Higher risk, lower reward? Attitudes to financial risk are seriously skewed

Most people are risk-averse and many have the counterintuitive belief that the more risk you take on, the lower the returns will be. These findings from our study on risk attitudes towards investments across 15 countries suggest significant flaws in financial planning

falling stocks

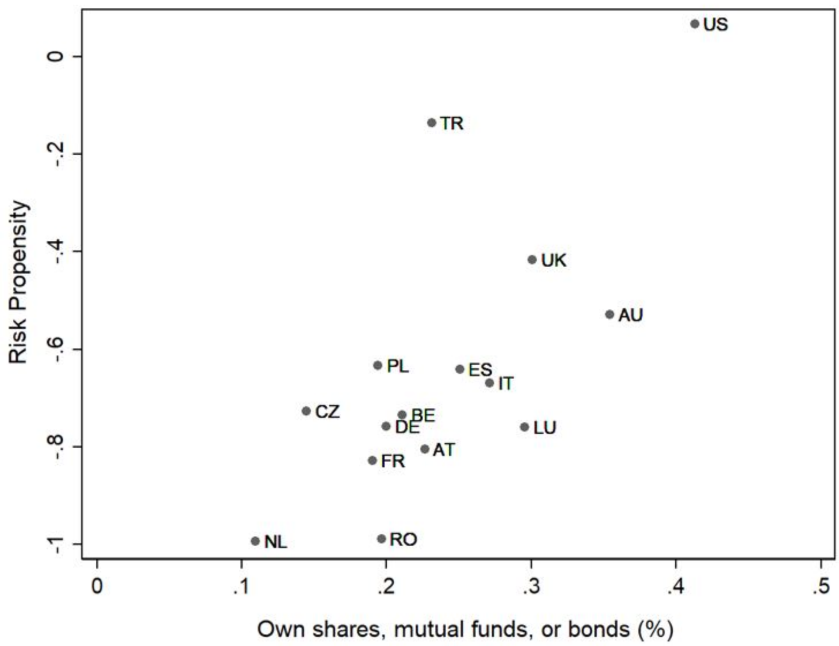
People's perception of financial risk varies noticeably both between individuals within a country and between individuals from different countries. These risk preferences play a crucial role in understanding households financial behaviour and decision making. In a recent article published on the VoxEU policy portal, I show the surprising extent of the differences in financial risk attitudes both within and between countries, the importance of behavioural factors in explaining these differences, and the challenges these present to standard investment theory and financial advice.

Risk avoidance

That people generally prefer to avoid risks when it comes to money should not surprise. However, the extent of that risk avoidance could be much higher than many realise.

Using individual responses collected in 2016 from approximately 15,000 people in 15 countries through the ING International Survey on Savings, I provide several graphical insights into the willingness of households to take risky investment decisions and their attitudes to financial risk. In general, I find that people seek to avoid risk. In 11 of the 15 countries studied, a large majority of the population prefers not to take financial risks.

This risk aversion is one of the most important characteristics that explains why households do not hold or have very low investments in risky assets such as shares, bonds and mutual funds. People prefer to keep their cash in checking or savings accounts instead, if they have the opportunity to do so. This is especially clear in the case of people living in the Netherlands, France, Germany, the Czech Republic and Romania. A more even spread between risk avoidance and risk-taking is seen in responses by people from the US, Turkey, Australia and the UK. While people in these countries still avoid risk in general, there are more risk takers.



Risk and reward?

What is more fascinating is the wide variation in the assessment of the trade-off between financial risk and financial reward between people in different countries.

People in the Netherlands, Austria and Germany think that investments in shares, mutual funds and bonds are much riskier than, for example, people in the US, Turkey, Australia and the UK. But at the same time, they expect the returns on these assets to be very low. This is consistent with the finding of a very skewed attitude towards more risk avoidance in these countries but it challenges one of the fundamental principles of investing. One of the first things people are told when investing is that higher financial returns require taking greater risk. This does not seem to be recognised by some. Many people living in, for example, Germany, Austria and Poland seem to have the counter-intuitive belief that the riskier the investment, the lower the expected rewards will be.

Behavioural matters

The results from this study show that people who indicated greater risk acceptance were also more likely to actually own shares, bonds or mutual funds. However, our analysis suggests that this indication to accept risk is ten times more powerful in explaining whether a person would own risky assets than other objective factors such as the market returns on and volatility of these assets over the past one, five or ten years. This suggests that cultural and subjective dimensions may be much more important than macroeconomic and return factors in explaining people's financial behaviour.

Challenging norms

To be more relevant to the everyday lives of people, the finance industry needs to take a more comprehensive approach to understanding households' true and complete risk profiles.

Risk avoidance by households is not necessarily a good thing. Taking too little risk may mean life goals, such as a financially secure retirement or being able to pay part of children's tuition fees may not be possible. Understanding the reasons for risk avoidance can help avoid these situations in line with personal preferences. Further, these reasons are likely to be different from one country to the next. A one-size-fits-all approach to financial advice is definitely not recommended.

Read more about this here:
https://voxeu.org/article/cross-country-differences-risk-attitudes-towards-financial-investment