A new study examined the impact of emotions on investments, financial risk and life in general, providing important insights and lessons for advisors.

Behavioral finance is the study of human behavior and how that behavior leads to investment errors – investors do not optimally trade off risk and expected returns to maximize the utility of their end-of-period wealth. This can even lead to mispricing of assets (anomalies for asset pricing models). The field has gained an increasing amount of attention in academia over the past 20 years or so, with the Nobel Memorial Prize in Economic Sciences awarded to psychologist and economist Daniel Kahneman, and behavioral science and finance professor Richard Thaler.

Chris Brooks, Ivan Sangiorgi, Anastasiya Saraeva, Carola Hillenbrand and Kevin Money contribute to the behavioral finance literature with their April 2020 study “The Importance of Staying Positive: The Impact of Emotions on Attitude to Risk.” They examined the impact of emotions towards financial investments and emotions towards life in general on attitudes to financial risk using data from a June 2017 questionnaire of 970 U.K.-based retail investors. Among the control variables were age, gender, investment experience, investment knowledge (both self-assessed and using a simple five-question test that is a subset of a FINRA 15-question test) and educational level.

Following is a summary of their most interesting findings:

• In terms of financial knowledge, only 12% of respondents were unable to answer any of the five most basic questions correctly; 22% got one correct; 23% got two correct; 26% got three correct; 13% got four correct; and only 4% answered all five questions correctly.
• Investors have stronger positive than negative emotions towards investing.
• Risk tolerance monotonically increases with positive emotions towards investments and life, and decreases with negative emotions.
• Perhaps surprisingly, positive emotions have a stronger impact on risk tolerance than negative emotions.
• Both positive and negative emotions towards life are significantly positively and negatively (respectively) correlated with risk tolerance, albeit less strongly so than feelings about finance – when a retail investor is more positive (or less negative) towards investments than towards life, his/her risk tolerance increases.
• Investors who are male and more knowledgeable are more positive towards investments than they are positive about their lives more generally.
• Women tend to state that they have lower levels of investment experience than men: Just over 50% of women put themselves in the lowest experience category versus 21% of men.
• Women are less risk tolerant than men at all ages. They are also more fearful and more nervous than men, with highly significant differences between the means.
• Women have lower positive emotions scores and higher negative emotions scores towards financial investments than men.
• A given increase in positive emotions has a larger effect on the risk tolerance of women than that of men, indicating that as well as having differing base levels of feelings about investing, men’s and women’s attitudes to risk are affected differently by emotions.
• Risk tolerance declines with age.
• Risk tolerance rises with income, self-assessed investment experience, objectively assessed financial knowledge and educational level.
• Investors’ own view of their investment experience has more explanatory power than their objectively assessed actual knowledge.

One of the most interesting (and amusing) findings was: “Men have highly significantly more positive
feelings about investment than women when both have the lowest levels of investment experience, but when men and women have high levels of previous experience the gender difference in emotions towards finance disappears. In other words, one might state that men are happy to invest in ignorance while women are not.”

These findings have important implications. For example, the authors note: “The relatively low proportion of women compared with men who are saving adequately for their retirement is a well-documented problem ... and our findings suggest that this may be because finance does not excite or inspire them and not because they are more frightened of risky investments as suggested in the existing literature. Put another way, it is positive, rather than negative, emotions that hold the key to explaining gender differences in risk appetites. Overall, the results here also suggest that investment education is not the key to reducing gender differences in risking investing.”

Their findings led the authors to conclude: “It is clear that omitting emotional factors from theoretical or empirical models is likely to result in [a] very incomplete view of how people make financial decisions.” It’s also important for investors and investment advisors alike to be aware that risk tolerance varies not over time but also with changing mood. Being aware can help avoid making behavioral errors. Clearly, advisors need to be aware of the emotional state of their clients when discussing risk tolerance and asset allocation decisions so that they can tailor how and what advice is provided.

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