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Impact of Financial Literacy on Investment Decisions Making: The Mediating Effect of Risk Tolerance

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Abstract:

This study examines how financial literacy affects investment decision-making, emphasizing how risk tolerance functions as a mediating factor among those who work in Gwadar, Pakistan's private sector. Using a cross-sectional survey approach, data were gathered from respondents aged 24 to 44, with a minimum educational background of the 12th standard. The analysis shows that risk tolerance is a mediator in the association between financial literacy and investment decisions, which is strongly influenced by financial literacy. However, little evidence supports the idea that risk tolerance directly influences investment choices. The results emphasize how critical financial literacy is in enabling people to make well-informed investing decisions while considering their risk level tolerance. This study adds to our knowledge of how people behave financially in developing economies and offers insights that financial educators and policymakers may use to improve financial literacy initiatives.

Keywords: Financial Literacy, Investment, Decision Making, Risk Tolerance, Gwadar

Introduction

The world's financial systems are becoming more erudite and intricate in today's fast-paced environment (Ibrahim et al., 2014). Everyone needs to be knowledgeable about finances in order to avoid financial issues. People usually choose between conflicting interests and give up one for the other (Irshad et al., 2023). In order to handle the complicated phenomena of modern financial markets, financial institutions are introducing new and inventive products, and more consumers need to become literate (He et al., 2024).

Four classifications exist for financial literacy: understanding financial principles, proficiency in handling personal funds, aptitude for making sound financial judgments, and assurance about future financial planning (Ahmad et al., 2022). The capacity to comprehend how money functions in our daily lives and how individuals manage, invest, and lend it to one another is known as financial literacy. The results of the link between investing decisions and financial literacy are not always constant (Tuffour et al., 2022). Making investment decisions is crucial and depends on several variables that fluctuate from person to person (Cheng et al., 2023). People tend to act differently when making decisions of any kind in life. When investors thoroughly understand all the complicating factors and the variables that guide them in making the best choice possible to prevent or minimize future losses, the decision-making process becomes easier (Ahmad et al., 2021).

When making investment decisions, investors must weigh various criteria, including market circumstances, risk tolerance, rate of return, and more. Making investment decisions is a crucial process for investors, and it depends on various elements (HASTINGS & MITCHELL, 2020). These factors change for each investor and are used in different ways. Some investors use them to form judgments, and they consider the majority of the criteria in order to act on an appropriate decision (Khan et al., 2022). When investors can recognize all of the unclear outcomes and use those outcomes as guidance to make the proper option and prevent potential losses in the future, the process of making decisions becomes easier (Xiao et al., 2024). Investments are medium- or long-term resource allocations to recover investment expenses and realize a high profit. However, the outcome is uncertain because the financial and economic environments influence investments (Dong et al., 2023).

Suppose risk managers and regulators do not know how users of financial reports evaluate risk. In that case, they cannot tell if risk-related data performs as predicted or surprisingly (Jain et al., 2023). For this reason, those in charge of monitoring and regulating use the results of financial risk assessments to help them make better decisions. Argues that from a financial planning perspective, a person's tolerance for financial risk is crucial in selecting an investment that will be psychologically satisfying for them (Khan et al. et al., 2022).

Problem Statement:

The factors impacting investment decision-making are one's financial knowledge and how to avoid the effects of risk. Some factors are financial knowledge, risk tolerance, income, and financial well-being that can affect the investing process.

Purposes:

- To evaluate how financial knowledge affects the way people choose to invest.
- To evaluate how financial literacy affects the way risk tolerance is mediated.

Question:

- Does financial literacy impact investment decision-making?
- Does Risk Tolerance affect investment decision-making?
- Does the Risk Tolerance affect the financial literacy?

Literature Review:

Financial Literacy:

Literacy of financial education may likewise be defined as the aptitude of persons to make financial choices by maintaining their immediate and long-term goals (Putri et al., 2021). The fundamental information required for survival in contemporary society is financial literacy, which entails comprehending the intricate concepts of investing, saving, and spending (Fong et al., 2021). Meanwhile, according to However, financial literacy is defined as understanding financial tools, such as saving, insurance, investments, and other financial instruments. Someone must be well-literate before making any investment decision since financial literacy is essential (Raut, 2020). Financially literate people can handle their money successfully and efficiently. The intricate concepts of investing, saving, and spending must be understood to possess this foundational knowledge (Ahmad & Shah, 2022).

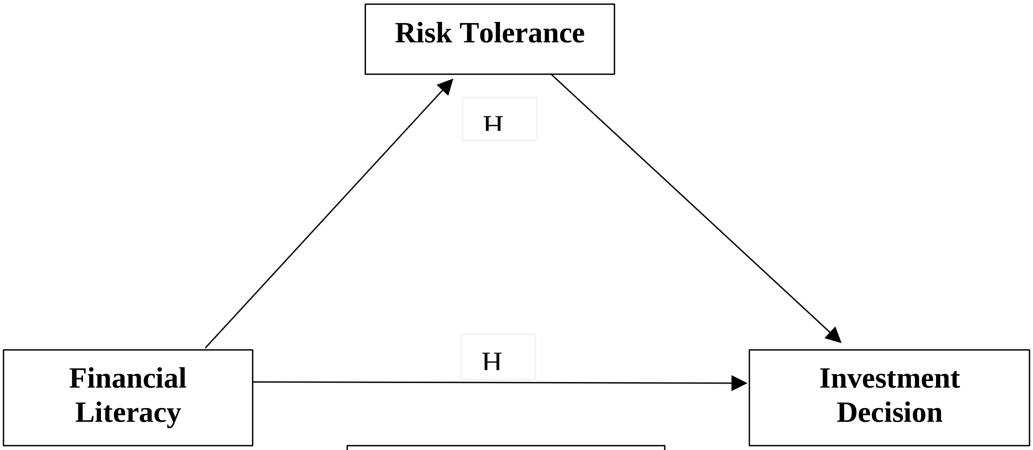
Investment Decision:

If there is any doubt in the investment, knowledge of finances can assist in making it safer. This indicates that financial literacy is critical in markets with great uncertainty and can save a significant amount of investment (Liu et al., 2022). The degree to which decisions can maximize wealth is one of these two factors that affect a person's choice of investments; the other is the psychological element of the investor in the decision-making process. Investing selections can be made when someone saves a portion of their cash to purchase more significant substances down the road (Luo et al., 2024).

Risk Tolerance:

This definition defines financial risk. Tolerance is a psychological component of making decisions in the face of financial uncertainty, which is how an individual assesses the likelihood of specific outcomes (Adil et al., 2022). Lender uncertainty, currency risk, and risk of inflation are three categories into which various investment risks can be divided. Numerous lone investors might be overpowered by this information's greater significance and ambiguous structure (Peng et al., 2023).

The study aims to determine how financial literacy affects investing decision-making, including risk tolerance. Risk tolerance can have both beneficial and harmful effects. This study can focus on factors influencing an individual's investing decision-making criteria. In this study, the dependent variable is investment decisions, the independent variable is financial literacy, and the mediating variable is risk tolerance (Ahmad et al., 2023).



Conceptual Framework

Hypothesis:

H1: Financial literacy has a significant impact on investment decisions.

H2: Risk tolerance mediates the effect of financial literacy on investment decisions.

Methodology:

This study adopts a causal associatory method to inspect the connection between investment decision-making and financial literacy among individuals working in the private sector in Gwadar, Pakistan. Employing a cross-sectional study design, data were collected through a survey method utilizing questionnaires administered via Google Forms. The research population consisted of individuals born between 1980 and 2000, aged 24 to 44 years, and currently employed in the private sector with a minimum educational qualification of 12th standard. The sample size ranged from 20 to 200 respondents selected from this population. Statistical tools will be utilized to evaluate and process the data together. This research provides insights into how financial literacy influences investment decision-making within the specified demographic and geographic context.

Results and Discussions:

Profile of the respondents' demographics:

Table 1 provides the demographic profile of the respondents, totaling 26 individuals. The first section indicates the gender distribution, with 23 males and three females. The second section details the age groups, with 24 respondents aged 20 to 30, 2 aged 31 to 40, and none between 41 to 50. The final section outlines the educational qualifications, with eight respondents undergraduates, 11 graduates, and seven postgraduates.

Table 1 of Respondent’s Demography:

Gender	Frequency	Percentage
Male	23	88.5%
Female	3	11.5%
Total	26	100%

Age Group	Frequency	Percentage
20 to 30 Years	24	92.3%
31 to 40 Years	2	7.7%

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Total	26	100%
Education Qualification	**Frequency**	**Percentage**
Under-graduate	8	30.8%
Graduate	11	42.3%
Post Graduate	7	26.9%
Total	26	

Reliability and Convergent Validity:

Table 2 presents the questionnaire's results regarding reliability and validity. There are two main types of reliability: construct reliability and item reliability. Outer loading values determine item reliability, while composite reliability determines construct reliability. A cutoff value of 0.7 or higher is typically used for both measurements, although 0.6 is deemed acceptable in some instances. Table 2 indicates that all elements within each construct and the constructs overall surpass the cutoff point, demonstrating the validity of the data for further analysis. Convergent validity is assessed using the Average Variance Extracted (AVE), ideally at least 0.5. Table 2 confirms the convergent validity of all constructs, as their AVE values exceed 0.5.

Table 2 Reliability and Convergent validity

Constructs	Items	Loading	CA	CR	AVE
Financial Literacy	FL2	0.532	0.552	0.702	0.466
	FL3	0.710			
	FL4	0.601			
	FL5	0.845			
Investment Decision	ID1	0.765	0.794	0.800	0.558
	ID2	0.689			
	ID3	0.863			
	ID4	0.825			
	ID5	0.765			
Risk Tolerance	RT2	0.902	0.676	0.976	0.636
	RT3	0.972			

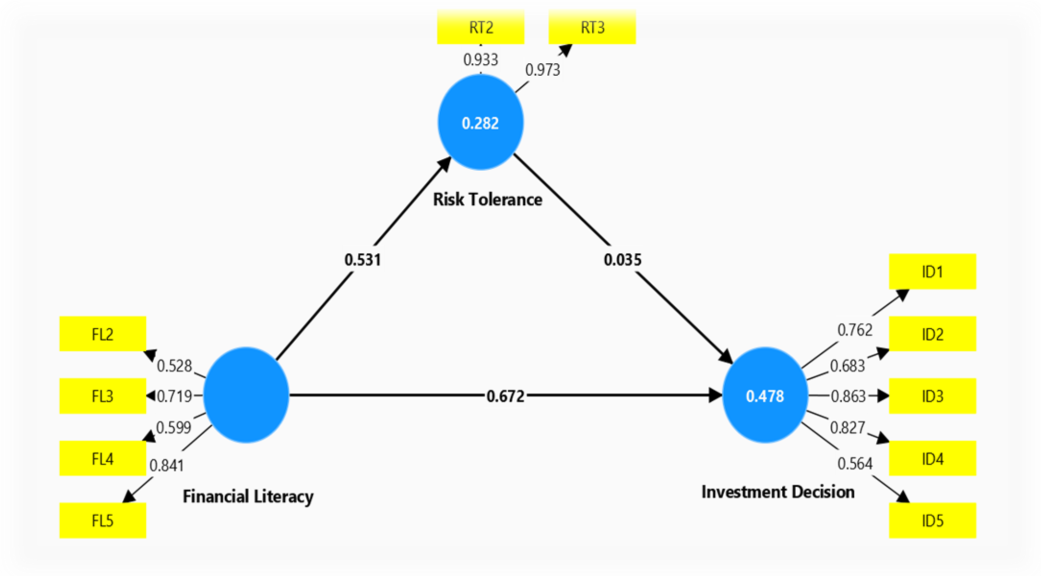
Discriminant Validity:

Three key measures are employed to assess the discriminant validity of a construct in a structural equation model: cross-loading values, HTMT values, and the Fornell Larcker criterion. Many researchers advocate for variance-based SEM with HTMT as a more dependable metric. The HTMT values for each research construct are presented in Table 3. A cutoff value of 0.85 or lower is typically used for HTMT. The table demonstrates that all HTMT values fall below the cutoff points, confirming the discriminant validity of the construct.

Table 3 of HTMT Ratios

	Financial Literacy	**Investment Decision**
Investment Decision	0.786	
Risk Tolerance	0.503	0.449

Structural Framework:



Tests of Hypothesis and Regression Analysis:

This study aims to investigate two hypotheses, as presented in Table 4 of the regression analysis and hypothesis testing. The metrics used for hypothesis testing are the p and t values. A cutoff of 0.05 or lower is typically used for the p statistic, while a cutoff of 1.96 or higher is used for the t statistic. The results of this study support all hypotheses, as indicated in Table 4, where all t and p values exceed the threshold values. Additionally, the beta coefficient of each relationship indicates the strength of that particular relationship.

Table 5 of Hypothesis Testing and Regression Analysis:

Hypothesis	β	T	P	Results
Financial Literacy -> Investment Decision	0.672	2.23	0.026	Supported
Risk Tolerance -> Investment Decision	0.035	0.125	0.901	Not Supported

R Square

The coefficient of determination, found in Table 6 under R square, signifies the extent to which the independent variables in the model contribute to the variation observed in the dependent variable.

Table 6 of R-square

	R-Square	**R-Square Adjusted**
Investment Decision	0.478	0.432
Risk Tolerance	0.282	0.252

Conclusion

The study concludes that financial literacy significantly shapes investment decisions among individuals within the private sector of Gwadar, Pakistan. Understanding financial concepts and tools directly impacts the quality of investment choices, highlighting the need for enhanced financial education. While risk tolerance mediates between financial literacy and investment decisions, it does not independently influence investment outcomes. These findings emphasize the necessity for comprehensive financial literacy programs that boost financial knowledge and address risk perception and tolerance. By promoting financial literacy, individuals can better navigate financial markets and make decisions aligned with their long-term financial objectives. This research offers valuable insights for crafting targeted strategies to enhance financial decision-making processes and advocates for ongoing financial education efforts.

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