# Market changes affect risk tolerance, study finds

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As the U.S. economy continues to lag, many investors remain wary about taking risks with the stock market. Now, researchers at MU have concluded that this attitude toward investment risk-taking is more than just a recent trend. Rui Yao, a University of Missouri assistant professor in the Personal Financial Planning department in the College of Human Environmental Sciences, has found that during the past two decades, the risk tolerance of investors is positively correlated to the movements of the stock market, meaning that investors are likely to invest more when market returns are high, and withdraw partially or even completely from the market when returns are negative.

Yao warns that this tendency will ultimately lead to ineffective investment tactics and unnecessary financial losses. She says that a positive correlation between risk tolerance and stock market returns shows that investors are buying stocks at a high price and selling them at a low price, which is not sound investment strategy.

"To maximize returns, the ideal strategy is to buy stocks at a low price, with the hope of selling them at a higher price," Yao said. "However, many investors seem to be unwilling to take risks when the market is at a low point and seem content to only invest when the market is at a high point."

In her study, Yao examined the Health and Retirement Study (HRS) to investigate changes of risk tolerance levels over time in response to stock market returns. The HRS is a longitudinal study conducted by the

University of Michigan since 1992. During the course of the study, participants were given hypothetical about income gambles and were assigned to a level of risk tolerance based on their answers. The study tracked the responses of each participant between 1992 and 2006 and compared it to the state of the stock market at the time of each response.

Yao found that many Americans are not behaving according to rational economic model assumptions. She says that such changes in risk tolerance in response to market returns may be an indication that investors, and possibly their financial advisors, overestimate their ability to understand risk and assess individual risk tolerance.

"Having the ability to understand risks and assess risk tolerance has a direct impact on individual well-being," Yao said. "Ultimately, improved financial education is the best way to help Americans overcome the bias of over-weighting recent market performance when making investment decisions."

This study was published in the *Journal of Economic Issues.*

Provided by University of Missouri-Columbia

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