Consumer Insights: Money & Investing

How Consumers Think About Investment Risk

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New research from the FINRA Investor Education Foundation suggests that, while eight in 10 consumers have at least a basic understanding of investment risk, little over half (55 percent) are able to recognize risk-mitigation strategies.

What we looked at and what we learned.

Understanding investment risk is an integral part of making decisions about investing. Without adequate knowledge of investment risk and how to manage it, a consumer's investment decisions may be based on misperceptions. Some may choose to avoid investing altogether. Conversely, a sound understanding of investment risk may help consumers deploy risk-mitigation strategies, like diversification, and assess various investment products to identify those that align with their goals and risk tolerance.

To examine how consumers think about investment risk—as well as the relationships among risk comprehension, risk tolerance and asset holdings—we fielded a survey to a nationally representative, probability-based sample of 1,066 respondents. The survey (see Appendix) gauged respondents' investment risk comprehension, financial risk tolerance, asset holdings, recognition of risk-mitigation strategies and specific risk-related investing concerns.

Results indicate that, while most consumers (80 percent) have at least a basic understanding of investment risk, fewer (55 percent) are able to recognize risk-mitigation strategies. We find that those with higher risk comprehension tend to be more willing to take financial risk,[1] and that investors and non-investors have different risk-related concerns about investing. We also find that investors' risk comprehension and risk tolerance generally align with their self-reported portfolio choices.

The findings suggest that consumers' concerns about inflation (a top concern among investors) and liquidity (a top concern among non-investors) may be especially important for financial educators and investment professionals to address when beginning conversations about investment risk and how to manage it. These topics are top of mind for consumers and should supplement discussions about the risk-reward relationship, which often is the starting point for education about investment risk.

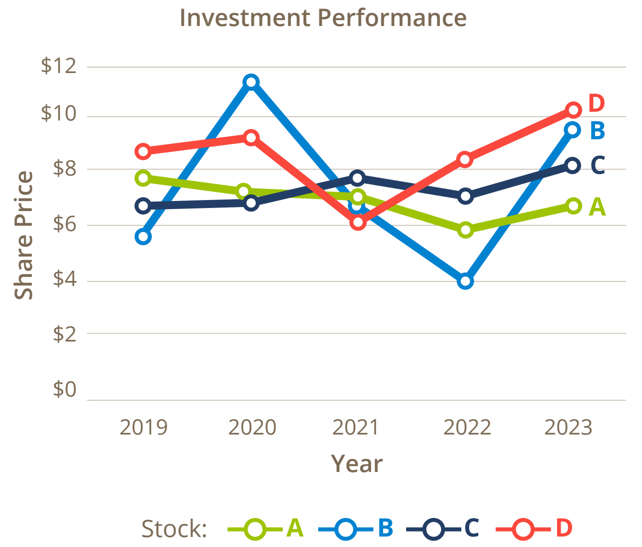
Consumers understand risk but not how to mitigate it.

To examine understanding of investment risk, we presented respondents with a graphic (Figure 1) displaying the performance of four hypothetical investments and then asked them to identify the investment with the greatest amount of risk.[2]

Over three-quarters (80 percent) of respondents correctly indicated that Investment B had the greatest amount of risk.[3] Very few respondents (3 percent) chose Investment C, which had the lowest risk. Nevertheless, nearly one in five respondents selected either Investment A (the investment with the lowest value at the end of the shown timeline) (9 percent) or Investment D (the investment with the highest value at the end of the shown timeline) (8 percent).

To measure respondents' ability to identify a common risk-mitigation strategy—diversification—we asked how they would invest $1,000 if they could choose among four companies. We offered respondents the following options: (A) invest $250 in each of the four companies; (B) invest the full $1,000 in one of the companies; (C) invest $500 in each of two of the four companies; or (D) don't know.[4] Specifically, we asked respondents to identify the approach that would generally keep the risk of losing money lowest. Only slightly over half (55 percent) of respondents were able to identify the lowest risk (and most diversified) choice (option A). Notably, almost one-quarter (23 percent) of respondents indicated they did not know the correct answer.

Figure 1: Investment Performance of Four Hypothetical Investments



Experience makes a difference.

Those with actual investing experience tended to have knowledge about investment risk and the ability to identify the widely used risk-mitigation strategy of diversification (Figure 2). Compared to non-investors (n=551), respondents with investments (n=515) more frequently correctly identified the investment with the greatest amount of investment risk (73 percent and 88 percent, respectively). Knowledge about investment risk was more prevalent among respondents with higher incomes (93 percent among those with incomes over $100,000 annually, compared to 70 percent with incomes less than $30,000 annually) and educational attainment (93 percent among those with a college degree, compared to 80 percent with no college), but only among investors.

In terms of respondents' familiarity with diversification as a risk-mitigation strategy, we see similar patterns between investors and non-investors. Compared to non-investors, investors correctly identified the most diversified strategy much more frequently (44 percent and 70 percent, respectively). In addition, among investors, those with higher levels of education more frequently identified the least risky strategy (78 percent of respondents with a college degree, compared to 51 percent of respondents with no college).

There appears to be a relationship between investment risk knowledge and the ability to recognize risk-mitigation strategies. Sixty-one percent of those who correctly answered the investment risk question correctly recognized the most diversified risk-mitigation strategy. In contrast, only 37 percent of those who *did not* correctly answer the investment risk question correctly identified the most diversified risk-mitigation strategy.

Figure 2: Understanding Risk and Risk Mitigation, by Investor Status

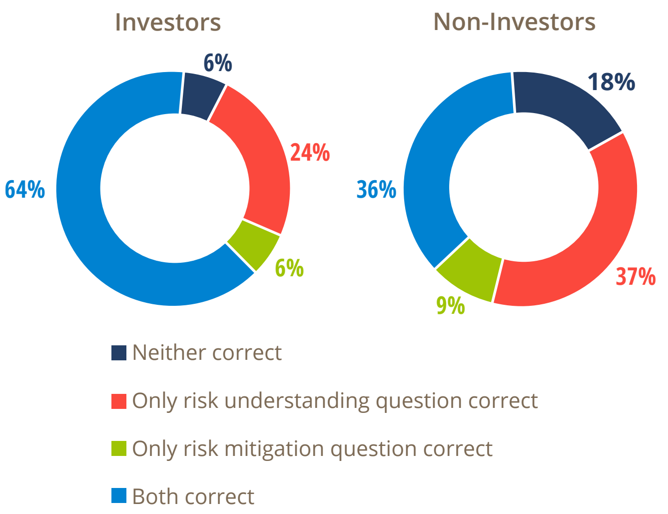
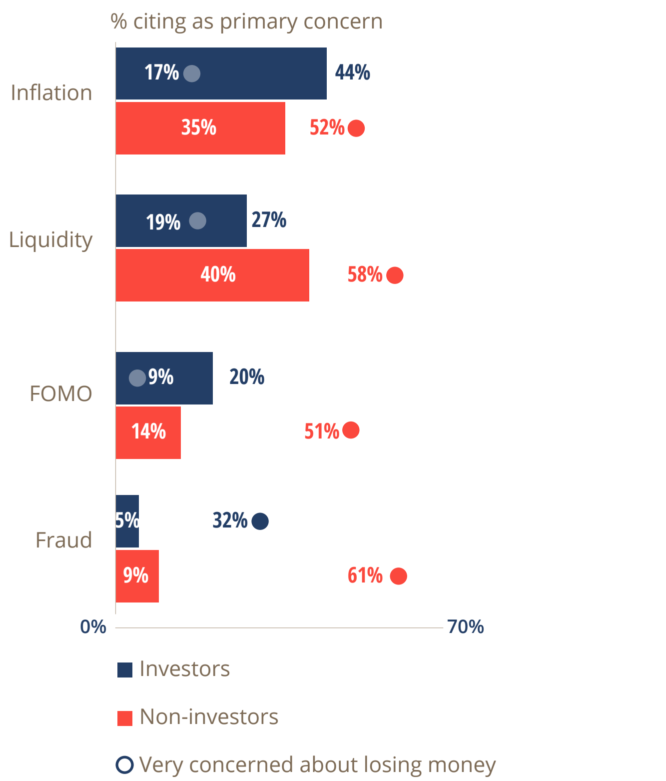


Figure 3: Risk Factors Shaping Consumer Decisions about Investing, by Investor Status



Investing decisions are influenced by concerns about losing money, inflation risk, and liquidity risk.

The vast majority (90 percent[5]) of respondents indicated that, to some extent, the possibility of losing money prevented them from investing or investing more. Nearly two-fifths (38 percent) said this concern affected their decision making "a great deal."

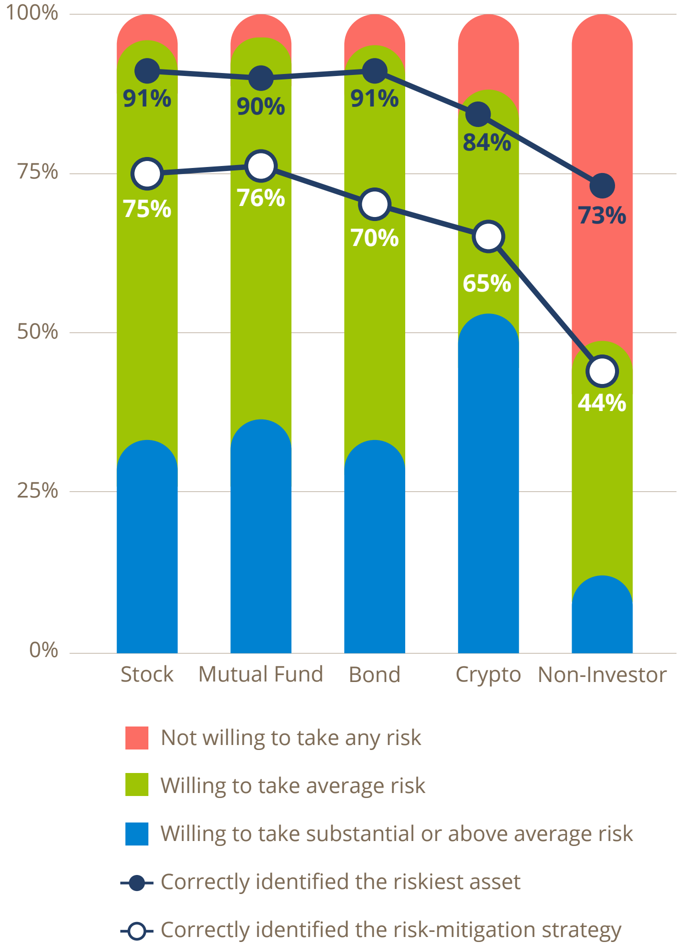
Among non-investors, nearly all (94 percent) indicated that concerns over potential losses prevented them from investing, with more than half (56 percent) indicating this affected their decision "a great deal." Among investors, 86 percent indicated that concerns about possible losses prevented them from investing more of their money, with 16 percent indicating this affected their decision "a great deal." It is possible that concerns about losing money may be more prevalent for consumers before they begin to invest, or that once a consumer begins to invest, concerns about losing money are lessened.[6]

Concerns about incurring investment losses appear closely tied to lower knowledge about investment risk and less ability to recognize risk-mitigation strategies. Those with more concern about potential losses have less knowledge about investment risk and risk-mitigation strategies. Among respondents who indicated a great deal of concern about losing money, 78 percent correctly identified the riskiest investment among a group of options (compared to 84 percent of respondents who did not indicate a great deal of concern), and only 52 percent (compared to 62 percent) identified the correct risk-mitigation strategy.

Beyond general concerns about losing money, concerns about inflation risks and liquidity risks are top of mind for consumers (Figure 3). Nearly four in 10 survey respondents (39 percent) identified keeping up with inflation as their primary concern when making decisions about investing. Another 34 percent indicated their primary concern as having access to their money when they need it.

Specific concerns differed by investor status: Investors more frequently named inflation risk as their primary concern (44 percent, compared to 35 percent among non-investors), while non-investors named liquidity risk as their primary concern (40 percent, compared to 27 percent among investors). Fewer consumers, both investors and non-investors, named other concerns, including missing out on an investment that does well (17 percent) or fraud (7 percent), as their primary concerns.

Figure 4: Risk Tolerance, Risk Understanding and Recognition of Risk Mitigation, by Investor Type



What consumers worried about most varied slightly by age, income, and risk tolerance. That said, inflation and liquidity generally remained the top two most reported worries. There were a few groups of investors for whom concerns about missing out on an investment that later performs well was prevalent. At least 20 percent of investors in the following groups reported missing out as their most concerning issue: investors with above average or substantial risk tolerance (28 percent); investors ages 18 – 29 (32 percent) and 30 – 44 (27 percent); investors with a college degree (23 percent); investors with incomes between $60,000 and $100,000 (21 percent) and over $100,000 (23 percent); and cryptocurrency owners (30 percent). Among non-investors, only respondents aged 30 – 44 cited fear of missing out as their top concern with similar frequency (22 percent).

Many consumers are willing to take average risk with their money, and consumers' investing choices generally align with their understanding of risk and risk tolerance.

When asked about the level of financial risk they would be willing to take, nearly one-third of all respondents (30 percent) indicated they would not be willing to take any risk. Nearly half (46 percent) indicated a willingness to take average risk, and almost a quarter (24 percent) said they would be willing to take above average or substantial risk. There appears to be a weak, but statistically significant, positive relationship between willingness to take risk and both knowledge about risk and recognition of risk-mitigation strategies, particularly for non-investors.[7,8] This suggests that having more risk knowledge may make consumers more willing to assume financial risk, or conversely, that consumers who are more willing to take financial risk are also more likely to learn about risk.

Risk tolerance, risk knowledge and recognition of risk-mitigation strategies differ among investors with different types of assets, as well as between investors and non-investors, in ways that generally align with expectations (Figure 4).

- Among investors, those holding stock had higher levels of risk tolerance and more frequently understood risk, but recognized risk-mitigation strategies at about the same level as other investors.
- When compared to investors without mutual funds, mutual fund owners were generally willing to take some level of risk and less frequently indicated they are unwilling to take any risk. They more frequently understood risk and recognized risk-mitigation strategies.
- Bond owners had similar levels of risk tolerance, understanding of risk and recognition of risk-mitigation strategies as investors who did not own bonds.
- Cryptocurrency[9] owners more frequently indicated willingness to take above average or substantial risk but were similar to non-crypto investors in their understanding of risk and risk-mitigation strategies.
- Non-investors had the lowest levels of risk tolerance and (as noted above) the lowest levels of risk understanding and risk-mitigation strategy recognition.

Figure 4 presents the proportion of consumers in each of the three risk-tolerance categories (not willing to take any risk, willing to take average risk or willing to take above average or substantial risk) for investors with different asset holdings and non-investors in stacked bars. The solid blue circles represent the proportion of consumers who correctly identified the riskiest asset in our survey (knowledge of risk), and the white circles represent the proportion of consumers who correctly identified the risk-mitigation strategy.

Conclusion

By and large, the U.S. adult population appears to have an intuitive, basic level of understanding of investment risk but seems much less aware about how to manage that risk. Investors display a better understanding of risk and risk-mitigation strategies than non-investors, suggesting that one of the best forms of education when it comes to investment risk may well be the actual experience of investing.

This study suggests a number of strategies for financial educators. Non-investors may benefit from a greater understanding of how to meet their liquidity needs while still experiencing the benefits that can come with investing. For risk-averse consumers, providing information on how to choose a portfolio that aligns with one's risk tolerance may help overcome concerns related to capital loss. Providing all consumers with a greater understanding of how to manage risk through diversification may result in more consumers entering capital markets and would support better decision-making related to investments by those already investing. Finally, the findings suggest that a better understanding of inflation—both how inflation might impact investment performance and how investing can help consumers keep pace with or ahead of inflation—may alleviate concerns for many investors.

Methodology

We conducted the poll of 1,066 adults between August 8 and 12, 2024, using a sample drawn from NORC's AmeriSpeak Panel, a mixed-mode probability-based panel designed to be representative of the U.S. adult population (18+). Interviews were conducted in English. The AAPOR3 response rate is 3.2 percent, and the margin of sampling error for all respondents is plus or minus 3.97 percentage points (at the 95 percent confidence level). For analysis, data were weighted to be representative of the U.S. population 18 and older (by gender, age, education, race/ethnicity and region) using 2023 Current Population Survey benchmarks. The poll and analyses were funded by the FINRA Investor Education Foundation.

Imputation

A total of 150 respondents were unable to be classified as either investors or non-investors due to missing data. To classify these respondents, we used a multiple imputation technique utilizing a logistic regression model to estimate the investor status for these 150 respondents. Specifically, we estimated the investor status for each respondent five times using the following independent indicators: age; race/ethnicity; gender; income; education; and financial risk tolerance. We obtained final investor status classifications for respondents by calculating the mode of investor status classifications from the five-model imputation.

About FINRA and the FINRA Foundation

The Financial Industry Regulatory Authority (FINRA) is a not-for-profit organization dedicated to investor protection and market integrity. It regulates one critical part of the securities industry—brokerage firms doing business with the public in the United States. FINRA, overseen by the Securities and Exchange Commission, writes rules, examines for and enforces compliance with FINRA rules and federal securities laws, registers broker-dealer personnel and offers them education and training, and informs the investing public. In addition, FINRA provides surveillance and other regulatory services for equities and options markets, as well as trade reporting and other industry utilities. FINRA also administers a dispute resolution forum for investors and brokerage firms and their registered employees. For more information, visit www.FINRA.org.

The FINRA Investor Education Foundation supports innovative research and educational projects that give underserved Americans the knowledge, skills and tools to make sound financial decisions throughout life. For more information about FINRA Foundation initiatives, visit www.FINRAFoundation.org.

All results, interpretations, and conclusions expressed are those of the research team alone and do not necessarily represent the views of the FINRA Investor Education Foundation, FINRA or any of its affiliated companies.

Notes

1 Respondents were asked to identify the statement that came closest to describing the amount of financial risk that they were willing to take with their money. The exact wording and response options can be found in the Appendix.

2 Respondents were also offered a "Don't know" option.

3 The volatility of Investment B (as measured by the standard deviation) is twice the volatility of the second riskiest investment (Investment D).

4 See Appendix for exact survey question wording.

5 Represents respondents who answered 2–5 on a 1–5 scale, where 1="not at all" and 5="a great deal."

6 Differences in the proportion of investors and non-investors who are concerned or concerned a great deal about losing money persist when controlling for income.

7 When disaggregated by investor status, these relationships are not significant for investors, and for risk knowledge, the relationship is marginally significant for non-investors ($p=0.08$).

8 $r=.15$, $p<0.0001$ for understanding risk; $r=.17$, $p<0.001$ for recognizing the risk-mitigation strategy.

9 There were 72 cryptocurrency owners in the sample.

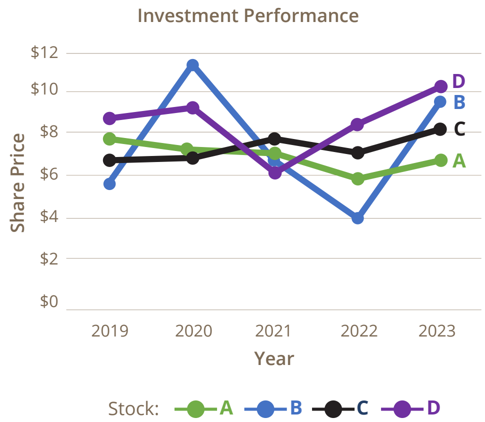
Appendix – Survey Questions

1. Which of the following types of financial investments do you currently own either inside or outside of a retirement account? Please select all that apply.

a) Mutual funds or exchange traded funds (ETFs)
b) Individual company stocks
c) Individual company bonds
d) Government bonds, including municipal bonds
e) Cryptocurrency or non-fungible tokens (NFTs)
f) None of these
g) Don't know

2. Looking at the following figure, which stock investment has the <u>greatest</u> amount of financial risk?

a) Stock A
b) Stock B
c) Stock C
d) Stock D



3. (If classified as an investor:) Other than the possibility of losing some or all of the money you invest, which of the following worries you the most when making investment decisions?

(If classified as a non-investor:) Other than the possibility of losing some or all of the money you invest, which of the following would worry you the most when making investment decisions?

a) The value of your investments may not keep pace with inflation
b) You may not be able to access your money when you need it
c) An investment you hold may be fraudulent
d) You may miss out on an investment that later performs well
e) Other: ______________________

4. (If classified as an investor:) To what extent does the possibility of losing money prevent you from investing more money?

(If classified as a non-investor:) To what extent does the possibility of losing money prevent you from investing?

a) 1 – Not at all
b) 2
c) 3
d) 4
e) 5 – A great deal
f) Don't know

5. You are trying to decide how to invest $1,000 and have narrowed the possibilities to four companies. Which of the following approaches would generally keep the risk of losing money lowest?

a) Investing $250 in each of the four companies
b) Investing the full $1,000 in one of the companies
c) Investing $500 in each of two of the four companies
d) Don't know

6. Which of the following statements comes closest to describing the amount of financial risk that you are willing to take with your money?

a) Take substantial financial risks expecting to earn substantial returns
b) Take above average financial risks expecting to earn above average returns
c) Take average financial risks expecting to earn average returns
d) Not willing to take any financial risks
e) Don't know