.e., Variable Income Securities, Fixed Income Securities, Deposits, Tax Sheltered Alternatives, Mutual Fund, Insurance and Real Assets on a five point scale where five represent highest Preferred and one represent least Preferred Investment Avenues. The results were shown with the help of graphical representations.

Table 02: Showing the Total Scores of Respondents in each categories of Financial Risk Tolerance

Risk Tolerance level and Preferred Investment Avenues								
Risk Tolerance Levels Categories	Total Respondents	Total Score						
		Variable Income	Fixed Income Security	Deposits	Tax Sheltered	Mutual Fund	Insurance	Real Assets
Low risk tolerance	66	126	257	260	131	213	268	143
Below-average risk tolerance	125	287	399	375	361	374	410	409
Average/moderate risk tolerance	488	1673	1513	1493	1337	1868	1464	1572
Above-average risk tolerance	225	635	674	567	610	655	685	710
High risk tolerance	70	232	189	200	196	207	217	253

Table 03: Showing the Arithmetic Mean of Preferred Investment Avenues in each categories of Financial Risk Tolerance

Risk Tolerance level and Preferred Investment Avenues							
Risk Tolerance Levels Categories	Arithmetic Mean						
	Variable Income	Fixed Income Security	Deposits	Tax Sheltered	Mutual Fund	Insurance	Real Assets
Low risk tolerance	1.91	3.89	3.94	1.98	3.23	4.06	2.17
Below-average risk tolerance	2.30	3.19	3.00	2.89	2.99	3.28	3.27
Average/moderate risk tolerance	3.43	3.10	3.06	2.74	3.83	3.00	3.22
Above-average risk tolerance	2.82	3.00	2.52	2.71	2.91	3.04	3.16
High risk tolerance	3.31	2.70	2.86	2.80	2.96	3.10	3.61

Preference of Investment Avenues was measured on five point scale where five represent highest preferred and one represent least preferred

6. Graphical Representation of Risk Tolerance Category wise with respect to Preferred Investment Avenues

Graphical representation was used to study the Preferred Investment Avenues with respect to Risk Tolerance Levels. Respondents were asked to rate preferred avenues i.e., Variable Income Securities, Fixed Income Securities, Deposits, Tax Sheltered Alternatives, Mutual Fund, Insurance and Real Assets on a five point scale where five represent highest Preferred and one represent least Preferred Investment Avenues. Arithmetic Mean of Preferred Investment Avenue was taken and represented with respect various Risk tolerance Categories.

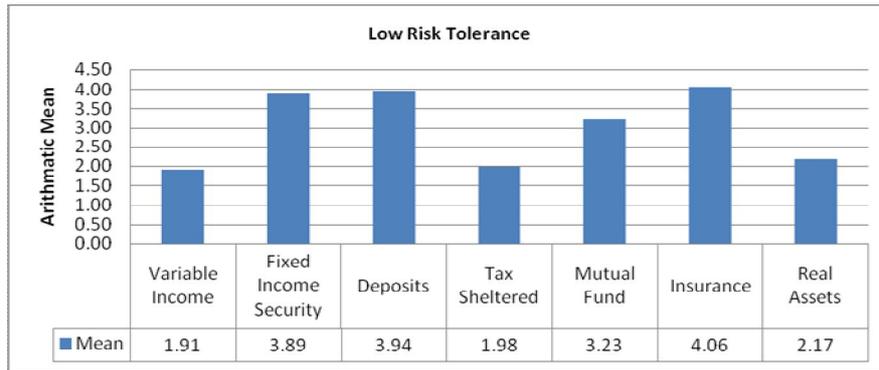


Figure 2: Showing the Mean of Preferred Investment Avenue of Low Risk Tolerance Investors

It has been observed from above graph that mean of Insurance was highest (i.e. 4.06) in Low risk tolerance categories of Investors. Hence, it can be inferred that Insurance was the highest preferred avenue for investors who belong to Low Risk Tolerance level. Deposits and Fixed Income Securities were found as second and third preferred categories of Investment Avenues to Low risk tolerance categories of Investors with mean of 3.94 and 3.89 respectively

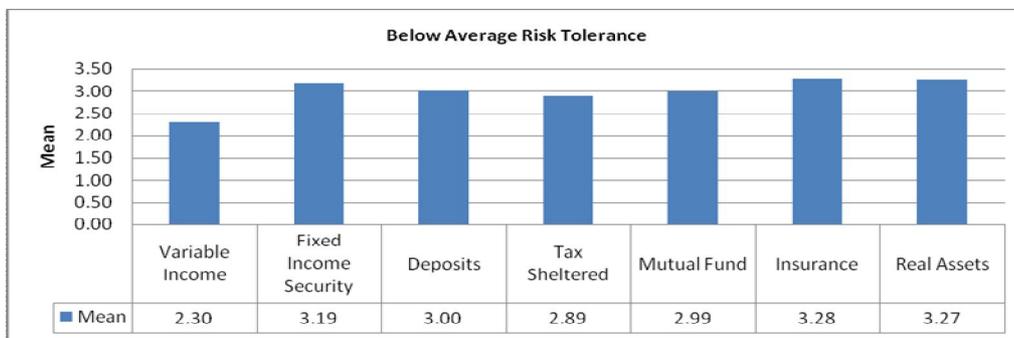


Figure 3: Showing the Mean of Preferred Investment Avenue for Below Average Risk Tolerance Investors

It has been observed from above graph that mean of Insurance was highest (i.e., 3.28) in Below Average Risk Tolerance categories of Investors. Hence, it can be inferred that Insurance was the highest preferred avenue for investors who belong to Low Risk Tolerance level. Real Assets and Fixed Income Securities were found as second and third preferred categories of Investment Avenues to Below Average Risk Tolerance categories of Investors with mean of 3.27 and 3.19 respectively.

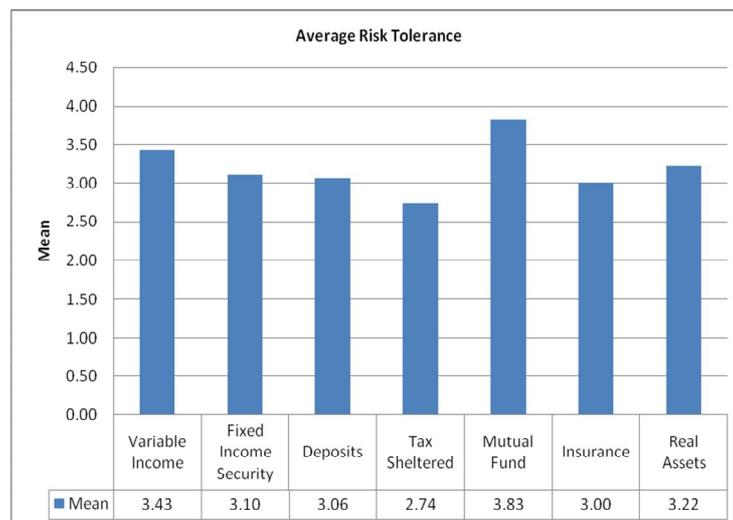


Figure 4: Showing the Mean of Preferred Investment Avenue for Average Risk Tolerance Investors

It has been observed from above graph that mean of Mutual Funds was highest (i.e., 3.83) in Average Risk Tolerance categories of Investors. Hence, it can be inferred that Mutual Funds was the highest preferred avenue for investors who belong to Average Risk Tolerance level. Variable Income Securities and Fixed Income Securities were found as second

and third preferred categories of Investment Avenues to Average Risk Tolerance categories of Investors with a mean of 3.43 and 3.10 respectively.

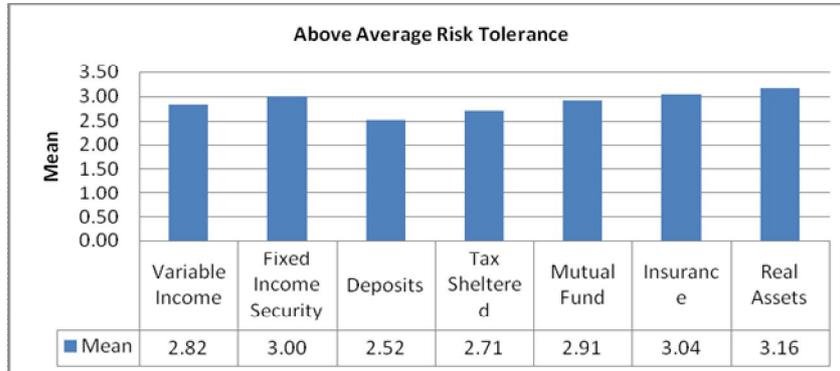


Figure 5: Showing the Mean of Preferred Investment Avenue for Above Average Risk Tolerance Investors

It has been observed from above graph that mean of Real Assets was highest (i.e., 3.16) in Above Average Risk Tolerance categories of Investors. Hence, it can be inferred that Real Assets was the highest preferred avenue for investors who belong to Above - Average Risk Tolerance level. Insurance and Fixed Income Securities were found as second and third preferred categories of Investment Avenues to Above Average Risk Tolerance categories of Investors with a mean of 3.04 and 3.00 respectively.

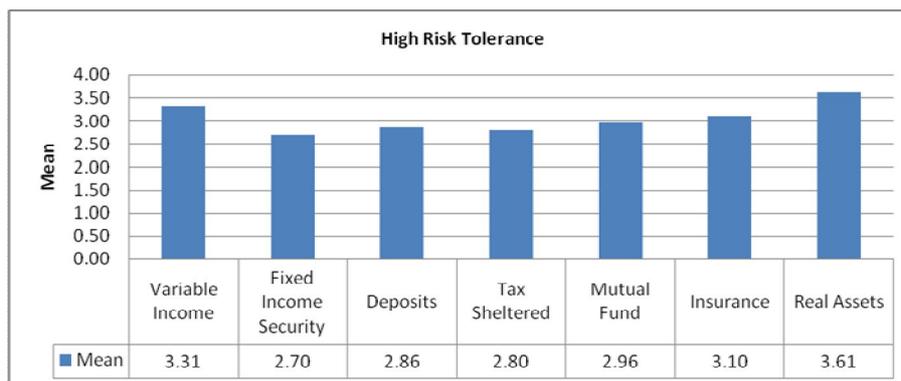


Figure 6: Showing the Mean of Preferred Investment Avenue for High Risk Tolerance Investors

It has been observed from above graph that mean of Real Assets was highest (i.e., 3.61) in High Risk Tolerance categories of Investors. Hence, it can be inferred that Real Assets was the highest preferred avenue for investors who belong to High Risk Tolerance level. Variable Income Securities and Insurance were found as second and third preferred categories of Investment Avenues to Risk Tolerance categories of Investors with mean of 3.31 and 3.10 respectively.

7.DISCUSSIONS

It was found in the study that maximum number of respondents belong to average risk tolerance that means investors were neither high risk taker nor risk averse. The result is in line with the study conducted by Grable (1997) who found that majority of male investors belong to average risk tolerance category. It has been observed recently that awareness related to financial market has been increased among investors because of education and accessibility of information through media and internet. This is the reason that investors are coming out of traditional investment like Gold and property and showing interest in securities like Mutual Funds and Equity shares supported by Pandey (2014) in her research on saving and investment pattern of investors. But because of global forces that affect domestic market as well as stock market, nowadays investors are cautious in selecting their investment alternatives. In this study the most preferred investment alternatives comes out to be Insurance, which clearly defines that still investors take their investment decision in light of safety and assure returns. The same result was reported in the study of Palanivelu and kumar (2013) that insurance was the most preferred investment alternatives followed by fixed deposit and real estate. Recently insurance industry in India has gained a substantial growth because of government policy related foreign investment and joint ventures with Indian insurance companies.

8.CONCLUSIONS

The main objective of the study was to assess the financial risk tolerance of investors and identifying their preferred investment avenues. The study found that majority of the respondents lying in Average Risk Tolerance Categories and preferring Insurance as their most preferred investment alternatives. This result showed that investors were neither extreme risk taker nor risk averse and they want safe return to secure their principle amount rather than expecting too much return from their investment avenues. The second choice was real assets which include investment in hard assets like gold and real assets which means investors still believes in traditional investment alternatives rather than putting their funds in risky and modern investment alternatives. Although many investors in Average Risk Tolerance like to invest in Mutual Funds which have substantial amount of risk. Financial service providers need to frame the products according to investors' preference as well as their risk taking capacity which definitely will increase market efficiency as well as investors' confidence.

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