Chapter 11
The Effects of Situational and Dispositional Factors on the Change in Financial Risk Tolerance

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ABSTRACT

Utilizing the lens of Heider’s (1958) attribution theory and Grable and Joo’s (2004) conceptual framework, this chapter studies the effect of situational and dispositional attributions on changes in financial risk tolerance. Situational factors are assessed through changes in household situation and changes in macroeconomic factors. For dispositional factors, changes upon sensation seeking attitudes are explored. The data employed in this research come from the 1993, 1994, and 2006 National Longitudinal Survey of Youth (N = 5,449). Results from structural equation modeling indicate that changes in internal attributions have a significant and positive effect (coefficient = 0.12, p < 0.01) on the change in risk tolerance, as is true for changes in external attributions where a significant effect is seen (coefficient = 0.30, p < 0.01). Thus, the findings from this study support the conceptual framework premised on Heider’s attribution theory and Grable and Joo’s (2004) conceptual model.

INTRODUCTION

Financial risk tolerance (FRT) is a significant and influential factor affecting those decisions of an economic and financial nature. Importantly, the concept has been deemed as an associative and predictive factor of financial risk-taking behaviors. During the last few decades, the concept has earned consideration among financial professionals committed to advising consumers, and for researchers dedicated

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to understanding and predicting individuals’ financial behaviors. The evaluation, understanding, and measurement of the elusive FRT are ongoing endeavors in the fields of finance and economics.

FRT is the level of uncertainty an individual is willing to assume despite experiencing less advantageous outcomes in the pursuit of a most advantageous outcome (International Organization for Standardization, 2005). At the household level, FRT becomes a relevant influencer on decisions such as asset and retirement portfolio allocation, and strategies for achieving wealth, growth, and accumulation (Barsky, Juster, Kimball, & Shapiro, 1997). Typically, individuals with higher levels of FRT obtain higher returns in their investments over longer periods of time. This is consistent with the idea of risk-return trade-offs, which suggest that those riskier investments are associated with potentially higher returns. Nonetheless, not all consumers are high-risk takers. Indeed, rational consumers are intrinsically risk-averse and will tolerate only a certain level of risk for any given return.

Numerous factors have been reported as having an association with FRT. For example, the literature suggests an association between FRT and multidisciplinary factors (e.g., social, economic, demographic, psychological factors, etc.) such as life cycle variables, race and ethnicity, wealth, employment status, economic outlook, personality, and psychological traits, among others (Barsky et al., 1997; Grable, 2000; 2008; Grable & Lytton, 1999; 2001; Grable & Joo, 2004; Hanna & Lindamood, 2005; Sung & Hanna, 1996).

An aspect that has been of particular interest is the notion of FRT’s stability or variability through time. This topic has created debate among academicians and professionals in the field (Grable, 2008; Sahm, 2007; Yao, Hanna, & Lindamood, 2004). While some maintain that FRT is a changeable attitude over time and attribute this elasticity to factors such as market conditions and sentiment, and expectation of the economy (Grable, 2000; 2008; Pan & Statman, 2010; Yao, Hanna, & Lindamood, 2004), others argue that FRT is relatively fixed over time (Gerrans, Faff, & Hartnett, 2012; Roszkowski & Cordell, 2009; Roszkowski, Delaney & Cordell, 2009; Sahm, 2007; Santacruz, 2009). In an effort to explore this topic further, the purpose of this study is to explore the research question of whether or not changes in circumstantial and internal variables can potentially affect the change in an individual’s FRT.

**BACKGROUND**

Financial risk tolerance (FRT) is an important factor in the process of financial decision making under uncertainty. FRT refers to an individual’s attitude towards financial risk, and the willingness to undertake more financial risk for the potential of obtaining higher returns. Barsky et al. (1997) express financial risk tolerance as the inverse of risk aversion—as viewed from an expected utility theory. Faff, Mulino, and Chai (2008) evaluate the link between FRT and risk aversion. Their findings suggest that both concepts are associated to a significant degree, especially when using questions regarding gambling to measure such concepts—as is the case in this study.

Regarding measurement of FRT, various instruments exist (see for example, Barsky et al., 1997; Grable & Lytton, 1999; Hanna, Gutter, & Fan, 2001). Despite these research instruments having been tested for validity and reliability, it is dubious as to the whether or not these instruments are measuring the same dimension of FRT (Ruiz-Menjivar, Blanco, Çopur, Gutter, & Gillen, 2014). A possible explanation for the discrepancy on measurements across instruments is the disagreement in terms of definition of FRT. For example, some researchers define it as an attitude while others conceptualize FRT as a trait. The use of different theoretical frameworks (e.g., economic theory, prospect theory) and/