

# THE ROLE OF EXPERTISE IN FINANCIAL RISK TAKING AND ABILITY TO FORECAST RETURN AND RISK ON FINANCIAL ASSETS

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## Background

Previous research is inconclusive regarding the importance of financial expertise for financial risk taking as well as accurately predicting return and risk on financial assets. Some studies have established a strong correlation between self-confidence and subjective knowledge in the financial domain and a close link between overconfidence and risky investment portfolios (Campbell & Kirmani, 2000). Some evidence however, shows that overconfidence may decrease with expertise and experience (Christoffersen & Sarkissian, 2002; Locke & Mann, 2001; Menkhoff, Schmidt & Brozynski, 2006), while other studies indicate that financial experts are more likely to be overconfident than inexperienced investors (Glaser, Langer & Weber, 2003; Törngren & Montgomery, 2004).

## Purpose

The purpose of this study was to investigate the role of experience and expertise in stock investors' financial risk taking and accuracy in return and risk predictions of financial assets.

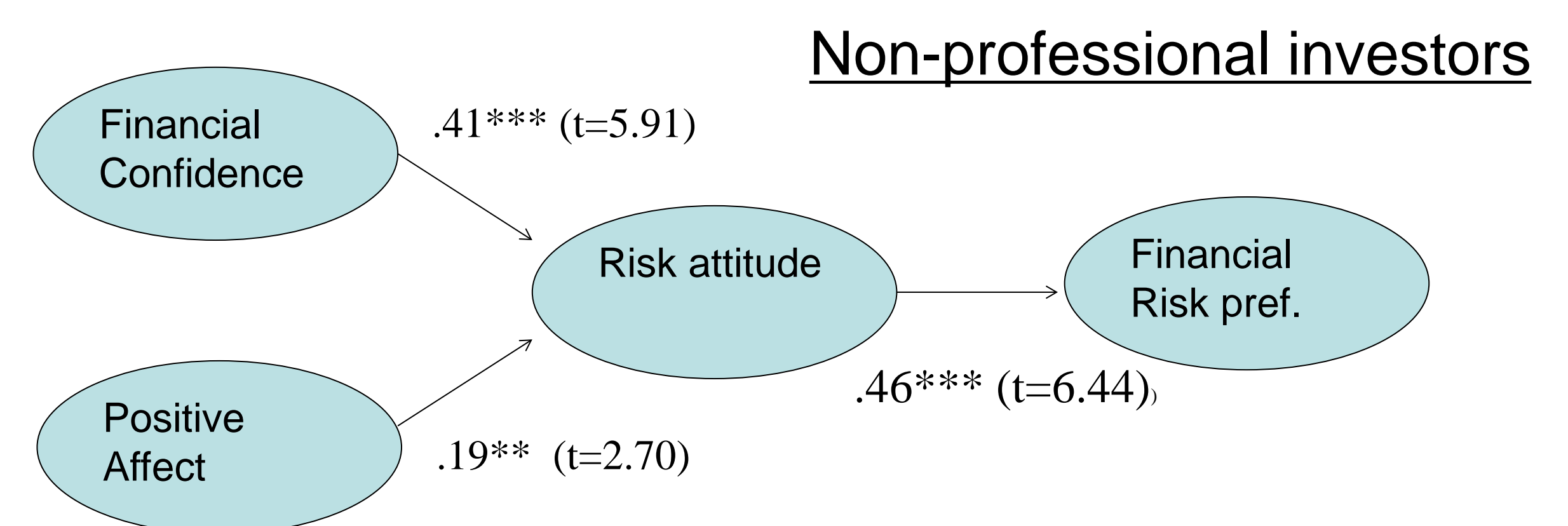
## Sample

Participants were professional and non-professional investors responding to a web-based questionnaire.

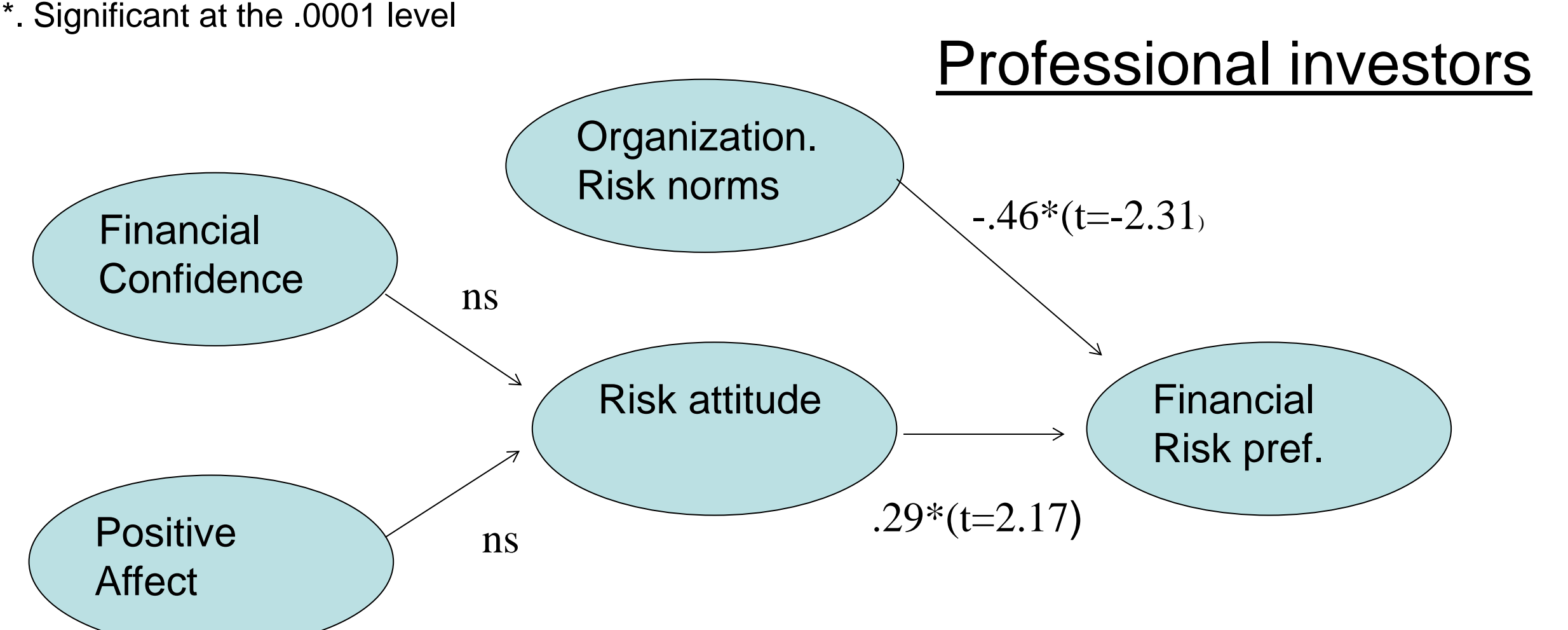
The professional investors were fund managers or financial analysts at Swedish investment institutions such as pension funds and investment banks. 137 questionnaires were distributed and 64 were returned and completed by professional investors (males = 60; females = 4; mean age=41), resulting in a response rate of 47%. The number of responding non-professional investors (students and lay people) were 278 representing a response rate of 18% (males=156, females=122, mean age=48).

## Results

The first part of the study investigated risk taking in portfolio decisions among professional investors and non-professional investors. Risk taking was measured by exposing respondents to hypothetical scenarios concerning portfolio allocation of risky and less risky assets (Hallahan, 2004). It was found that professionals and more experienced non-professional investors had a more positive financial risk attitude and were more risk taking in portfolio decisions than unexperienced non-professionals investors. While professional investors' risk taking was influenced by organizational risk norms and risk attitude, non-professionals were influenced by positive affect and financial confidence. Two SEM-models (see figure) explain better non-professionals risk taking in portfolio decisions than professionals (poor model fit).



Standardized beta coefficients are given for the structural paths. Model fit:  $\chi^2/df=1.7$ ; RMSEA=.050; NFI=.900; CFI=.956; AIC=445  
\*\*. Significant at the .001 level  
\*\*\*. Significant at the .0001 level



Standardized beta coefficients are given for the structural paths. Model fit:  $\chi^2/df=1.40$ ; RMSEA=.080; NFI=.602; CFI=.832; AIC=592  
\*. Significant at the .05 level

The second part of the study investigated the importance of financial expertise for investors ability to accurately predict return and risk of financial assets. The respondents' task was to make predictions of the 3-months' return and risk (volatility) on stock indices and sectors (e.g., energy sector) of the Swedish stock exchange. First, and in line with some previous studies (e.g., Törngren & Montgomery, 2004), professionals were worse than both non-professionals and chance in predicting returns. Secondly, both non-professionals and professionals were equally accurate and better than chance at predicting risk at a period of 3 months. There was no correlation between professionals' financial self-confidence and their ability to predict return and risk. Among non-professionals there was a negative correlation between financial self-confidence and forecasting accuracy for both predictions of return and risk.

## Conclusions

We draw the conclusion that investors are inclined to be positively influenced by their financial experience and expertise in their risk preferences and risk attitude. However, there seems to be no gain in having financial experience and expertise to predict return and risk on the stock market. The implications of these results are that professional investors should downplay beneficiaries' expectations of their ability to perform better than the market and control financial risks.

