

Challenges for Investors: How do behavioural biases influence our willingness to take risks?

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Abstract

Different behavioural biases can be identified in the literature as having an impact on decision-making in finance. This paper focuses on the risk profile of individuals, by studying how the most common behavioural biases impact risk tolerance, defined by Grable & Lytton (1999) as the willingness to engage in a risky financial situation. Using data from a survey of 285 individuals with a financial background, either still in their studies or with some working experience, a robust statistical analysis identified the type of behavioural biases that have a direct impact on risk tolerance. Interestingly, we find that emotional biases supersede cognitive biases. High scale scores (representing willingness to take risks) were found to be positively correlated with overconfidence, loss aversion and bandwagon effects, whereas local bias and regret avoidance were found to be negatively correlated with risk scores. The effect of some cognitive biases disappears when controlling for working experience, suggesting that cognitive biases could be mitigated compared to emotional biases. This research is useful to provide insight for investors and advisors to consider emotional biases when setting up the risk profile of an individual, typically as requested when filling in MiFID client profiles. This will help in a better alignment of risk appetite with benefit expectations, investment protection and client satisfaction.

Keywords: behavioural finance, emotional biases, cognitive biases, risk tolerance, risk profiling.