

FINANCIAL LITERACY AND ITS IMPACT ON INVESTMENT DECISIONS IN NIGERIA: A THEORETICAL PERSPECTIVE

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Abstract

Over the years financial literacy has gain prominence in the field of investment all over the world. This is attributed to its importance in investment decision making. This study sought to explore the theoretical perspective of financial literacy and its impact on investment decisions in Nigeria. Decision theory, prospect theory and theory of mental accounting were adopted for the study. These theories provided more insight on the impact of financial literacy on investment decisions. The study is of the view that financial literacy of individuals positively impacts on their investment decisions. Therefore, successful investment decisions depend on the level of financial literacy of investors.

Keywords: Financial Literacy, Investment Decisions, Decision theory, Prospect Theory and Theory of Mental Accounting

1. Introduction

The world economy has become more complex and thus, every individual needs to be active and smart in investment decisions in order to manage the rising cost of living. Many individuals are interested in one investment or the other, they view investments to be fascinating because they make decisions and later see the outcomes of the decisions they make (Awais, Laber, Rasheed & Khurshed, 2016). So virtually everybody partakes in one form of investment or the other, even those that do not partake in buying and selling of specific financial assets such as stock, they still undertake investments through participation in employee saving programme and pension plan or through purchase of life insurance or by some other kinds of investments such as real estate investments and through depositing of cash in fixed savings accounts of banks (Musundi, 2014). However, not all investments lead to profit, as investors will not always be right in their investment decisions (Natalie, 2010; Obamuyi, 2013).

Baker and Nofsinger, (2010) and Thilakam (2012) opine that investment today has become a dynamic field. A successful investment decision is highly dependent on the level of an individual's financial literacy. Financial literacy refers to the extent to which an individual possesses the understanding of key financial concepts, the confidence and ability to make appropriate short term and long term investment decisions, while considering the changing economic conditions (Nye, Pete & Cinnamon, 2013).

In Nigeria, financial literacy has over the years gained attention from a wide range of stakeholders which include government agencies, banking institutions, grass-roots consumer and community interest groups among other institutions. Interested groups, including policy makers, are concerned about the lack of adequate knowledge of financial concepts by citizens as they do not possess the tools that are needed to make sound investment decisions which will enhance their economic well being. The Federal Government of Nigeria through the National University Commission (NUC) has mandated all Universities to make entrepreneurship a compulsory course (unit) for students irrespective of their fields of study be it medicine or engineering. This is aimed at providing students with basic financial concepts which will enhance their level of financial literacy (National University Commission, 2014).

2. Literature Review

The study by Müller and Weber (2010) indicate that financial literacy positively influences investments decisions in low-cost funds. The study further indicate that even the most sophisticated investors go for actively managed funds rather than the less expensive ETFs (exchange traded funds) or index fund alternatives.

Mahmood (2011) carried out a study in Pakistan to assess the influence of various demographic and socioeconomic factors that influence the investment decisions of investors. The study indicated that risk perception plays a major role in the investment decision process and also, the changes in government policies impacts greatly on the risk perception of an investor. Awais *et al.*, (2016) conducted a study on financial literacy and investment decisions in Pakistan. The study concluded that financial literacy positively affects investment decisions. Concerning the developing countries, the findings of the study by Klapper and Panos (2011) indicated that higher financial literacy is positively impacts on retirement planning and private pension

funds investments. Similarly, Musundi (2014) provided evidence of a significant positive impact of financial literacy on investment decisions in the real estate sector of Kenya.

3. Theoretical Framework

Decision Theory, Prospect Theory and Theory of Mental Accounting are adopted to provide more insight on financial literacy and its impact on investment decisions.

3.1 Decision Theory

Decision theory was propounded by Warner (1968). The theory is about people's perceptions and actions. Decision theory comprises of two versions with are prescriptive and descriptive versions. The prescriptive version asserts that an individual should choose the action that maximizes expected utility. The description version asserts that an individual does choose the course of action that maximizes expected utility. In these cases a decision support system can be very valuable in order to minimize the risk of potential losses due to wrong investment decisions (Kamau, 2011; Kariuki, 2013; Musundi, 2014).

Investment decision making process is a vital process which is dependent on various factors which may vary from one person to another due to the unique nature of humans (Musundi, 2014). People behave differently when making decisions. Some make decisions based on judgment while others may consider other factors such as free riding (cases where someone else made such decisions and succeeded) to make investment decisions. When making investment decisions, investors are inevitably faced with highly complex factors which include risks, choice overload and ambiguity. These are challenges faced by investors and financial professionals (analysts).

3.2 Prospect Theory

Prospect theory also referred to as the loss aversion theory was propounded by Kahneman and Tversky (1979). This theory contradicts expected utility theory upon which Standard finance is based. Prospect theory lays emphasizes on the different behaviors of investors when they are faced with prospective gains and losses. Investors exhibit different behaviors, they are much more disturbed about prospective losses than they are happy about potential gains. An investor considers the impact of a loss or possibility of a loss to be higher than that of a gain, though negative and positive impacts respectively (Jordan & Miller, 2008; Baker & Nofsinger, 2010).

Prospect theory is relevant to this study as it explains how investors respond in different ways to identical situations, depending on whether they are presented in terms of gains or in terms of losses. Investors are willing to take up more risks to avoid a potential loss than they are to make a gain. The theory is of the view that investors have the tendencies to be risk-averse when it comes to gains but risk-seeking when it comes to losses. When investors are faced with an option of a sure gain and an option of a gamble which could increase or decrease the sure gain, investors are more likely to take the sure gain. However, when faced with an option of a sure loss and that of a gamble that could increase or decrease the sure loss, investors are likely to opt for the gamble (Musundi, 2014).

3.3 Theory of Mental Accounting

Theory of Mental Accounting was propounded by Thaler (1985). The theory postulates that an individual holds an asset with some kind of framing in his mind. Framing here refers to the way an individual subjectively views a transaction in their mind. This determines the satisfaction that he expects. Investors maintain a separate mental account for each asset and unknowingly, they have some kind of personal relationship with each asset (Jordan & Miller, 2008). This subsequently results in the difficulty to sell such assets especially when the offer is lower than the amount which they paid to get such assets (Shefrin & Statman, 1985; Van Rooij, Lusardi, & Alessie, 2011; Musundi, 2014).

Theory of Mental Accounting is relevant to this study as it explains how investors see the closing of a mental account at a loss as a source of regret while closing at a gain as a source of pride. Regret is stronger than pride; therefore investors always strive to make gains at all times (Van Rooij *et al.*, 2011). They do this by selling an asset only when the selling price will surpass the purchasing price that is the price which they bought it, otherwise they will prefer to hold back their assets. However, regrets may still exist within them if after selling an asset and the price goes higher. They then feel they should have held on to their asset a little longer as they have sold it too quickly.

4. Conceptual Framework

The conceptual framework of the study highlights the relationship between financial literacy and investment decisions that is, the independent and dependent variables respectively.

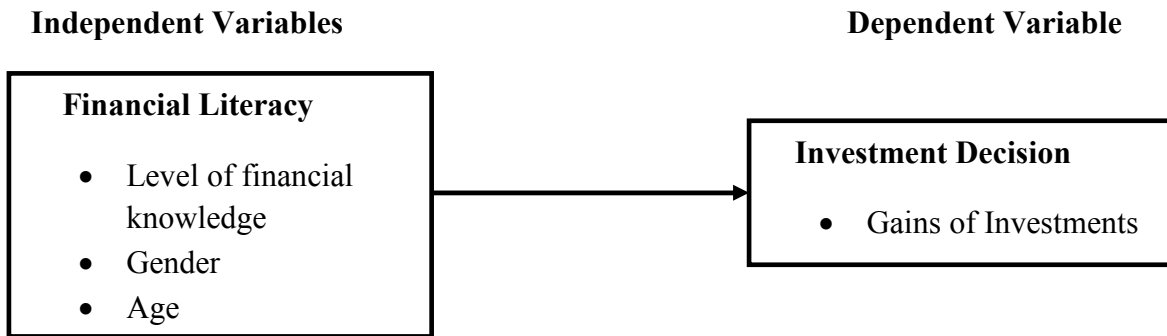


Figure 1: Conceptual Model

Source: Researcher, 2017

4.1 Discussions

The level of financial knowledge of an individual influences the investment decisions such an individual will make. The higher the financial knowledge level of an individual, the better his investment decision. Similarly, investment decisions can be affected by the gender of the investor. The age of an individual also affects his decision making when it comes to investments, older people may think more of retirements than younger people, thus they may be more active in investments such as pension schemes and other retirement schemes.

Mahmood (2011) opined that possession of financial literacy skills enables investors to make informed investment decisions concerning their money and it minimizes the chances of investors being misled on financial matters. In addition, Musundi (2014) opine that financial literacy influences investment decision making because individuals with low literacy often rely on others as their main source of financial advice, such individuals may make decisions based on the outcome of previous investments made by others (free rider problem). As such they are not likely to make sound investment decisions.

5. Conclusion

This study was aimed at assessing financial literacy and its impact on investment decisions in Nigeria. Financial literacy is the ability to have an understanding about financial instruments and terms. Various studies such as Rehman, Faridi and Bashir (2010); Wahid, Salahuddin and Noman (2008); Klapper and Panos (2011); Musundi (2014) and Awais *et al.*, (2016) reveal that in order to make effective investment decisions, an investor needs to make the right choice among various alternatives at the right time.

Financial literacy is an applicable instrument for predicting the investment behavior of individuals. It is due to the low level of financial literacy and the lack of awareness of its importance in the country that a number of citizens are in rural areas who are lacking basic education facilities and other basic needs. The study recommends that individuals and organizations should invest in building financial literacy as higher financial literacy is positively related to successful investment decisions. Similarly, early-life financial education is a strong predictor of late-life financial knowledge. Therefore, government should encourage early childhood education among its citizens as education is a great source of financial literacy.

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