

How much risk can you handle? Making better investment decisions

August 22 2008

Many Americans make investment decisions with their retirement funds. But they don't always make informed judgments. A new study in the *Journal of Consumer Research* introduces a new tool that investors can use to choose investments based on their financial goals and risk attitudes.

Authors Daniel G. Goldstein (London Business School), Eric J. Johnson (Columbia University), and William F. Sharpe (Stanford University) developed a tool, which they call the Distribution Builder. With brief training, people can use the Distribution Builder to better understand their investment goals and trade-offs.

"We think that the Distribution Builder can function like a flight simulator, allowing investors to explore the outcomes of their decisions with only virtual outcomes," write the authors.

The Distribution Builder is an online tool that estimates the level of risk a user considers unacceptable in his or her investments by using a probability distribution. Since many employees make retirement investment decisions without understanding the complex picture of their own risk preferences, the Distribution Builder is a novel way for people to uncover their preexisting preferences. And, according to the researchers, it can also help people construct better preferences.

The researchers claim that by using the tool, investors can become more actively involved in the process of deciding where and how much to

invest. They also believe investment management companies could use the tool to better serve their investors.

The Distribution Builder may have applications that reach beyond retirement investments. "Beyond financial services, the basic DB framework could be used to study other consumer choices in which there is a risk-reward tradeoff, including waiting times at health clinics (or on customer support lines), delivery times of packages, and overage charges for mobile-phone plans," they conclude.

Source: University of Chicago Press Journals

Citation: How much risk can you handle? Making better investment decisions (2008, August 22) retrieved 6 May 2024 from <https://medicalxpress.com/news/2008-08-investment-decisions.html>

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