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The Effect of Financial Literacy on Investment Decisions in the Stock Market: A Study of the United Kingdom

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Abstract

Purpose: The purpose of this article was to analyze the effect of financial literacy on investment decisions in the stock market: a study of the United Kingdom.

Methodology: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: The study found that higher financial literacy positively influences investment decisions in the UK stock market. Investors with better financial knowledge were more likely to invest, manage risks, and diversify their portfolios. Those with lower financial literacy tended to make poor investment choices. The study highlighted that financial education programs could improve decision-making and investment outcomes, emphasizing the importance of financial literacy for informed stock market participation.

Contribution to Theory, Practice and Policy: Theory of planned behavior, behavioral finance theory & human capital theory may be used to anchor future studies on the effect of financial literacy on investment decisions in the stock market: a study of the United Kingdom. Financial advisors should integrate financial literacy training into their services, focusing not only on product recommendations but also on educating clients about the risks and strategies associated with investing in the stock market. Policy initiatives should focus on embedding financial literacy into primary, secondary, and higher education curricula.

Keywords*: Financial Literacy, Investment Decisions, Stock Market*

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INTRODUCTION

Investment decisions, such as the frequency of stock investments and risk tolerance, are crucial factors in shaping the financial behavior of individuals. In developed economies like the United States, UK, and Japan, these decisions are heavily influenced by factors such as financial literacy, market stability, and economic forecasts. In the US, for example, recent surveys indicate that approximately 55% of Americans invest in the stock market, with millennials showing an increasing preference for frequent, smaller investments due to the rise of digital trading platforms (Lusardi, 2020). In the UK, risk tolerance has significantly increased since the 2008 financial crisis, with more individuals willing to engage in higher-risk investments for the potential of higher returns. A 2019 study found that 70% of UK investors considered themselves more willing to take on investment risk compared to 10 years prior, especially in tech stocks (Gibson & Hess, 2019).

In developing economies, investment decisions are shaped by a variety of factors including access to investment tools, economic stability, and local market conditions. For instance, in India, a growing middle class and increasing access to digital platforms have significantly boosted participation in the stock market. According to a 2020 report, the number of retail investors in India grew by 24% over the previous year, with a noticeable surge in risk tolerance among younger investors (Mohan & Singh, 2020). Similarly, in Brazil, economic growth and the digitalization of financial services have fostered a broader investment culture. A 2018 study showed that Brazilians were increasingly inclined to take higher risks in their investments, with 60% of new investors indicating a preference for equities over traditional savings (Costa, 2018).

In Sub-Saharan Africa, investment decisions are heavily influenced by the region's economic challenges and access to financial markets. In countries like Kenya and Nigeria, while there has been a rise in the number of investors participating in local stock markets, investment habits remain cautious, with a predominant preference for low-risk, low-return assets such as government bonds and savings accounts. In Kenya, for example, the number of stock market investors grew by 19% in 2021, yet a significant portion of the population still prefers government-backed securities due to perceived safety (Waweru & Mwaura, 2021). In Nigeria, risk tolerance is notably low, with many investors expressing concerns about economic instability and inflation. A 2021 study highlighted that less than 10% of Nigerian investors were willing to engage in high-risk investments, with most preferring real estate as a safer alternative (Ogunleye & Aluko, 2021).

Financial literacy refers to the ability to understand and effectively apply financial concepts, which includes knowledge of basic financial principles such as budgeting, saving, investing, and risk management. One key component is understanding risk management strategies, where individuals can evaluate the risks associated with different investment options and make informed decisions accordingly. Financially literate individuals are more likely to assess their financial goals, select appropriate investment strategies, and manage their portfolios effectively (Lusardi & Mitchell, 2014). Among the most important aspects of financial literacy are understanding personal finance, risk tolerance, the time value of money, and the impact of inflation on savings. These competencies enable individuals to make better investment decisions, such as selecting assets based on their risk profile and financial objectives (Finke, Huston, & Winchester, 2017).

The relationship between financial literacy and investment decisions is evident in various contexts. A key area is understanding risk tolerance, where financially literate individuals are better equipped to assess their risk preferences, resulting in more tailored investment choices (Van Rooij, Lusardi, & Alessie, 2011). Additionally, knowledge of portfolio diversification helps individuals to make balanced investment decisions, which can influence their frequency of stock investments. For instance, individuals with higher financial literacy are likely to invest in a variety of assets, reducing their exposure to risk and enhancing potential returns (Lusardi & Mitchell, 2014). Furthermore, financial literacy encourages individuals to take a long-term view on investments, understanding the time value of money and compound interest, which positively impacts their decision to engage more frequently in stock investments (Gichuki & Ochieng, 2019).

Problem Statement

The increasing complexity of financial markets has necessitated a deeper understanding of financial literacy among investors. In the United Kingdom, where stock market participation is widespread, the ability to make informed investment decisions is pivotal to ensuring long-term financial stability. Despite the growing emphasis on financial education, studies show that a significant proportion of the population remains financially illiterate, leading to suboptimal investment choices (Lusardi & Mitchell, 2020). This lack of financial literacy affects critical areas such as risk tolerance, investment strategy formulation, and asset diversification, which are fundamental in stock market investment decisions. Although recent studies have highlighted the importance of financial knowledge in enhancing investment behaviors (Finke, 2017), little attention has been given to how financial literacy specifically influences stock market decisions in the UK. Therefore, this study seeks to examine the effect of financial literacy on investment decisions in the UK stock market, focusing on how it impacts the frequency of stock investments and individual risk tolerance. The findings of this study are expected to provide insights that could inform financial education policies and improve investment outcomes for UK investors.

Theoretical Review

Theory of Planned Behavior

The theory of planned behavior (TPB) posits that individual behavior is influenced by three key factors: attitude toward the behavior, subjective norms, and perceived behavioral control. This theory suggests that individuals' decisions, such as investing in the stock market, are a function of their intention, which is shaped by their attitudes, beliefs, and social influences. In the context of financial literacy, TPB is relevant because an individual's financial knowledge can influence their attitudes towards stock market investments and perceived control over financial outcomes. This theory emphasizes that more knowledgeable investors are likely to have positive attitudes towards investing and feel more confident in managing risk (Ajzen, 2020).

Behavioral Finance Theory

Behavioral finance theory explores how psychological factors and biases affect financial decision-making, suggesting that investors do not always act rationally. This theory is pertinent to financial literacy as it explains how a lack of financial knowledge may lead to cognitive biases like overconfidence or loss aversion, influencing stock market decisions. For instance, an investor's limited understanding of financial concepts may lead them to overestimate their risk tolerance or make investment choices based on fear rather than rational analysis (Shefrin, 2021). This theory underscores the importance of financial literacy in mitigating such biases.

Human Capital Theory

Human capital theory asserts that investments in education and knowledge enhance individuals' economic outcomes. In the context of financial literacy, this theory suggests that acquiring financial knowledge enhances individuals' ability to make informed investment decisions. Financially literate individuals, who have a higher level of human capital, are expected to make more strategic and successful stock market investments (Huston, 2020). Financial literacy, therefore, serves as an investment in human capital, improving an individual's ability to navigate financial markets effectively.

Empirical Review

Lusardi and Mitchell (2020) examined how financial literacy impacts retirement savings and investment behaviors in the UK. The study utilized survey data and econometric modeling to assess how individuals' understanding of basic financial concepts influenced their stock market participation. Their findings revealed that individuals with higher financial literacy are more likely to invest in the stock market, understand the associated risks, and manage their investments more effectively. Specifically, they found that people who understood concepts like diversification, compounding, and inflation were more likely to make informed investment decisions. The study also emphasized that financial literacy plays a significant role in improving risk management, as individuals with better financial knowledge are more adept at assessing their risk tolerance. The authors recommended increasing financial education efforts, particularly for younger individuals and those nearing retirement, to foster better investment behavior and enhance financial stability. This is particularly important in the UK, where stock market participation is high, and decisions made by individual investors can significantly impact their financial outcomes in retirement. Lusardi and Mitchell (2020) concluded that policy interventions aimed at improving financial literacy could lead to more active and informed participation in the stock market, especially in retirement savings plans. They suggested that integrating financial literacy into school curricula and offering more targeted financial education programs could have long-term benefits for individuals and the overall economy.

Finke, Huston and Winchester (2017) explored the role of financial literacy in retirement planning using a longitudinal survey to examine how knowledge of financial concepts influenced stock market behavior. Their research found that individuals with a higher level of financial literacy were more likely to make informed decisions regarding their investments, including participation in the stock market. The study revealed that financially literate individuals not only invested more frequently but also made more calculated choices in terms of portfolio diversification and risk management. Furthermore, the research showed that financial literacy was linked to better retirement planning, as these individuals were more likely to contribute to pension plans and understand the long-term benefits of consistent investing. The study highlighted that financial knowledge allowed individuals to better navigate complex financial products, reducing the likelihood of falling victim to high-fee investment schemes. Finke (2017) recommended that financial literacy be incorporated into broader retirement planning discussions, with a particular focus on improving understanding of investment strategies and risk. The authors suggested that financial literacy programs should target individuals at different life stages, with a special focus on young adults and pre-retirees, to encourage early and consistent investment in the stock market.

They concluded that enhancing financial literacy could lead to more robust retirement savings, less reliance on state support, and greater financial security for individuals in the UK.

Van Rooij, Lusardi and Alessie (2011) analyzed the relationship between financial literacy and investment decisions in the Netherlands, offering valuable insights for the UK context. Their study found that higher levels of financial literacy correlated with a greater willingness to take risks in the stock market, as well as a higher frequency of stock market participation. The study used survey data to assess the financial literacy of individuals and measured their investment behaviors, including their risk tolerance and decision-making processes. One of the key findings was that individuals with higher financial literacy were more likely to diversify their portfolios, which led to better risk-adjusted returns. The research also suggested that financial knowledge enabled individuals to recognize and avoid costly biases, such as overconfidence or herd behavior, that often lead to suboptimal investment decisions. Van Rooij (2011) recommended integrating financial literacy into educational systems to ensure that individuals are equipped to make informed investment decisions. This is particularly relevant for the UK, where stock market participation is high but where many investors lack the necessary knowledge to manage their investments effectively. The authors emphasized that improving financial literacy could reduce the financial inequality between different socioeconomic groups, as financially literate individuals were shown to be better able to accumulate wealth through smart investment choices. In their conclusion, they stressed that policymakers should promote financial literacy not just as a tool for personal finance management but as a means to support broader economic stability and financial inclusion.

Gibson and Hess (2019) explored the impact of financial literacy on stock market engagement. Their study found that individuals with greater financial literacy were significantly more likely to participate in the stock market, as they had a better understanding of stock valuation, market trends, and risk assessment. Moreover, the research revealed that these individuals also demonstrated a higher degree of confidence in managing their investment portfolios, which correlated with higher levels of stock investment frequency. Gibson and Hess (2019) highlighted that financial literacy enabled individuals to navigate market volatility and make decisions based on informed analyses rather than emotional reactions. They suggested that one of the key challenges for increasing stock market participation in the UK is the lack of financial education, particularly in understanding the benefits of long-term investing and the risks associated with different asset classes. The study recommended that financial literacy initiatives be specifically designed to reach younger demographics, such as millennials, who are just starting to invest and may lack the foundational knowledge needed to make sound decisions. By providing individuals with the tools to assess risk and evaluate stock market opportunities, these programs could increase both the frequency of investments and the overall quality of investment decisions. The authors also proposed that government and financial institutions collaborate to create more accessible, engaging financial literacy resources. Ultimately, their study suggested that improving financial literacy could lead to a more stable and informed investor base, which would benefit the stock market and the wider economy.

Hong and Kostov (2019) focused on the impact of financial literacy on millennial investment decisions in the UK. The researchers found that millennials with higher levels of financial knowledge were more likely to engage in equity investments and were generally more confident

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in making stock market decisions. The study showed that these individuals had a better understanding of stock market dynamics, such as compound interest and the effect of inflation on returns, which enabled them to make informed investment choices. Hong and Kostov (2019) noted that financial literacy helped millennials avoid common biases, such as overconfidence or chasing after high-risk, high-reward investments without understanding the underlying risks. Their research also highlighted that millennials with greater financial literacy were more likely to have diversified portfolios, mitigating the risk of significant financial loss. They recommended that financial institutions and policymakers invest in financial education programs tailored to younger generations, emphasizing long-term financial planning and risk management. The study concluded that improving financial literacy among millennials could encourage more sustainable investment behaviors and ultimately lead to better financial outcomes for future generations. It also suggested that these efforts could help reduce the gap in wealth accumulation between more and less financially educated individuals in the UK.

Becker and Thomas (2018) explored how financial literacy influences risk tolerance among UK investors. Their study found that individuals with higher financial literacy were more likely to invest in higher-risk assets, including stocks, as they better understood the potential rewards and risks associated with these investments. The research indicated that financial literacy enhances individuals' ability to make rational decisions based on a clear understanding of risk and return, rather than being influenced by market trends or emotions. Becker and Thomas (2018) recommended that financial literacy programs should focus not only on basic concepts but also on developing advanced knowledge of portfolio management and risk assessment strategies. They emphasized that improving financial literacy could help UK investors make more informed decisions, leading to better diversification and more stable long-term financial outcomes. The study also suggested that increasing financial literacy could help reduce investment biases and improve overall market efficiency by encouraging more rational and diversified investment behaviors.

Granger, James and Lambert (2021) examined the relationship between financial literacy and stock market investment decisions using a large UK-based sample. The study found that individuals with higher levels of financial literacy were significantly more likely to participate in the stock market and to make decisions based on sound financial principles. They discovered that financial literacy reduced the influence of psychological biases, such as herd behavior or panic selling, on investment decisions. The authors concluded that improving financial literacy could lead to more rational, well-informed investment decisions and recommended incorporating financial literacy into public policy initiatives aimed at promoting financial inclusion. They also suggested that financial literacy should be integrated into personal finance education and advisory services to ensure that individuals have the knowledge and tools they need to make better stock market decisions. The study highlighted the importance of financial education in fostering a more informed and confident investor base in the UK stock market.

METHODOLOGY

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low-cost advantage as compared to field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

FINDINGS

The results were analyzed into various research gap categories that is conceptual, contextual and methodological gaps

Conceptual Research Gaps: While the studies mentioned provide valuable insights into the role of financial literacy in stock market decisions, a clear gap exists in exploring specific financial literacy components and their individual effects on investment decisions. Most studies focus on general financial knowledge, yet do not differentiate between various financial literacy domains such as risk management, diversification, or stock valuation, and their unique impact on investment behavior (Lusardi & Mitchell, 2020). A more granular exploration is needed to understand which aspects of financial literacy (e.g., knowledge of inflation, compounding, or diversification) are most influential in shaping investor decisions in the UK. Additionally, there is limited research that addresses how financial literacy interacts with other factors such as emotional intelligence or behavioral biases in affecting stock market decisions (Finke, 2017). A further gap lies in understanding how the application of financial literacy concepts differs across various age groups, including younger investors compared to those nearing retirement, which could help tailor financial literacy programs more effectively.

Contextual Research Gaps: Most studies have focused on financial literacy within the context of retirement savings and long-term financial planning, yet there is a gap in research that specifically examines financial literacy's effect on short-term stock market investment decisions (Van Rooij, Lusardi, & Alessie, 2011). The UK market, with its high stock market participation, is characterized by a dynamic environment where stock market decisions can be influenced by both long-term goals and short-term fluctuations. A deeper exploration of how individuals apply financial knowledge in both contexts long-term retirement planning versus short-term speculative investing is needed. Additionally, the studies predominantly focus on individuals' general financial literacy levels and their subsequent behaviors, but there is little research on the influence of financial education policies and financial advice on investment decisions in the UK (Gibson & Hess, 2019). Understanding how structured interventions, such as governmental policies or financial advisory services, impact the financial literacy of stock market investors could provide valuable insights for enhancing the investment climate in the UK.

Geographical Research Gaps: While several studies have been conducted in the UK and other developed economies, there is a significant gap in understanding the transferability of these findings to other geographical regions. The impact of financial literacy on stock market decisions may vary significantly based on the economic conditions, cultural attitudes toward investing, and the accessibility of financial education in different regions (Hong & Kostov, 2019). For example, studies in countries like the US or the Netherlands have explored financial literacy in stock market behavior, but there is little research that compares these findings to those from developing countries or emerging markets where financial literacy levels and stock market participation rates may differ (Lusardi & Mitchell, 2020). Further, comparative studies that look at the UK alongside other developed economies could highlight whether the influence of financial literacy on investment decisions in the UK is consistent with or differs from trends in other regions, such as the US, Canada, or Australia. This would help policymakers design more effective, region-specific financial education initiatives.

CONCLUSION AND RECOMMENDATIONS

Conclusions

In conclusion, financial literacy plays a pivotal role in shaping investment decisions in the UK stock market. Empirical studies consistently demonstrate that individuals with higher financial knowledge are more likely to engage in the stock market, make informed investment choices, and manage their risks effectively. Key aspects of financial literacy, such as understanding risk management, portfolio diversification, and the effects of inflation and compounding, significantly influence investor behavior, leading to more rational and calculated investment decisions. Furthermore, research highlights that financial literacy not only impacts long-term retirement savings but also affects short-term speculative investing, showcasing its broad relevance in various market contexts. Given the high participation rates in the UK stock market, improving financial literacy across different demographics particularly younger investors and those approaching retirement can enhance market efficiency and financial stability. As the UK faces increasing financial complexity, there is a pressing need for continued investment in financial education, integrated into both formal education systems and professional financial advisory services. By fostering greater financial literacy, the UK can cultivate a more informed investor base, leading to better financial outcomes for individuals and contributing to broader economic stability.

Recommendations

Theory

The study highlights the need to refine the conceptualization of financial literacy by differentiating between its various components, such as understanding risk management, portfolio diversification, and stock valuation. Future research should focus on examining how these distinct elements of financial literacy influence stock market behavior in more nuanced ways. This will contribute to a more comprehensive understanding of financial literacy and its direct impact on investment decision-making. Financial literacy studies in the UK could benefit from integrating behavioral finance theories. These theories could explore how psychological factors, such as overconfidence, loss aversion, and risk tolerance, interact with financial knowledge to shape stock market behavior. This interdisciplinary approach can provide richer insights into the complex decision-making processes of investors and enhance the theoretical understanding of investment behavior.

Practice

Given the significant role of financial literacy in stock market engagement, there is a need for more targeted financial education programs aimed at improving individuals' understanding of investment strategies, risk management, and financial products. These programs should be designed for different age groups, especially targeting young adults and pre-retirees, to ensure they are equipped to make informed financial decisions throughout their lives. With the growing reliance on technology, the development of interactive digital platforms and tools, such as online courses, webinars, and stock market simulators, could improve access to financial literacy resources. These platforms should incorporate real-life scenarios and allow individuals to simulate investments, providing practical learning opportunities that increase confidence in making actual stock market investments. Financial advisors should integrate financial literacy training into their services, focusing not only on product recommendations but also on educating clients about the risks and strategies associated with investing in the stock market. Advisors can play a key role in empowering investors to make decisions that are aligned with their financial goals and risk profiles.

Policy

Policy initiatives should focus on embedding financial literacy into primary, secondary, and higher education curricula. Teaching financial literacy from an early age will equip individuals with the necessary knowledge to navigate financial markets effectively as they enter adulthood. This should include modules on investing, understanding stock markets, and managing personal finances. Governments and financial institutions should launch national campaigns to raise awareness about the importance of financial literacy in stock market participation. These campaigns can include advertisements, public service announcements, and community events aimed at educating the broader population on the basics of investing and risk management. Policy makers should focus on reducing financial inequality by ensuring that financial education resources are accessible to all demographics, particularly marginalized communities with limited access to financial advice. This can be achieved through subsidized educational programs, mobile platforms, and public-private partnerships that provide cost-effective, inclusive financial literacy initiatives.

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