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The Role of Financial Literacy in Investment Decision-Making: A Review

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Abstract

In order to facilitate economic development, financial services are essential in that they offer individuals and enterprises access to capital, risk management, and financial products. Understanding the necessity and raising awareness of financial literacy is crucial for the expansion of the financial sector in this context. Understanding how financial literacy affects investing choices is the main focus of this essay. This study underscores the pivotal role of financial literacy in shaping investment decisions. Individuals with higher financial knowledge exhibit greater confidence in making informed investment choices, while those lacking such knowledge tend to avoid risks. Financial education is crucial for enhancing financial independence and fostering rational decision-making. The results demonstrate that better investing outcomes are achieved when financial knowledge and a modest degree of overconfidence are combined. Additionally, age and education significantly influence financial behavior. Promoting financial awareness and encouraging active participation in financial planning can improve economic well-being and enable individuals to navigate complex investment landscapes effectively.

Keywords; Financial service, Economic growth, Financial literacy, Investment decision, Financial awareness

INTRODUCTION

A key element of efficient financial management in today's globalised society, financial literacy has a big impact on people's financial choices, especially those pertaining to investments. People need to be able to comprehend and use financial data in order to make wise choices on borrowing, investing, and saving as the financial landscape becomes more complicated [1]. Therefore, economic stability and individual financial well-being are based on financial literacy. Financial literacy is essential for effective personal financial management, particularly at a time when people are increasingly accountable for their financial stability [2]. Due to a lack of knowledge of fundamental financial principles, many people made bad financial decisions during the 2008 global financial crisis, highlighting the negative effects of low financial literacy. Understanding financial goods, interest rates, inflation, and the time worth of money are just a few of the many concepts and abilities that make up financial literacy [3]. The capacity to use financial information and skills to manage financial resources is known as financial literacy. Making well-rounded judgements about borrowing, investing, saving, and budgeting requires not just understanding important financial ideas but also putting them into practice [4].

In the end, financial literacy promotes stability in finances and economic resilience by empowering individuals to make informed investment decisions consistent with their tolerance for risk. Since more financial literacy is often associated with the capacity to diversify portfolios and interact with financial markets with greater assurance, it is imperative that financial education programs be made available to all groups [5]. This need is especially noticeable in areas with poor financial literacy rates, as people may encounter obstacles in their quest for financial well-being and investment portfolio optimisation.

In order to guarantee fair access to financial knowledge and resources, it is imperative that future financial education programs address the particular difficulties encountered by under-represented groups, such as women and those from lower socioeconomic backgrounds [6]. Furthermore, digital platforms provide encouraging opportunities to improve financial literacy and make well-informed investment decisions as they become more and more used as instruments for financial education. A more focused approach to financial education may improve both individual financial health and overall economic stability by preparing people of all demographics to handle complicated financial environments [7].

A. Financial literacy

The ability to make informed judgements about money is a result of the possession of the skills, knowledge, and behaviours that are referred to as financial literacy. The terms financial literacy, financial education, and financial knowledge are frequently used interchangeably [8]. People who lack financial sophistication are unable to make financial plans due to their inadequate financial literacy. For instance, individuals who are financially sophisticated are adept at financial calculations, such as compound interest, which enables them to participate in low-credit borrowing. In the majority of cases, individuals who lack sophistication incur substantial expenses associated with their debt financing [9].

B. Investment decision

In order to achieve all of your financial goals, you must first evaluate and choose the finest possibilities for investing your money. This process is known as an investment decision. Many elements are considered in this process, including market circumstances, inflation and interest rates, objectives, investment horizon, risk tolerance, financial state, and the risks and rewards of various investment possibilities. The way you manage and distribute your money is determined by your investing choices [10].

C. Financial literacy and investment behaviour

A thorough understanding of a range of financial ideas, instruments, and systems is necessary for people to make wise and efficient choices about their financial resources. This is where financial literacy comes in. Involves the capacity to employ financial skills to effectively manage one's financial resources, such as budgeting, saving, investing, and comprehending financial hazards [11].

Financial literacy enables an individual to make informed financial decisions, plan for the future, and effectively navigate the intricacies of the financial sector. Investment behaviour, in contrast, pertains to the decisions and actions that individuals implement when investing their funds [12]. This comprises judgements regarding portfolio diversification, asset allocation, risk tolerance, and the selection of particular investment instruments, including equities, bonds, mutual funds, real estate, and more. Financial objectives, risk tolerance, market conditions, individual preferences, and time horizons are all factors that influence investment behaviour [13].

D. Benefits of financial literacy

By empowering people to make more informed financial choices, financial literacy generally has benefits.

Prevent devastating financial mistakes: Contributions to a conventional "individual retirement account (IRA)" cannot be taken out until retirement, but interest rates on variable rate loans may change from month to month. Financial decisions that appear to be benign may have long-term consequences that result in financial losses or affect life plans for an individual who is oblivious of these and other financial facts. In order to prevent individuals from making financial errors with their personal finances, financial literacy is essential.

Prepares people for financial emergencies: People are better prepared for unpredictable times by learning about topics like emergency preparation and saving. Despite the financial repercussions of losing an employment or incurring a significant unanticipated expense, an individual can mitigate the impact by consistently saving.

Individuals reach their goals: By developing a more comprehensive comprehension of budgeting and saving money, individuals can establish plans that establish expectations, hold them accountable for their finances, and establish a path to attaining significant financial objectives. A person may create a strategy that will help them achieve their goals even if they can't afford them right now.

Increase to confidence: Please consider the repercussions of being compelled to make a financial decision that could have a profound impact on your life without all the requisite information. Financial literacy empowers individuals to make significant life decisions with increased assurance. With less room for surprise or

unfavourable consequences, they have a better chance of getting the conclusion they want.

E. Factors Affecting Investment Decisions

Risk Tolerance: This is a significant factor in the investment decision-making process. It denotes an individual's level of tolerance with the potential for financial loss. It is a common misconception that risk tolerance is solely determined by an individual's comfort level with the prospect of financial loss; however, this is not the case. A person's capacity to accept risk is also influenced by other factors, including "age, financial stability and situation, income, and investment objectives".

Market Conditions: Various factors, such as "inflation, interest rates, stock market trends, and national and geopolitical events" like conflicts, influence the market's performance. Investment returns, hazards, and opportunities may be affected by these circumstances.

Investment Goals: Our investing selections are driven by financial objectives. Long-, mid-, and short-term goals are the three categories into which these objectives are often separated. Affirm financial objectives such as retirement savings, home ownership, or kid education finance by choosing investing alternatives.

Financial Situation: An individual's earnings, spending, savings, continuing investments, and existing debts all contribute to their financial condition. Only one may make investments based on their existing financial circumstances.

Time Horizon: The term "time or investment horizon" refers to the amount of time you intend to hang onto an investment until you really need the money. Those that approach investing with a long-term perspective are able to take on more risk and invest in alluring possibilities like equity funds. People with shorter time horizons could like more liquid, safer assets, such as debt funds.

Diversification: Spreading investments across many asset classes and sectors in order to reduce risk is known as diversification. Investing in a variety of industries and a range of asset classes, including stocks, bonds, and mutual funds, are crucial when making investing selections. In this manner, profits from one investment might balance out any losses from a bad one.

Interest Rates: Bonds and liquid funds are examples of fixed-income investment alternatives that are often most impacted by interest rates. Existing debt arrangements may

lose value as interest rates rise. Additionally, their value may rise as the rates decline.

Economic Outlook: Inflation rates, employment patterns, GDP growth, and other economic indicators of the county also have an impact on market and investment choices. It is possible to persuade investors to undertake more aggressive investments if the economic outlook is favourable.

LITERATURE REVIEW

(Naghera et al., 2024) [14] The capacity to comprehend and be aware of financial ideas and terminology is what is meant by financial literacy... The process of making an investment choice also involves gathering, analysing, and choosing financial data. The purpose of this research is to examine the factors that influence and influence investing choices. The factors influencing financial literacy and investing choices are identified in this article. Prospective findings will be employed to determine the primary attributes of financial literacy and to illustrate the correlation among "financial literacy and investment decisions".

(Sharma et al., 2024) [15] Even if financial literacy programs are implemented effectively, additional research is necessary to investigate their influence on the financial decisions of young individuals. This study has attempted to address a number of specific research topics, including the connection among "financial literacy and socioeconomic factors, investment choices", and the impact of financial literacy on adolescent investment decisions. According to the poll, age has a significant influence on both financial knowledge and investing behaviours, underscoring the crucial link between financial literacy and young people's investment choices. Improving financial literacy via education may result in more confident young people, better investment choices, and more knowledgeable financial practices.

(Savaliya, 2024) [16] examine the relationship between the financial literacy of investors and the impact it has on their investment patterns and satisfaction levels. The study utilises a convenience sampling method to collect primary data by administering a structured questionnaire to 100 respondents. Financial institutions, planners, and advisers may benefit greatly from the findings of this study, which raises public awareness and promotes financial literacy. Ultimately, this will enhance the quality of financial decisions made by individuals and corporations and demonstrate the growth of the backbone of the economy.

(Pallavi & Dsa, 2024) [17] One of its objectives is to ascertain the investment factors and financial literacy level of youthful professionals. For youthful professionals, the investigation investigates investment strategies and short- and long-term financial objectives. The factors that influence the investment decisions of young professionals are determined through the use of a straightforward random sampling technique to gather information about the survey. More financial education and a proactive approach to investing in decision-making are recommended for young professionals. The findings illuminate the unique requirements and obstacles that this demographic faces when making informed economic decisions by providing a comprehensive understanding of their financial comprehension, investment cognisance, and the factors that influence their behaviour. Additionally, the discovery of significant variation in behaviour factors emphasises the significance of prioritising financial instruction and investment approaches to meet young professionals' needs and promote their future financial empowerment and well-being.

(Adil et al., 2022) [18] In the link between gender-based investing choices and behavioural biases, look at the moderating role of financial literacy. Herding and risk aversion had a detrimental and statistically significant impact on female investors' investing decisions, according to the findings. It has been shown that the association between male investors' overconfidence and investment decision-making is significantly influenced by financial literacy. Female investors demonstrated statistically significant results regarding the interaction among "financial literacy and overconfidence, risk aversion, disposition, and herding". According to the research, investors should have access to training programs, workshops, and seminars that improve their financial literacy and understanding in order to assist them overcome behavioural biases when choosing investments.

(Seraj et al., 2022) [19] This research looks at how financial knowledge affects investing choices while controlling for the overconfidence behavioural bias. The partial least squares structural equation modelling (PLS-SEM) method was used to assess the study's results. Investment choices were shown to be favourably and considerably impacted by financial literacy. The results also show that overconfidence moderated the relationship among "financial literacy and investment decisions", which is a positive development, and that overconfidence positively affected investment choices overall.

(Shaheen et al., 2022) [20] intends to investigate how financial knowledge influences investing choices. People that are financially literate might diversify their portfolios and pursue different investment options to manage their financial resources. Through stock exchanges and both traditional and unconventional investment channels, individual investors sought to balance their income and expenses by taking advantage of the most recent investment possibilities in shares, bonds, stocks, and other financial instruments of the firms. "Capital gains, financial interest, stock market rumours", and inexpensive stock prices are all factors that motivate individual investors to engage in stock market trading under the current economic conditions. These indexes provide equitable investing choices in contrast to bank savings and other investment options. Nonetheless, financial literacy (FL) provides a means for investors to make wise investment choices by making the most efficient use of available resources.

(Alaaraj & Bakri, 2020) [21] The subject of this study is the influence of financial education on the investment choice-making procedure of clients in South Lebanon. This encompasses the investor decision model, process, and investment risk. A quantitative approach was implemented to accomplish the research objective, which involved the collection of 150 self-administered questionnaires through convenience sampling. In South Lebanon, the sample comprises customers from four distinct banks. Data analysis was conducted with SPSS software. The hypotheses that were proposed were evaluated through "Pearson correlation and multi-regression analysis, and descriptive statistics were determined". Results indicated a significant positive correlation between investment decision-making and financial literacy. I encourage future research to broaden the scope of the study to include other regions in Lebanon and to employ additional variables over an extended time frame.

CONCLUSION

Investment decisions, particularly those made by young people, are significantly influenced by financial literacy, as this study emphasises. Financial knowledge, coupled with education, enhances confidence in making investment selections. Risky investments are often avoided by those with little financial literacy, who instead turn to more conventional choices like post office schemes and fixed deposits. Their capacity to make well-informed financial decisions is impaired by their lack of cognisance of a variety of investment opportunities. On the other hand, those who are well-versed in finance are more self-assured and make wise investment decisions. The findings also suggest that

financial education plays a vital role in fostering economic independence and improving financial behaviors. While highly educated and employed individuals, particularly men, often seek professional financial advice, a lack of awareness persists, emphasizing the need for enhanced financial education. Moreover, investment confidence is linked to decision-making efficiency, where moderate overconfidence contributes positively. Overconfident but financially literate investors incline to make better investment decisions. In order to enable people to properly manage their money, make wise investment decisions, and enhance their general economic well-being, financial literacy may be promoted via education.

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