Impact of Personality Traits on Risk Tolerance and Investors’ Decision Making

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ABSTRACT

This article investigates the relationships between personality traits, risk tolerance, and investment decisions and highlights the importance of personality traits in determining risk tolerance levels and investment decisions. Personality traits are classified according to the Big Five taxonomy: extroversion, agreeableness, conscientiousness, neuroticism and openness to experience. Primary data was collected from 330 individual investors from Islamabad. Descriptive analysis of the data was run on SPSS, reliability of the constructs was assessed through Confirmatory Factor Analysis (CFA), whereas, Structural Equational Modelling (SEM) was used to conduct hypothesis testing through path analysis. As per the results of CFA, the constructs were found to be reliable. Mediation analysis confirmed that risk tolerance partially mediated the relationship between personality traits and investment decisions. This study and results have theoretical and practical implications for the investors, financial planners and managers.

KEYWORDS

Investment Decision, Islamabad, Personality Traits, Risk tolerance

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INTRODUCTION

Portfolio Theory (Markowitz, 1952) and Efficient Market Theory (Fama, 1970), two traditional theories of finance, state that individual investors make investment decisions that are totally based on publically available market information. This decision-making approach makes them rational investors. On the other hand, researches in the area of Behavioral Finance challenges the rationality of investors and provides evidence that the investors do not always make rational decisions. Therefore, the factors behind investment decisions can be behavioral and/or psychological (Chang, 2008; Kourtidis et al., 2011). According to the traditional theories mentioned before, market information regarding investments is publicly, perfectly and readily available to all investors. Whereas, in reality, investors don’t have access to all the required information and therefore, have limited market knowledge. Due to this they make satisfactory or opportunistic investment decisions rather than rational or optimal. The investors try to make a rational investment decision, but are unable to due to some psychological and cognitive factors that impact investment decision making.

Research into investor psychology is fairly a new development in the field of psychology and has invited the attention of psychologists and investment professionals. Studies on individual investor emphasize on personality traits based on the Trait Approach. There are three major works based on this approach that are a significant part of literature on personality traits. First is the study by Allport (1937) that classifies personality traits into three categories; secondary, central and cardinal traits. Second is the extensive research, by Cattell (1943), into hundreds of personality traits that make individuals different from one another. Lastly, it is the Big Five Personality Model proposed by Norman (1963) and later improved by Goldberg (1981). This model proposes five major dimensions of personality namely; extroversion, agreeableness, conscientiousness, neuroticism and openness to experience. Each dimension is rated as high or low to conclude about an individual’s personality (Feldman, 1987).

Previously, studies have been conducted to investigate the impact of an individual investor’s personality traits on risk tolerance and investment decisions. Risk tolerance is the maximum amount of uncertainty that, in this case, an investor is willing to accept when making an investment decision (Grable, 2000). The literature includes studies of Carducci and Wong (1998), Nicholson et al. (2005), Keller and Siegrist (2006) and Pak & Mahmood (2015) that have investigated that impact of personality traits on risk tolerance and investment decisions.

This study contributes to the existing literature on Behavioral Finance by investigating the relationship among personality traits, risk tolerance and investment decision in the context of Pakistan that has not been studied till present. Keeping in consideration that the financial markets in Pakistan are driven by the investment decisions of the investors in response to the stock market fluctuations. Therefore, it is necessary to investigate the impact of personality traits on the risk tolerance level that ultimately have an impact on the investment decisions of the individual investor. So, the main purpose of the study is to find out whether personality traits have an