Risk taking, diversification behavior and financial literacy of individual investors

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This study investigates whether the financial literacy influences risk taking decisions. We know that this kind of decisions moves along two dimensions: on one side, investors must decide how much risk they are willing to take (meaning that they have to choose among more or less risky assets); on the other side, they can decide to exploit the diversification principles to reach the target level of risk.

Prior empirical evidence shows that many people are unable to perform a "sophisticated" portfolio diversification: what they do is to split equally their wealth among the asset classes available, in a naïve way. We try to detect if the financial literacy is a driver of this kind of decisions.

By submitting a questionnaire to 200 American individuals, we find that financial literacy affects the amount of risk taken, but does not influence the diversification strategies, both sophisticated and naïve, pursued by investors.

Our findings show that financial literacy may help investors to be bolder in exploiting the opportunities offered by financial markets, but not to use the properties offered by the financial theory, such as the diversification principle, even in its naïve version.

Therefore, there might be a pitfall in the financial education programs, making investors more aware of their investment decisions, but, at the same time, pushing investors to assume more risks that they do not know how to manage.

Keywords: risk taking, diversification behaviour, financial literacy