# Impact of Investor's Risk Perception on Investment Decisions in Nigeria

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**Abstract**

*Risk is an inherent feature of all types of financial investments due to the variability in the actual and expected returns on investment .The concept 'risk perception' means the way in which investors view the risk of financial assets, based on their concerns and experience. The risk perception of investors is an important factor that influences the investment decisions. Hence, in the present study, based on the review of literature and discussions with experts in the field, a number of factors influencing the risk perception of investors were identified. These factors include unpredictability of returns, knowledge about the financial assets, chance for incurring loss, diversification of portfolios, and dependence on professional investment advice. The study utilized secondary data and is explorative. The study concludes that investors' risk perception impacts positively on investment decision. The study recommends that investors have a better understanding of an investments' potential return of fixed-income products. Finally, future researches in this area should be conducted that will utilize more statistical techniques*

Keywords: Investors, Risk Perception, Investment Decisions, Financial Assets

## 1. INTRODUCTION

The impact of risk perception on the investment decisions of a prudent investor is an emerging subject in the behavioral finance literature. Risk is the chance that an outcome or investment's actual gains will differ from an expected outcome or returns. Risk is an inherent feature of all types of financial investments. Lazarte and Tranchard (2011) defined risk as 'the effect of uncertainty on objectives. According to Pandy (2006), risk is the variability that is likely to occur in the future returns of a project. To an investor, risk could be the probability that the actual return on an investment will be lower than the expected return. Perception is the process by which organisms interpret and organize sensation to produce a meaningful experience of the world (Lindsay & Norman, 1977). Perception is the process by which an individual is in search of pre-eminent clarification of sensory information so that the investor can make a final judgment based on their level of expertise and past experience. Therefore, risk perception means the way in which investors view the risk of financial assets, based on their concerns and experience. Risk perception is the belief, whether rational or irrational, held by an individual, group, or society about the chance of occurrence of a risk or about the extent, magnitude, and timing of its effect is a critical success factor that promotes effective decision-making in risky situations.

According to modern portfolio theory, the objective of an investor is to select the investment in such a way as to diversify the risk and at the same time, not reducing expected returns. Risk is described as 'the possibility of loss, or other adverse or unwelcome developments. Farounbi (2006) supported this view by stating that risk occurs where it is not known what the future outcome will be, but where the various possible outcomes may be expected with some degree of confidence from knowledge of past or existing events, in order words probabilities of alternatives could be estimated. He described uncertainty on the other hand as a situation where future outcome cannot be predicted with any degree of confidence from knowledge of past or existing events thus probability estimates are not available for possible outcomes. This is an indication that risk and uncertainty affects investment decisions and therefore directly or indirectly affect the organizational goals and objectives in focus. This explains why Damodaran (2003) view risk to include both downside and upside risk. Risks and uncertainties are evident in investment decisions thus the investors' perception of risk guides them on

making investment decisions. Complicating the analysis of financial risk is the fact that each investor has his or her own tolerance of risk and perception towards risk. The risk perception of investors is an important factor that influences the investment decisions. This study therefore seeks to examine the impact of investors' risk perception on investment decisions.

## 2. LITERATURE REVIEW

### 2.1 Conceptual Framework

#### 2.1.1 Concept of Investment Decisions

The Investment Decision relates to the decision made by the investors with respect to the amount of funds to be deployed in the investment opportunities by selecting the type of stock in which the funds will be invested by the firm or individual.
Investment decision generally means the determination made by investors as to where,when,how, and how much funds will be invested on various avenues of financial products or instruments with the objective of generating income or appreciation in value.Also, the concept, investment decision is defined as the decision taken by individual investors while investing in the capital market. The behavioral finance scholars found out that decisions could be influenced by unavoidable psychological and emotional factors. Better understanding of these factors will help the investors to take an appropriate investment decision and also help them to avoid their repeating mistakes in future in extracting the best financial investment avenue. Also Barber and Ordean (2011), there is an ample impact of various factors on the decision making process of aninvestor while making any kind of investment in a particular security.

Riaz (2012**)** found that the propensity to take risk, the available information and how it is presented to investors have influenced the decision making of investors in an obvious strength. Another contribution in behavioral finance concluded that the demographical factors including Investor's age, Income, and psychological factors such as Awareness concerning investment channel and Past experience have most common effect on the decision making behavior of individual investors (Sohan & Patidar*;* 2010*)*. Factors like financial statement elements, real EPS (earning per share) were considered important than economy and industry related factors (Khanifar, 2012). For many years of research and investigation, researchers have been doing serious studies of how individual investor state of mind has to do while making investment decisions.

#### 2.1.2 Concept of risk

Risk is the chance of loss due to variability of returns on an investment. Incase of every investment, there is a chance of loss. It may be loss of interest, dividend or principal amount of investment. However, risk and return are inseparable. Return is a precise statistical term and it is measurable. But the risk is not precise statistical term however, the risk can be quantified. The investment process should be considered in terms of both risk and return. Common concepts in risk such as risk-averse, risk seeker and risk neutral give an understanding of the various positions from which investors view risk in their investment decisions.

A risk-averse investor is one who when given a choice between more or less risky investments, with identical expected money returns; he will select the less risky investment. Investors usually prefer the least spread of variance, if expected return is supposed to be held constant. People always prefer a sure outcome rather than a risky prospect with the same expected values. The risk averse investor is not interested in high risk investment especially those requiring heavy capital outlay. For this type of investor, he may, unknown to him be losing to inflation as a result of holding the cash loosely without investing it. The risk seeker tends to be on a gaining side because this investor pursues investments with high risk for high capital gain. The risk neutral investor does not have regard for the presence of risk or the uncertainty that follows investment decisions. He attempts any investment that comes his way whether the gain is high or not. For each of these groups, the presence of risk is identified from risk of loss of cash that could

have been invested profitably as compared to the risk of losses that can be pre-empted and managed in order to eliminate or reduce risk. Various components cause the variability in expected returns, which are known as elements of risk. There are broadly two groups of elements classified as systematic risk and unsystematic risk.

### 2.1.3 Concept of Risk Perception

Each and every investor is different from the other. They perceive risk differently. The variance of portfolio returns is generally said to be the most important risk measure, used in the risk-return trade-off. On the other hand, in the common perception risk is mostly related to the possibility and magnitude of negative deviations from the pre-set benchmark. Veld and Merkolova (2007) in their study of individual investor's risk perception revealed that individual investors use a variety of risk measures at the same time. They tried to test which risk measures influence the individual investor's decision-making. The variance is one of the risk measures, but besides the variance, investors also use several measures of shortfall risk. In particular, semi-variance of returns is found to reflect the investors risk perceptions most often.

### 2.1.4 Concept of Risk Tolerance

Financial risk tolerance is defined as the maximum amount of uncertainty that someone is willing to accept when making a financial decision. Although the importance of assessing financial risk tolerance is well documented, in practice the assessment process tends to be very difficult due to the subjective nature of risk taking (the risk of investor willing to reveal their risk tolerance) and objective factors such as Grable and Joo (1997), Grable and Lytton (1999), and Grable (2000). Risk tolerance represents one person's attitude towards taking risk. This indicated is an important concept that has implications for both financial service providers (asset management institution or other financial planner) and consumers (investors). For the latter, risk tolerance is one factor which may determine the appropriate composition of many assets in a portfolio which is optimal and satisfied investors invest preference in terms of risk and return relative to the needs of the individual investors Droms, (1987), Hallahan (2004).

### 2.1.5 Investor's Socio-Economic Status and Risk Tolerance

Some researchers have indicated that the validity of widely used demographics as determinants of risk tolerance is noteworthy as the relationship between socio-economic status differences including gender, age, income level, net assets, marital status, educational level and investment decision or portfolio choice. With regard to the financial risk tolerance literatures, there is much interest in the demographic determinants and risk attention (involving three risk types: risk aversion, risk moderate and risk seeking) is particularly focused on age, gender, education level, income level, marital status, the number of dependents and net assets. Specifically, although debate remains on some issues, a range of common findings are generally observed. There are five phenomenons in socio-economic status variables differential and portfolio choice as the following; Risk tolerance decreases with age; females have a lower preference for risk than males; risk tolerance increases with education level; risk tolerance increases with income level and net assets; single (i.e., unmarried) investors are more risk tolerant than married (Roszkowski, Snelbecker, & Leimberg 1993; Grable 2000).

## 2.2 Empirical Literature

Aregbeyen and Mbadiugha (2011) in their study in Nigeria found that the ten most influencing factors on investor's decision in order of importance are: motivation by people who have attained financial security through share investment, future financial security, recommendations by reputable and trusted stock brokers, management team of the company, awareness of the prospects of investing in shares, composition of the board of directors of companies, recent financial performance of the company, ownership structure of the company, reputable predictions of future increment in share value and bonus payments. Tomola, Marshal and Obamuyi (2013), posits in their study that investment decisions of

investors in Nigeria are influenced by certain identified factors. The most important principal factors are past performance of the company stock, expected stock split/capital increases/bonus, dividend policy, expected corporate earnings and get-rich-quick. These factors were significantly influenced by gender, age, marital status and educational qualification of investors in the Nigerian capital market. Specifically, the investment decisions of investors relating to past performance of the company's stock differ based on their socio-economic characteristics (age, gender, marital status and educational qualification).

Investment Company Institute (1993) conducted a study based on the objective to examine mutual fund shareholder perceptions of risk. In examining investors' perception of risk-return trade-off, the ICI findings suggested that mutual fund shareholders have a better understanding of an investments' potential return of fixed-income products. A shareholders' family history could influence his or her investment behavior and tolerance for financial risk. Madhumarthi (1998) carried out a research to find out the preferences of the investors and their perception about the risk in the Indian markets. Three classes of investors had been identified based on their risk perception namely, risk seekers, risk bearers and risk avoiders. The result indicated that a majority of the investors were influenced by the operating performance of the companies. The risk perception influenced the investment decisions of the investors and the profit earned by them. Diacon (2004) presented the results of a detailed comparison of the perceptions by individual consumers and expert financial advisers of the investment risk involved in various personal financial services' products. Factor similarity test showed that there were significant differences between expert and lay investors in the way financial risk were perceived. Financial investors were likely to be less loss averse than lay investors, but were prone to affiliation bias, believed that the products were less complex, and were less cyclical and distrustful about the protection provided by the regulators. The traditional response to the finding was that experts and non experts had different perception and understanding about risk.

## 2.3 Theoretical Framework

### 2.3.1 Target MOTAD model

The Target MOTAD model is also applied in this study. The study makes use of the linear programming model referred to as Target MOTAD (i.e Minimization of Total Absolute Deviation programming developed by Tauer (1983). The model is criticized because they can only be used when an individual decision maker exists who is risk-averse and whose utility function is available. The Target MOTAD model is said to be superior to other programming models under risk because it is computational, efficient and generates solutions that meet the second –degree stochastic dominance test (Tauer1983). This is characteristic of the model will enhance the process of analyzing the impact of risk.

### 2.3.2 Cultural Risk theory

The Cultural Risk theory is one of the prominent theories of risk perception. The theory treats risk perception as manifesting individuals' implicit weighing of costs and benefits. Cultural theory asserts that structures of social organization endow individuals with perceptions that reinforce those structures in competition against alternative ones. This position is however criticized by Douglas and Wildavsky (1982) arguing that it ignores the role of cultural ways of life in determining what states of affairs individual see as worthy of taking risks to attain. Other criticisms indicate that the theory does not present reliable measures of individual attitudes and the amount of variance in individual perception of risk. Dake's (1991) measures are however refined to show that risk perceptions are distributed across persons in patterns better explained by culture other than other asserted influences. In actual fact, risk is common to every facet of business and human life. This agrees with Pandy (2009), Horngreen (2007) and Dennis L (2006). Within the context of risk, it is a phenomenon that has determined the success or failure of investments in projects and businesses in general where adequate care is not taken to prepare ahead for possible uncertainties.

As defined by Pandy (2006), risk is the variability that is likely to occur in the future returns of a project. Risk exists in investments because the decision maker cannot make perfect forecasts due to uncertainties in future events and forecast of cash flows. Several factors like the internal political situation of the organization, unanticipated environmental factors, natural disasters and inconsistent government policies may militate against investment plans and result in alternative sequences of cash flows which a manager may not have expected. Gate, Nicholas and Walters (2012) posited that objective setting, risk identification and reaction as well as the need for information and communication will enhance the process of risk management. A combination of all these will positively enhance performance to achieve the enterprise goal. Categorizing risk in order to pave way for effective risk management, Kaplan and Mike (2007), identified the following as types of risks: preventable risks, strategic risks and external risks.

### 2.3.2 Sequential decision-making Theory

This is a decision theory where decisions making proceeds into a step by step rationality, in this context Drury (2000), posited that this decision model includes seven stages that follow each other. The first five stages of this model belong to the decision making process also called the planning process described as "making choices between alternative". At the end of the decision making process he added other two stages called the control process that should measure and correct the concrete performance of the alternative selected or chosen (In investment context, the control and correction stages may record losses or low return on investments).

## 3. METHODOLOGY

The research presented here builds on an analysis of discourses within the range of archival evidence. The study relies on many previous studies from internet, books and already existing journals using an explorative research design.

## 4. RESULTS AND DISCUSSION

This study seeks to investigate the impact of investors' risk perception on investment decisions. Building on the exploratory approach, the United State Securities and Exchange Commission issued an Investor Alert to give the investors tools to make an informed decision. Before an investor makes any decision, these areas of importance need to be considered. This case in point is used as a reference based on its wide acceptability.

### i. Draw a personal financial roadmap

The first step to successful investing is figuring out your goals and risk tolerance – either on your own or with the help of a financial professional. There is no guarantee that you'll make money from your investments.

### ii. Evaluate your comfort zone in taking on risk

All investments involve some degree of risk. If you intend to purchase securities - such as stocks, bonds, or mutual funds - it's important that you understand before you invest that you could lose some or all of your money. The reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you are likely to make more money by carefully investing in asset categories with greater risk, like stocks or bonds, rather than restricting your investments to assets with less risk, like cash equivalents. On the other hand, investing solely in cash investments may be appropriate for short-term financial goals. The principal concern for individuals investing in cash equivalents is inflation risk, which is the risk that inflation will outpace and erode returns over time.

### iii. Consider an appropriate mix of investments

By including asset categories with investment returns that move up and down under different market conditions within a portfolio, an investor can help protect against significant losses. Historically, the returns of the three major asset categories – stocks, bonds, and cash – have not moved up and down at the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns. By investing in more than one asset category, you'll reduce the risk that you'll lose money and your portfolio's overall investment returns will have a smoother ride. If one asset category's investment return falls, you'll be in a position to counteract your losses in that asset category with better investment returns in another asset category. In addition, asset allocation is important because it has major impact on whether you will meet your financial goal. If you don't include enough risk in your portfolio, your investments may not earn a large enough return to meet your goal.

### iv. Be careful if investing heavily in shares of employer's stock or any individual stock

One of the most important ways to lessen the risks of investing is to diversify your investments. It is common sense: don't put all your eggs in one basket. By picking the right group of investments within an asset category, you may be able to limit your losses and reduce the fluctuations of investment returns without sacrificing too much potential gain.

### v. Create and maintain an emergency fund

Most smart investors put enough money in a savings product to cover an emergency, like sudden unemployment. Some make sure they have up to six months of their income in savings so that they know it will absolutely be there for them when they need it.

### vi. Pay off high interest credit card debt

There is no investment strategy anywhere that pays off as well as, or with less risk than, merely paying off all high interest debt you may have. If you owe money on high interest credit cards, the wisest thing you can do under any market conditions is to pay off the balance in full as quickly as possible.

### vii. Consider rebalancing portfolio occasionally

Rebalancing is bringing your portfolio back to your original asset allocation mix. By rebalancing, you'll ensure that your portfolio does not overemphasize one or more asset categories, and you'll return your portfolio to a comfortable level of risk.You can rebalance your portfolio based either on the calendar or on your investments. Many financial experts recommend that investors rebalance their portfolios on a regular time interval, such as every six or twelve months. The advantage of this method is that the calendar is a reminder of when you should consider rebalancing. Others recommend rebalancing only when the relative weight of an asset class increases or decreases more than a certain percentage that you've identified in advance. The advantage of this method is that your investments tell you when to rebalance. In either case, rebalancing tends to work best when done on a relatively infrequent basis.

### viii. Avoid circumstances that can lead to fraud

Investment decision of individual investors in financial assets is usually affected by their risk perception. Hence, in the present study based on the review of literature and discussions with experts in the field a number of factors influencing the risk perception of investors were identified.

## 5. CONCLUSION AND RECOMMENDATIONS

From the forgoing analysis, it is clear that investors are financial conservatives. They are aware about the principle higher the risk, higher will be the return and at the same time they understand that diversified portfolio will reduce the risk. So, the investors should consider investing in a combination of schemes to achieve their specific goals. There is a need for Nigeria Mutual Funds to come out with innovative

products that cater to the ever-changing customer requirements. Diversified products will keep the present momentum going for the industry in a more competitive and efficient manner. The Asset Management Companies must consider the changing perceptions, especially risk perception of investors while launching new products. This will help the Mutual Funds to capture the market.

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