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# Investment experience to expected return: Consequences of risk behavior

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ABSTRACT: Decision making for financial products requires scientific justification because it involves uncertainty in returns and financial risks. This study aims to examine the effect of investment experience on risk propensity, risk propensity to risk perception, risk perception to return expectation and investment experience to return expectation. Past investment experience acts as an anchor of benchmarks and the basis of individual decision making in investment. Risk propensity and risk perception are risk behaviors that show a person's attitude and behavior based on previous investment experience, while the return expectation of the financial products reflects the decision of individual investors on the chosen investment opportunities. This study expects to discover how the influence of past investment experience on variable risk propensity, risk propensity to risk perception, and the effect of investment experience on return expectation. Participants are investors and traders of financial instruments in the capital market. This study uses Structural Equation Modelling to test the hypothesis. The result showed that investment experience has positive effect on risk propensity of investors. Higher investment experience will increase the awareness of investors toward risk. Risk propensity has negative effect on risk perception, therefore will support the investors perception toward reducing risk mechanism. Risk perception has positive effect on return expectation, while investment perception has insignificant effect on return expectation. The result showed that investment perception has indirect effect to return expectation through risk perception.

## 1 INTRODUCTION

The subprime mortgage crisis in United States middle of 2008 was followed by the bankruptcies suffered by several major US financial firms such as Lehman Brothers, Merrill Lynch, Goldman Sachs and other financial firms which have had a global financial impact and caused a domino effect. As a result of the financial crisis, the financial products suffered a fantastic loss of value so as to give a hard blow to investors. Today's financial institutions need to pay attention to risk and understand the investor's assessment of the risks and how investor's attitude toward risk matches their risk needs and preferences. Thus, financial institutions can assist the decision-making process of investors and will affect the return expectation. Several issues arise during investors' investment process, such as experience of losses, and the benefits they gain will have a meaningful personal experience for them, affecting their behavior and attitudes toward the risks of any financial products (Chou et al. 2010). It will affect attitudes and behavior, as well as investment decision making. Investors who typically invest in high risk assets will reconsider investing in these assets even if their future returns are high enough to influence investors' investment decisions in the future. Attitudes gained through experience will have a direct effect on subsequent behavior. In this study, the variable that shows the attitude and behavior is the risk propensity and risk perception. Risk propensity is the tendency of a person to a certain risk, while risk perception is the judgment of decision makers on the risks that exist in certain situation (Sitkin & Pablo 1992).

Chou et al. (2010) argued that past investment experience acts as anchor, the benchmark as well as the basis of individual decision making in investment. Risk propensity and risk perception are risk behaviors that show how people's attitudes and behaviors are based on previous investment experiences. The return expectation of the financial products reflects the decision of individual investors on their chosen investment. This research examines how the influence of past investment experience on risk propensity, risk propensity to risk perception and the influence of investment experience on return expectation which is the basic decision-making process of investors. The gap between studies of investment experience, risk propensity, and risk perception showed that each factor has its specific effect to financial decision of investor. However, this research tries to combine the issues of investment experience, risk propensity, and risk perception with return expectation from investor's point of view. The research problem formulated is there is a direct influence of investment experience on the return expectation; as well as the indirect effect of investment experience on the return expectation through risk propensity and risk perception.



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### 1.1 *Risk propensity*

Wong (2005) defines risk propensity as a decision-makers tendency to avoid or take risks. Each individual has a different understanding of risk-taking behavior. Maturity of decision makers in terms of seniority and age will decrease risk propensity compared to young decision-makers. Thus, individuals who have high risk propensity are more risk-seeking, while individuals with lower risk propensity will be risk-averse.

### 1.2 *Risk perception*

Risk perception is defined by Sitkin and Pablo (1992) as the assessment of decision makers of the risks that exist in a situation. The definition of risk perception is consistent with the definitions of several previous studies (Douglas 1985, Dutton & Jackson 1987, Vlek & Stalen 1980). According to Sitkin and Weingart (1995), the assessment of those risks reflects the degree to which a person perceives a situation as negative, threatening, and out of control. Weber and Milliman (1997) stated that risk perception is the main factor causing behavior change in betting, because basically risk preference or risk attitude of a person is stable.

### 1.3 *Investment experience*

Osborn and Jackson (1988) and Thaler and Johnson (1990) argued that the success or failure of an event influences how decision makers assess risky situations and their actions. Thus, the events that occur beforehand will influence the tendency of decision makers to take risks. Chou et al. (2010) stated that previous investment experience and investor expertise will provide awareness of risk and be an important factor for future risk assessment. Investment experience is an important factor and has an anchor effect toward behavior.

### 1.4 *Return expectation*

According to Chou et al. (2010), in traditional financial concepts, investors assume do not like risks, but investments with high returns will have a high level of risk. Muradoglu (2005) describes professional traders supporting a positive relationship between risk and return, but novice traders and low-ability investors feel that expected returns are negatively related to risk. In Chou et al. (2010), the behavior of decision making is reflected in the expected return and how the portfolio configures by investors. Based on these considerations, in this study decision making in the investment will be represented by the return expectation that the investor expect on the amount of funds invested.

### 1.5 *Hypothesis*

Based on the theory described earlier, the hypotheses that can be drawn are as follows:

$H_1$: Investment experience positively influence the risk propensity.

$H_2$: Risk propensity negatively affects risk perception.

$H_3$: Risk perception has a positive effect on return expectation.

$H_4$: Investment experience has a positive effect on return expectation.

### 1.6 *Research model*

The structural model for the path diagram in this study is shown in Figure 1.

## 2 METHOD

This study obtains respondents directly through the responses of questionnaires, for example investors who invest in several financial instruments. There are 200 questionnaires distributed to potential respondents, and 197 were returned and only 153 were valid and fully completed questionnaires.

### 2.1 *Operational definition of variables*

The indicators used to measure investment experience are adapted from the research of Chou et al. (2010) and Byrne (2005). Investment experience can be known from the investment knowledge as well as the successful experience or failure of respondents in investing in several types of financial products. Indicators for investment experience include: adequacy of knowledge about financial management, ability or experience in investing, success in investing in financial products previously invested. All investment experience indicators (X1) will be measured using a Likert scale (1–5).

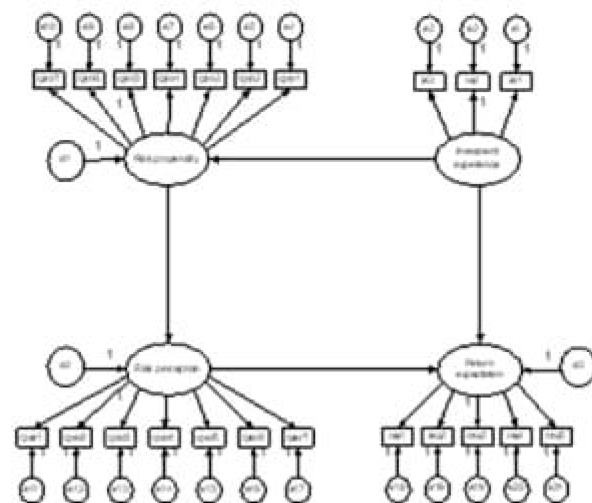

Figure 1. Structural model of path diagram.



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The indicators used to measure risk propensity are adapted from the research of Byrne (2005) and Chou et al. (2010). Risk propensity can be drawn from how the investor's subjective opinion on the risk level contained in risk propensity indicators, which include: use daily income to buy lottery tickets or place them on sports betting (football, boxing, horse racing, etc.), lend money to friends whose amount is as big as income in 1 month, invest 10% of your annual income on highly speculative stocks, invest 10% of your annual income on government bonds, invest in a business that has a high risk, but prospects good and profitable, gambling using weekly earnings at the casino, take a job where you earn an exclusively commission-based income. All indicators of risk propensity will be measured using a Likert scale (1–5).

While risk perception is defined as the decision maker's judgment of the risks contained in a situation (Sitkin & Pablo 1992). According to Sitkin and Weingart (1995), the assessment reflects the degree to which individuals perceive a particular situation as negative, threatening, and out of control. People who have high risk perception will be risk averse or prefer to avoid risk. For risk perception assessments will also be measured using the Likert scale (1–5).

The return expectation of investors can be seen from the amount of expected returns from a number of investment funds. The indicators used to assess the return from investors are based on Byrne (2005) and Chou et al. (2010), where investors will be given the option of the return value they expect from their investment. The questions asked are of each type of investment below, estimate the amount you expect back within the next 3 years assuming you have $300 million to invest. Choice of answers include: (a) less than 2 hundred million, (b) 2–3 hundred million, (c) 3–4 hundred million, (d) more than 4 hundred million. The answer option (a) has a score of 1, the answer option (b) has a score of 2, the answer choice (c) has a score of 3, and the answer option (d) has the highest score of 4.

## 3 RESULT AND DISCUSSION

### 3.1 *Variable description*

Description begins with identifying the characteristics of respondents based on demographic factors. Respondents characteristic were gender, marital status, age, final education, occupation, and monthly income of the respondents with 153 respondents (111 men and 42 women). Goodness of fit for Goodness of index (GFI) with maximum likelihood method.

Table 1. Direct hypothesis.

| Variable | | | CR | Significance |
|---|---|---|---|---|
| *Investment Experience* | → | *Risk Propensity* | 2.669 | 0.008 |
| *Risk Propensity* | → | *Risk Perception* | -2.692 | 0.007 |
| *Risk Perception* | → | *Return Expectation* | 2.445 | 0.014 |
| *Investment Experience* | → | *Return Expectation* | -0.278 | 0.781 |

### 3.2 *Direct hypothesis*

CR value on investment experience to risk prospensity is 2.669, which has a value greater than 1.96. Level of significance is 0.008 which has a value smaller than 0.05. Because the level of significance is smaller than 0.05 and the value of CR calculated greater than 1.96 it concludes that there is a direct signify–can't affect between investment experiences on risk propensity. Thus, the hypothesis that investment experience has a positive effect on risk propensity is hold.

CR value of investment experience against the risk propensity is –2.692, which has a value smaller than –1.96. The significance level is 0.007 which has a value smaller than 0.05. Therefore, there is a direct significant between risk propensity to risk perception. Thus, the hypothesis that risk propensity negative effect on risk perception is hold.

The CR value of risk perception to the return expectation is 2.445, which has a value greater than 1.96. The significance level is 0.014, which has a value less than 0.05. There is a direct significant influence between risk perceptions to return expectation. Thus, the hypothesis is risk perceptions positively affect the expected return expectation.

The value of CR in the investment income variable to risk propensity is –0.227, which has a value smaller than 1.96. The significance level is 0.781 where the value has value greater than 0.05. There is no significant effect between investment experiences to return expectation. Thus, the hypothesis that investment experience has a positive effect on the return expectation is rejected. In addition, because there is no direct influence, the investment experience has an indirect influence on the return expectation through risk propensity and risk perception.

## 4 CONCLUSION

Chou et al. (2010) suggests that investment experience is an important factor affecting behavior, in addition to the failure or success of previous investment experiences can affect investors' tendency towards risk.



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An experience can certainly affect how a person behaves in his or her life, especially in investing. Experience on investment and success in investing will increase investor confidence (self-confidence). Such confidence gives optimism to investors, so optimistic investors will prefer to take any risk and bolder to take more risk.

These results support the argument of Sitkin and Weingart (1995), suggesting that someone who is risk-averse is someone who likes challenges and wants to take high risks and expects high returns on investment, therefore their perception of risk is low. The results of this study are also in line with previous research by Byrne (2005) and Chou et al. (2010) that risk propensity has a negative effect on risk perception.

The practical implication is every investor with post success investment experience will prefer riskier investment rather than post unsuccess investment experience investors or even inexperience investor. The tendency of experienced investors to have lower risk perception will increase their risk making behavior. Regulators should have more agile regulation to accommodate the needs of higher risk investment opportunity for experienced investors while protect inexperienced investors from making unfavorable investment decisions.

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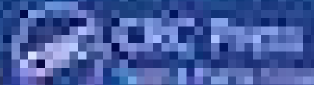

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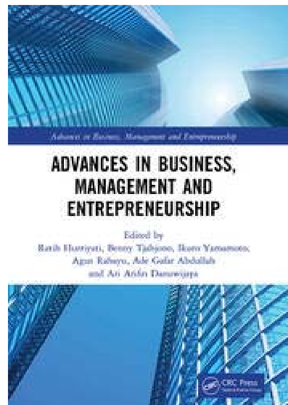


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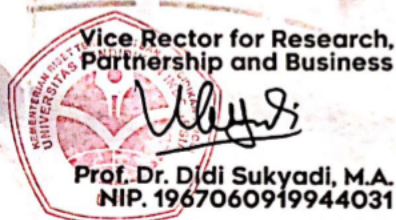

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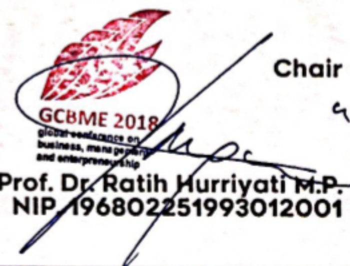


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