

Role of Financial Literacy on Investment Behavior

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ABSTRACT

Financial literacy is essential for making key financial decisions related to saving, borrowing and investment. Financial literacy can be acquired either by practicing or by studying the fundamentals, theories and processes of business at several levels such as higher education, secondary education or university education. Thus, the present study focuses on the relation between financial literacy and the investment behavior of the individuals. The study found that there was positive relation between the financial literacy and the investment behavior of the individuals.

1. Introduction

Finance is as necessary in life as blood in human body. It is needed everywhere, whether for personal uses, public uses or corporate uses. Behavioral finance is a new field that combines behavioral and cognitive psychological theory with conventional economics and finance to find out the reasons of irrational financial decisions made by rational people. It can be described as a study of psychological & sociological factors that influence the financial decision making process of individuals, groups, corporate entities & other financial practitioners. Investment means sacrifice of certain present value for some uncertain future value. It aims at multiplication of money at higher or lower rates depending upon its maturity period and risk factor attached with it. In business, investment is the amount used to start a new business or expand the existing business. Investment is made for earning additional income, capital appreciation, safeguarding the funds and avail tax concessions. Because it is made in present to earn gain in future, some risk is always attached due to uncertainty of future. So investment can be more risky, less risky & in some cases risk free. Investment behavior is the study of all activities of individual investors regarding allocation of surplus financial resources into various investment avenues. It reveals why individuals invest, where & how they get information, what factors they consider & evaluate while making investment, which factors influence their choice of investment, how they react after making investments. Behavioral finance helps us to study the investment behavior of investors by focusing on how investors interpret & act on micro & macro information to make investment decisions. Education means learning, in which the knowledge, skills and habits of group of people are transferred from one generation to the next through teaching, training or research. It's not just about what we are learning, but also how we are using our knowledge and skills in practical life. Financial literacy is the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being. Financial literacy is the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources. It is the ability to understand how money works in the world, how someone

manages to earn on make it, how that person manages it, how he/she invest it and how that person donates it to help others. It is the possession of knowledge and understanding of financial matters and is mainly used in connection with personal financial matters (Raheja and Singh, 2018). It often entails the knowledge of making proper decisions pertaining to certain personal finance areas like saving, insurance, investing, real estate, tax planning and retirement. It involves a clear and proper understanding of financial concepts like compound interest, financial planning, and time value of money, advantageous saving methods, stock exchange working and dealing. Financial literacy can be acquired either by practicing or by studying the fundamentals, theories and processes of business at several levels such as higher education, secondary education or university education.

2. Literature Review

Lusardi (2005) concentrated on African-American and Hispanic Households, where savings were most scarce. She used the data from the 1992 wave of Health and Retirement Study and the 2002 National Survey of Latinos. She used Descriptive Statistics and Regression Analysis for data analysis and found that only African-Americans were affected by financial education programs while the behavior of Hispanics seemed to be unaffected by these programs. She observed that financial education did not affect the portfolio choice of minorities. Her findings suggested that due to lack of information and low literacy, the financial behavior of African-Americans and Hispanics was very different than rest of the population. She suggested the introduction of effective financial education programs, provision of information and reduction of planning cost to improve their financial behavior and financial security. Perry and Morris (2005) examined the relationship between consumer financial knowledge, income and locus of control on financial behavior. They collected data from 1999 Freddie Mac Consumers Credit Survey with 10,997 respondents and analyzed the data with Averages, Step Deviation, Correlations & Multiple Regression and they found a negative relationship of external LOC with financial knowledge and responsible financial management behavior but positive

relationship between income & responsible financial management behavior. They observed LOC to have a significant impact on responsible financial management behavior both directly and indirectly. They suggested that individuals may not take full advantage of their knowledge or financial resources unless they feel that they control their own financial destiny. Fu (2006) followed an empirical research design to explore the relationship between financial information transparency and investors' behavior in the Taiwan Stock Market. He collected data through a structured questionnaire and analyzed the same with the help Descriptive Statistics, Correlation Analysis, Independent Samples t-test Analysis ANOVA and Multiple Regression analysis. He found that ownership structure, financial transparency and board structure were significant explanation variables of investors' behavior. He also suggested that improved financial transparency can lead to an increase in investment in Taiwan Stock Market. Lyons et al (2006) investigated the impact of financial education on financial behaviors of the agency staff, trained to deliver the program and the low-income individuals' participants of the program. They examined the association between total number of financial education lessons completed, previous financial experience and improvement in individuals, financial behaviors. They collected 763 evaluations, including 546 from agency staff and 217 from clientele. They used Descriptive Statistics, Correlation Analysis and Two-tailed t-test for data analysis and observed that financial education has a strong association with financial behaviors and may result in improved financial behaviors. They also suggested that previous level of financial experience may matter more than the number of lessons completed in financial behaviors of individuals. Peng et al (2007) investigated the impact of personal finance education delivered in high school and college courses by measuring investment knowledge and household saving rates, years after the financial education was delivered. They concluded that experience with financial instruments explained more of the variance in investment knowledge and saving rates. Hathaway and Khatiwada (2008) provided an exhaustive critical analysis of research investigating the impact of financial education programs on consumer financial behavior. They took two approaches: link between financial knowledge & financial behavior and evaluation of previously administered programs. They found that financial knowledge actually lead to better financial behavior but they were not sure about the working of financial programs due to improper evaluation. They suggested that future programs should be focused on a specific audience and area of financial activity and program evaluation should be included in the design of the programs being an essential element. Howlett et al (2008) examined the potential explanations of why consumers behave differently in making personal financial decisions that will be most beneficial in the long run. They collected data from a sample of 89 graduating seniors at a Public University in the South Central portion of the United States. They used an experimental design with light different conditions. They analyzed the observations with MANCOVA and found that self-regulatory state had a significant influence on retirement investments. Their observations suggested that the consumers with a basic level of financial knowledge and expressed higher levels of future orientation were more likely to participate in a retirement plans.

Joan et al (2008) attempted to investigate the association between financial behavior and sources of financial information, the association between savings and investing knowledge and financial information sources and the association between financial behavior and saving and investing knowledge. They collected data from 253 teenagers aged 14 to 19 years, who attended a State-Wide 4-H event in Georgia in Dec 2006. They used a General Linear Model for data analysis and observed the importance and effectiveness of parents' in teaching their children about personal finance. They also found that white teens reported obtaining less information from media /internet and educators than did non-white teens. Rebecca et al (2008) used the data collected from 1,483 Indiana participants of the program to investigate the success of program in impacting financial management behavior in terms of account usage and asset- building after the completion of the program. They documented that the program positively influenced the financial management behavior of Non-whites in terms of recording transactions & communicating with financial institutions. They also observed a significant positive effect of financial management skills emphasized in the programs on the actual behavior of the participants in terms of obtaining a loan. Mandell and Klein (2009) conducted a study based on a survey administered to a matched sample of 79 students who graduated during 2001 to 2004 from three high schools within a single school system. They analyzed the data with the help of statistical techniques like Chi-Square test, ANOVA and Regression Analysis. Their results indicated that those who took the course in Personal Financial Management were no more financially literate than those who had not. They also discovered that students having course in Personal Financial Management did not evaluate themselves to be more savings-oriented and didn't appear to have better financial behavior than those who had not taken the course, hence raised serious questions about the long-term effectiveness of high school financial literacy courses. Wang (2009) attempted to find out the relation between the knowledge of male investors & female investors and risk taking behavior. They collected the data from 524 respondents through online survey by using seven point Likert scale and analyzed the data by Correlation & MANCOVA. He found all the three variables objective knowledge; subjective knowledge & risk taking were highly correlated. He also observed that the female investors had less objective knowledge & subjective knowledge than male investors and they took less risk. He concluded investors' subjective knowledge as the mediator between objective knowledge & risk taking. Xiao et al (2010) examined associations among financial education, financial knowledge and risky credit behavior of college students and focused on potential impact of financial education on risky credit behavior among college students. They collected data from 1,206 first-year students, enrolled full-time at a Southwest University during 2008. They analyzed the data by using Mean, Correlation Analysis, t-test and Multiple Regression Analysis. They found a positive relation between subjective financial knowledge and personal finance courses. They concluded that objective credit knowledge reduced the likelihood of engaging in both risky paying and borrowing behaviors whereas subjective financial knowledge reduced the chance of engaging in risky paying behavior only. Banerjee (2011) investigated the role of the states in explaining financial literacy

and financial behavior. He applied Regression Analysis to find variation in financial literacy and financial behavior across states. The results revealed that in case of financial literacy, the significance of the state fixed effects were mostly limited to states that ranked low in the financial literacy ranking but in case of financial behavior ranking the state fixed effects are significant for almost all states and the chance of having a worse financial behavior increases as the financial behavior ranking drops. Capuano and Ramsay (2011) conducted an in-depth study of the relationship between financial literacy and consumer behavior. They evaluated the key areas of complexity and vulnerability for Australian consumers in relation to the financial products available to them. Their research project explored the cause of financial behavior and considered whether suboptimal financial behavior has causes other than lack of financial literacy. They conducted 23 financial literacy surveys that displayed lower levels of financial literacy for traditionally disadvantaged groups and higher levels of financial literacy for traditionally privileged groups. They found that literacy appeared to be result of financial experience gained through wealth or exposure to the markets and financial education. The results concluded that experience and education resulted in increased savings, financial efficiency and favorable consumer habits i.e. financial behavior. Cliff (2011) examined relationship between financial knowledge and credit card behavior of college students. He collected data from 1,354 students from a major Southeastern University and used Multiple Regression Analysis considering five dependent variables to analyze the data. His finding provided an evidence of financial knowledge being a significant factor in the credit card decisions of college students. He concluded that college students were benefited greatly from enhanced financial knowledge in the form of generally more responsible credit card behavior. Cliff and Woodyard (2011) examined the relationship between personal financial knowledge (both objective & subjective), financial satisfaction & selected demographic variables in terms of best practice financial behavior. They obtained data from the Financial Industry Regulatory Authority's (FINRA) National financial capability study. A sample of 1488 respondents was collected via a digit-dialed telephone survey. By using Multiple Regression Analysis with best practice behavior as the dependent variable, they found that subjective financial knowledge has a great influence on financial behavior. Cavezzali et al (2012) investigated the influence of financial literacy of individuals on their risk taking decisions and diversification behavior. They collected data from 208 U. S. individuals through a structured questionnaire and analyzed the same by using Average, Standard Deviation and Regression Model. They found that financial literacy positively affects the risk taking decisions of individuals but less significant in explaining more sophisticated diversification strategies. They suggested boosting the financial literacy of the investors to enable them in using all the investment techniques required by the Standard Theory and to promote advisory activities among the individual investors. Hastings et al (2012) reviewed the literature available on financial literacy, financial education and consumer financial outcomes to understand the measures of these in current literature. They examined the extent to which existing literature addressed the contribution of financial education in the improvement of financial literacy or personal financial

outcomes. They surveyed the literature on the relationship between financial literacy and economic outcomes, including wealth accumulation, savings decisions, investment choices and credit outcomes. They compared the evidence to evidence on the efficacy and cost of financial education and observed that the existing research was inadequate to draw conclusions about the working and efficacy of financial education. Lusardi and Mitchell (2014) undertook an assessment of a rapidly growing body of economic research on financial literacy. They started with an overview of theoretical research casting financial knowledge as a form of investment in human capital. They drew on recent surveys to establish how much or how little people know and identify the least financially savvy population subgroups. They examined the impact of financial literacy on economic decision making in the United States and elsewhere. They concluded with many people around the world being financially illiterate. They found the research on efforts to enhance financial literacy suggest that some interventions work well but additional experiment work is critical to control for the endogeneity and confirm causality. They suggested theoretical models of saving and financial decision making to be further enriched to incorporate the fact that financial knowledge is a form of human capital. Singh and Sharma (2016) studied the relation between investment behavior and the financial literacy of the individuals. The data was collected from MCD school teachers and chi-square was used to study the impact. They found that there was a relation between the investment behavior and the financial literacy of the individuals. They found that effective financial literacy helped an investor to develop an insight for analysing their investment behavior. Assefa and Rao (2018) preferred to invest in traditional and safe financial products and did not invest much in complex financial products which were comparatively more risky and can give higher return. These results highlight the need for financial education programs focusing specifically on developing investment knowledge and skills to facilitate informed investment decisions. Gangwar and Singh (2018) studied the relation between the investment behavior and financial literacy among the adults in India. The data was collected from the 309 investors. They found that there was a relation between the financial literacy and investment behavior of the individuals.

3. Discussion

Several studies have suggested that an higher levels of financial literacy result in more sophisticated investment behavior among individuals. Prior studies have found that financial literacy has a direct effect on the amassment of wealth (Van Rooji, Annamaria, & Rob, 2012; Behrman, Mitchell, Soo , & Bravo, 2010), retirement planning (Lusardi & Mitchell, 2006; Van Rooji, Annamaria, & Rob, 2012), participation in the stock market (van Rooji, Lusardi, & Alessie, 13 2007) and saving behavior (Klapper, Annamaria, & Panos, 2013). However, Grohmann (2018) finds that levels of financial literacy do not have much effect on investment behavior among the middle class in Thailand. This led the researcher to conduct a multivariate analysis to check if financial literacy has an impact on investment behavior among people in India. Even though several financial education programs have been started all across the world and numerous studies to determine determinants of financial literacy have been conducted, most of

them focus on developed countries and information about developing economies remains scarce. Furthermore, substantial differences were found to exist in 14 various sub-groups within the sample- differences existed based on gender, age, income, educational attainment, and wealth among others. However, it was observed that socio-demographic, economic and family characteristics were important predictors of whether a respondent would own stocks, mutual funds and/or fixed income securities. It is vital to acknowledge that the adult population displays large differences in financial literacy- adults should not be thought of as a homogenous group. Rather differences such as gender, age, educational attainment, income, wealth among others as showcased in this study should be considered while designing public initiatives aimed at improving financial literacy. The various programs to foster financial knowledge should be targeted at disadvantaged groups like women, the elderly and those with low incomes and educational attainment. Some of the authors studied that there was positive relation between

the financial literacy and the investment behavior of the individuals. The results highlight the need for financial education programs focusing specifically on developing investment knowledge and skills to facilitate informed investment decisions. They examined the extent to which existing literature addressed the contribution of financial education in the improvement of financial literacy or personal financial outcomes.

4. Conclusion

So, from the above discussion it has been found there was positive relation between financial literacy and the investment behavior of the respondents. The literature provided an evidence of financial knowledge being a significant factor in the credit card decisions of college students. The existing literature addressed the contribution of financial education in the improvement of financial literacy or personal financial outcomes.

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