Risk Tolerance Level of the Investors-Psychological Behavioural Approach

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Abstract

The paper assesses investor behavior by proposing psychological -based theories to understand stock market and other factors of investment anomalies. Behavioral finance models often rely on a concept of individual investors who are prone to judgment and decision-making errors. This article provides a brief introduction of behavioral finance, which encompasses research that drops the traditional assumptions of expected utility maximization with rational investors in efficient markets. The article also reviews prior research and extensive evidence about how psychological biases affect investor behavior and prices. This article also focuses on the effect of gender and marital status on financial risk tolerance. The paper found that the most common behavior that most investors do when making investment decisions are (1) Investors often do not participate in all asset and security categories, (2) Individual investors exhibit loss-averse behavior, (3) Investors use past performance as an indicator of future performance in stock purchase decisions, (4) Investors trade too aggressively, (5) Investors behave on status quo, (6) Investors do not always form efficient portfolios, (7) Investors behave parallel to each other, and (8) Investors are influenced by historical high or low trading stocks. However, there are relatively low-cost measures to help investors make better choices and make the market more efficient. These involve regulations, investment education, and perhaps some efforts to standardize mutual fund advertising. Moreover, a case can be made for regulations to protect foolish investors by restricting their freedom of action of those that may prey upon them.

Key Words-Financial Risk Behaviour, Statistical Test, Non-Parametric Test, Prospect Theory

1. Introduction

The study is primarily developed to analyze the role of psychological factors in the investment (decision making) process. Considering the stock market fluctuation, the study aims to analyze the resource allocation pattern of the potential investors. Behavioral Finance, a study of investor market behavior that derives from psychological principles of decision making, to explain why people buy or sell the stocks they do. The linkage of behavioral cognitive psychology, which studies human decision making, and financial market economics. Behavioral Finance focuses upon how investors interpret and act on information to make informed investment decisions. Investors do not always behave in a rational, predictable and an unbiased manner indicated by the quantitative models. Behavioral finance places an emphasis upon investor behavior leading to various market anomalies.

De Bondt and Thaler (1985) extended Dreman’s reasoning to predict a new anomaly. They refer to representativeness, that investors become overly optimistic about recent winners and overly pessimistic about recent losers. -Overweight salient information such as recent news-Underweight salient data about long term averages -Investors overreact to both bad news and good news.

Many researchers believe that the study of psychology and social studies throw considerable light on investor’s behavior which explains the efficiency of financial market, market anomalies and market bubbles and crashes. Behavior of the individual investors has long been the interest of academics and portfolio managers but not the investors themselves since the herd mentality sometimes dominates over reasons. Human herding behavior results from impulsive mental activity in individuals responding to signals from the behavior of others (Prechter, 1999).
Risk tolerance is important because it affects a household’s portfolio decisions, which are crucial in achieving long term financial goals. If risk tolerance is based on a rational, informed evaluation, then the portfolio will be appropriate; otherwise, inappropriate levels of risk tolerance might lead to problems. Previous research has shown how households form attitudes toward risk and what factors impact their risk-tolerance level. Demographic characteristics, economic characteristics, and expectations/opinions were found to have significant effects on financial risk tolerance.

Furthermore the investor is guided by his own needs, his behavior is based on the different shapes of the utility function. Accepting three main behavioral patterns, namely, aversion, neutrality and preference emphasis is to given to measuring the degree of risk aversion. This helps determine the price a risk averse investor is willing to pay in exchange of risk he is willing to undertake.

Beginning with a general introduction and review of literature, the paper comprises two parts with the conclusion. Primarily, the demography of investors who are residing aboard in Dammam, Kingdom of Saudi Arabia is assessed to determine their risk aversion along with their age group and their marital status. Followed with investor psychology, which is assessed with the help of statistical tests to find out if endowment, disposition, fear of regret and framing affect the investors’ principle of rationality with proposed conclusion for the assessment.

2. Review of Literature
2.1. Precursors to Behavioral Finance

Benjamin Graham and David Dodd in their classic book, Security Analysis, asserted that over reaction was the basis for a value investing style.

David Dreman in 1978 argued that stocks with low P/E ratios were undervalued, coining the phrase overreaction hypothesis to explain why investors tend to be pessimistic about low P/E stocks.

Tversky and Daniel Kahneman published two articles in 1974 in Science. They showed heuristic driven errors, and in 1979 in Econometrica, they focused on representativeness heuristic and frame dependence. Heuristics is a term for experience-based techniques that help in problem solving, learning and discovery. Identical outcomes are set as reference points, lower outcomes as losses and larger as gain.

2.2. THE BEHAVIOR OF INVESTORS

It has long been recognized that a source of judgment and decision biases, such as time, memory, and attention are limited, human information processing capacity is finite. Therefore, there is a need for imperfect decision-making procedures, or heuristics (Simon, 1955, Tversky and Kahneman, 1974). Hirshleifer (2001) argues that many or most familiar psychological biases can be viewed as outgrowths of heuristic simplification, self-deception, and emotion-based judgments. Study done by Kent, Hirshleifer and Subrahmanyan (2001) had found the evidence for systematic cognitive errors made by investors and these biases affect prices.

According to Kent, et al. (2001), The most common behavior that most investors do when making investment decision are
(1) Investors often do not participate in all asset and security categories,
(2) Individual investors exhibit loss-averse behavior,
(3) Investors use past performance as an indicator of future performance in stock purchase decisions,
(4) Investors trade too aggressively,
(5) Investors behave on status quo,
(6) Investors do not always form efficient portfolios,
(7) Investors behave parallel to each other, and
(8) Investors are influenced by historical high or low trading stocks.
2.3. Prospect Theory

*Prospect theory* introduced by Kahneman and Tvernsky (1979, 1981, 1986) suggests that people respond differently to equivalent situations depending on whether it is presented in the context of a loss or a gain. Investors typically become distressed at the prospect of losses and are pleased by possible gains: even faced with sure gain, most investors are risk-averse but faced with sure loss they become risk-takers. Thus, according to Kahneman, investors are “loss aversion”. This “loss aversion” means that people are willing to take more risks to avoid losses than to realize gains. Loss aversion describes the basic concept that, although the average investors carry an optimism bias toward their forecasts (“this stock is sure to go up”), they are less willing to lose money than they are to gain.

Prospect theory explains how decision makers actually behave when confronted with choice under uncertainty and formalizes an S-shaped value function to substitute for expected utility function of expected utility theory. In original formulation, the term prospect refers to a lottery. In the theory such decision processes follow two stages, editing and evaluation.

![Figure 1](image1.png)

The value function which passes through the reference point is s-shaped and its asymmetry implies that losses hurt more (function for losses is convex and relatively steep) than gains satisfy (function for gains is concave and does not have a sharp slope).

![Figure 2](image2.png)
Cognitive Bias (Winner Loser Effect):

De Bondt and Thaler (1985) argued that investors overreact to both bad news and good news. Therefore, overreaction leads past losers to become underpriced and past winners to become overpriced. De Bondt and Thaler propose a strategy of buying recent losers and selling recent winners. Investors become too pessimistic about past losers and overly optimistic about past winners.

Representativeness Heuristic:

Barberis, Shleifer and Vishny (1998) argued that investors find patterns in data too readily, tend to over react to information and conservatism (clings to prior beliefs, under reacts to information).

2.4. Disposition Effect

The disposition effect is suggested by Shefrin and Statman (1985) to demonstrate a pervasive behavior of holding losers too long while selling winners too soon. Shefrin and Statman (1985) employed a behavioral model consisting of four elements to study the disposition effect. The four elements are prospect theory, mental accounting, regret aversion, and self-control.

2.4.1 Relationship between Overconfidence and Disposition Effect

Lichtenstein, Fischhoff and Phillips (1982) proposed that people often do the wrong judgments of the event happening probability, and comparing to the real happening times it appears to be overestimate this situation. It means that people are usually overconfident.

Odean (1998) pointed out that overconfidence may result from investor’s overestimate of the precision of their private signals, and their knowledge about the value of a financial security. They always remember the success and easily forget the failure. Overconfidence often cause the wrong decision thus lose the chance to correct or enhance the ability to make a right decision.

2.4.2 Relationship between Mental Accounting and Disposition Effect

Tversky and Kahneman (1981), Thaler (1985) and Kahneman and Lovallo (1993) argued that investors will divide all outcome into several small parts that is several mental accountings. Thaler(1999)argued the mental accounting of paper gains and losses is tricky, but one clear intuition is that a realized loss is more painful than a paper loss. Because closing an account at a loss is painful, a prediction of mental accounting is that people will be reluctant to sell securities that have declined in value.

Shefrin and Stateman (2000) develop the portfolio theory of investment behavior based on the prospect theories of Lopes (1987) and Kahneman and Tversky (1979). They employ single account and multiple accounts to deduce the portfolio theory. Because of concerning the covariance of various stocks, investors with single account tendency will put the whole portfolio into the same account. In contrary, investors with multiple accounts tendency divided portfolio into different account and ignored the covariance. Mental accounting is positively related to disposition effect.

2.4.3 Relationship between Regret Aversion and Disposition Effect

Shefrin and Statman(1985) suggested regret is an emotional feeling associated with the ex post knowledge that a different past decision would have fared better than the one chosen, as one of the factors leading to the disposition effect. Baber and Odean(1999) suggested investors want to avoid regret. when investors hold the paper gains stock, investors worry about the stock price will fall, so investors sell paper gains stock to become realized gains. Conversely, when investors ride the paper losses stock, investors will expect the stock price will go up in the future, so they will ride the loss stock. Shiller (2000) argued that regret theory may apparently help explaining the fact that investors defer the selling of stocks that have gone down in value and accelerate the selling of stocks that have...
going up in value. Since the fear of regret leads investors to postpone losses, symmetrically, the desire for pride leads to the realization of gains. In summary, we can infer that investors might feel regret when they realize a loss, and, conversely, feel pride when they realize a paper gains. Investors expected stock price will mean reversion when investors hold losses stock, conversely, Investors worried about stock price will fall in the future when investors hold gains stock, so causing irrational behavioral. Avoid regret is positively related to disposition effect.

2.4.4. Relationship between Self-Control and Disposition Effect

Self-control is to control one’s emotion. Investor with high self-control will avoid reluctant to realize loss and realize gains. But they will also realize loss to avoid larger losses. Klenfield (1983) suggests an iron-clad rule that mandate the realization of a loss to avoid extreme loss. Investor should sell the loser once the declining reaches a predetermined percentage (e.g., ten percent) of the original purchase price. Odean’s (1998) and Grinblatt and Keloharju’s (2001) results showed that investors do sell more losers near the end of a year. One possible explanation is tax-loss selling hypothesis, which is derived from the consequence of the US tax code and the tax year end of December 31. One of the properties of the US tax code is that capital losses are tax-deductible. Therefore, any losses can be offset against gains which provide a motivation for individual investors to sell stocks before the end of the current year. Selling in the December shows the function of self control. Investors can not enjoy benefit of tax-loss in Taiwan, but can use precommitment techniques to control their resistance to realizing losses. Self control is negative related to disposition effect.

Behavioral finance encompasses research that drops the traditional assumptions of expected utility maximization with rational investors in efficient market. The two building blocks of behavioral finance are cognitive psychology and the limits to arbitrage (Ritter, 2003). Cognitive refers to how people think and the limit to arbitrage when markets are inefficient.

There is a huge psychology literature documenting that people make systematic errors in the way they think: they always making decision easier (heuristics), overconfidence, put too much weight on recent experience (representativeness), separate decisions that should be combined (mental accounting), wrong presenting the individual matters (framing), tend to be slow to pick up the changes (conservatism), and their preferences may also create distortion when they avoid realizing paper losses and seek to realize paper gains (disposition effect). Behavioral finance uses models in which some agents are not fully rational, either because of preferences or because of mistaken beliefs.

3. Research Methodology

Type of Research: Research in common parlance refers to the search of knowledge. Research has it significance in solving various operational and planning problems of business and industries. Present research work is descriptive of nature.

Sample Size: Sample size refers to the number to be selected for conducting a survey. Here it has been kept 50.

Type of data and collection method: This survey has been done through primary data collection. For primary data collection questionnaire method has been adopted. The questionnaire was closed ended structured questionnaire and measured with the five scale questions.

Universe: The universe is the entire group of items the researcher wants to study and generalize. The universe of the present study is regarded as whole investing community of Dammam, Kingdom of Saudi Arabia.

Sample techniques: As the universe is quite large so a relatively small group of individual are selected is able to present the whole universe. In this survey convenience sampling has been used.
Data Presentation and analysis Techniques: The data analysis techniques used was quantitative in nature and the data analysis instruments used for conducting the research are tabulation, chi-square test, five scale measurement, bar chart and pie chart.

4. Identify the Investors Psychology, Attitudes and Feelings Regarding Behavioral Finance:

4.1 Assessing the Demography of Investors (NRIs) in Dammam city to estimate the risk averseness:

For analyzing the demography of the investors and approximation climate in Dammam a questionnaire was circulated among investors who conducted the brokers of the Indian Stock Market. By interpreting the questionnaire the risk aversion of the investors could be determined.

The questionnaire was distributed to the investors who gathered for the investment profile discussion and improvement in the investment methodology meeting which was conducted by the NRIs forum in Dammam, KSA, to study their risk averseness/risk-seeking abilities.

The data was classified and grouped on the various parameters i.e. gender, age group, marital status, educational qualification, and earning potential to determine the risk averseness in the group. The interview and the data collection was focused on and followed by standardized techniques of recording the data. The main purpose was to confine the respondents to a discussion of issues in order to explore the reasons and motive, by means of helping the interviewer to formulate the basis for hypothesis testing.

For the interpretation purpose and to understand the investors’ mindset each reply to the question was awarded different points. Twelve risk profile questions. Each question uses a five-point scale ranging from Strongly Agree through to Strongly Disagree. The questionnaire includes a blend of ‘normal’ questions, where agreement indicates an inclination to take risk and ‘reverse’ questions where agreement indicates aversion to risk. The profiling tool compiles the score by weighting the answers equally, taking account of whether they are ‘normal’ or ‘reverse’ questions.

Likert-type scale was used to interpret the results; total 12 questions were given 60 points.

*Points between 0 to 34       Lows risk Tolerance
*Points between 35 to 41    Averages risk Tolerance
*Points between 42 to 48   High risk Tolerance
*Above 48 Points            Very high risk Tolerance

Table 1 showing the Risk Tolerance Level of the Respondents

Cautious investors:

Out of the total respondents 20% of them were very cautious on their investment plans. Cautious investors typically have low levels of knowledge about financial matters and limited interest in keeping up to date with financial issues. They may have some limited experience of investment products, but will be more familiar with bank and building society accounts than other types of investments.

Moderately Cautious investors

40% of the respondents were, majority of them, Moderately Cautious investors typically have low to moderate levels of knowledge about financial matters and quite limited interest in keeping up to date with financial issues. In general, moderately cautious investors are uncomfortable taking risk with their investments, but would be willing to do so to a limited extent. They realise that risky investments are
likely to be better for longer-term returns. They prefer certain outcomes to gambles. They can take a relatively long time to make up their mind on financial matters and may suffer from regret when decisions turn out badly.

**Balanced investors**

22% of the survey respondents were Balanced investors typically have moderate levels of knowledge about financial matters and will pay some attention to keeping up to date with financial matters. They may have some experience of investment, including investing in products containing risky assets such as equities and bonds. In general, balanced investors understand that they have to take investment risk in order to be able to meet their long-term goals. They are likely to be willing to take risk with at least part of their available assets.

**Moderately Adventurous investors**

Rest of the given sample were moderately Adventurous investors typically have moderate to high levels of financial knowledge and will usually keep up to date on financial issues. They will usually be fairly experienced investors, who have used a range of investment products in the past. Moderately Adventurous investors will usually take gambles where they see the potential rewards as being attractive. They will usually be able to make up their minds on financial matters quite quickly. While they can suffer from regret when their decisions turn out badly, they are usually able to accept that occasional poor outcomes are a necessary part of long-term investment.

**The role of demographic factors**

Psychometrics is that area of psychology dealing with the design and analysis of measurements of human characteristics. Perhaps the most prominent example of psychometric testing is the Myers–Briggs Type Indicator, an attitudinal and personality test widely used in the recruitment and personnel areas. Callan and Johnson (2003) provide an overview of the issues involved in constructing an appropriate psychometric instrument to measure financial risk tolerance. A good attitudinal test will meet accepted psychological standards for both face validity (perceived relevance of the questions) and predictive validity (prediction of later performance or behavior), reliability (consistency in results for repeated tests of the same person), as well as having appropriate test norms so that subjects’ test scores can be interpreted against an appropriate reference group. For this reason given questionnaire were divided into four groups namely Knowledge, Comfort with risk, Investment choice and Regret

**Knowledge (2Questions)**

Individuals with more financial and investment knowledge are generally more willing to accept investment risk. Knowledgeable individuals often know that they will need to take at least some risk to generate higher returns. Short-term fluctuations in the values of investments need not matter for investors with longer-term horizons.

**Comfort with risk (3Questions)**

Some individuals have psychological traits that allow them to accept taking risk. These Individuals typically see risk as involving a ‘thrill’ or ‘opportunity’ rather than as a ‘danger’ or a ‘loss’. Questions addressing risk comfort levels often involve individuals choosing among alternative courses of action relating to saving decisions, or simply stating their comfort level with risk.
Investment choice (6 Questions)

Preferences for different kinds of investments can also help to gauge risk attitude, for example, the safety of a bank account versus the risk/return potential of the stock market. However, questions of this nature need to avoid using financial jargon to ensure that clients truly understand the questions asked.

Regret (1 Question)

This negative emotion arises from making the wrong decision. Individuals who are particularly prone to regret tend to try to make decisions that are less likely to cause it. For example, they might engage in regret avoidance.

CHI SQUARE ANALYSIS

$H_0$: There is no significance relationship between the Age and Investors Psychology, attitudes and feeling regarding behavioral finance.

While referring the Table 2, it is clear that when analyzing the factors Age and Knowledge, Comfort Risk, Investment choice and Regret, the Chi-Square value shows that $p$-value is less than 0.05, the null hypothesis rejected at n5% level of significance. The Hypothesis “There is no significance relationship between the Age and Investors Psychology, attitudes and feeling regarding behavioral finance.” is disproved. Hence, the survey proves that the there is a relationship between the age and other psychometric factors.

THE EFFECT OF GENDER AND MARITAL STATUS ON FINANCIAL RISK TOLERANCE/ANNUAL INCOME LEVEL

The pattern suggests that the sex difference in risk tolerance is diminishing over time, due perhaps to cultural changes in how women are socialized, especially during the critical developmental phase. When dealing with married people financial advisors usually must advise the couple rather than just one spouse. While risk tolerance differences between males and females in general have been well documented, the more critical issue for financial advisors is whether such a pattern is also to be expected between spouse.

If people behave according to a rational economic model, and if there are no systematic differences in risk aversion between men and women, then women should tolerate more risk in investment portfolios because of their longer life expectancies. Similarly, married couples have longer life expectancies than single people of the same age, so married couples should tolerate more investment risk than single people.

1. There are no differences in risk tolerance between married men and married women (assuming the respondent for couple households answers based on the preferences of both partners.)
2. Unmarried female respondents are more risk tolerant than unmarried male respondents;
3. Married respondents are more risk tolerant than unmarried respondents.

This article studies on the effect of gender and marital status on financial risk tolerance. Most previous studies have compared single males to single females, but this study also differentiates married males from married females. Risk tolerance is highest for single males, followed by married males, then unmarried females, then married females.

For this study, a cross-tabulation of risk-tolerance levels /Annual income level and gender/marital status was conducted to examine the percent distribution of risk tolerance across
different gender/marital status categories. A p-value of .05 or lower was considered as significant (Refer table 3, 4, 5 &6)

**CHI SQUARE ANALYSIS**

H₀: There is no significance relationship between Marital status and investment choice, Gender and Annual income

The chi square test shows that, TABLE 7, H₀ “There is no relationship between marital status and investment choice, Gender and Annual income” was disproved except the marital status and gender. Hence the survey says that invariably the male and women whether they married or not their risk tolerance and risk aversion level were not having any inter relationship.

**CONCLUSION**

In general, people tend to ruminate on the unusual aspects of the events that led to bad outcomes, and to focus their regrets on such unusual or abnormal aspects. In particular, people are most likely to regret actions (or even failures to act) that they perceive as being "out of character" for them. If they followed someone’s recommendations in straying from their normal path, the regret will easily turn into resentment and anger. All respondents were asked about the degree to which they attributed two outcomes to luck: one of which they were proud, the other an occasion for regret. The risk takers tended to assign little role to luck as a cause of both outcomes.

Investors who own risky assets must commit themselves psychologically to stay with their investments for some time. The amount of time probably varies greatly for different individuals. As Benartzi and Thaler [1995] show that this characteristic of investors is reflective of their experience in the market and it may determine their preferences for risk, they apply this idea to an analysis of financial markets. They assume that investors are myopically loss averse, and use the observe difference in returns between stocks and bonds to derive the investment horizon for which such investors will find the two forms of investment to be equally attractive. It turns out to be about a year. One important conclusion from their analysis is that an investor who considers a longer horizon will be willing to take risks that a more myopic investor will reject, even if their underlying aversion to risk is the same.

The anticipation, diagnosis, and the management of investor discomfort and regret are central elements of responsible financial advising and therefore part of the financial advisor’s job description. The following are some of the reasons:

1. Investment decisions have both emotional and financial consequences over time. There is potential for worry and for pride, for elation and for regret, and sometimes for guilt. A financially optimal decision (the one that a fully rational investor would make) is of little use to an investor who cannot live comfortably with uncertainty. And the optimal decision is certainly irrelevant if it is one that means the investor is likely to change course at the wrong time.

2. No one likes to lose, but regret makes losing hurt more. Clearly, the losing investor who believes that he should have anticipated the poor performance of his investment feels worse than if he believes the failure could not have been predicted.

**References**


ANNEXURE

Table1

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CHI-SQUARE ANALYSIS - TABLE 2

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CHI-SQUARE ANALYSIS - TABLE 7

MARTIAL STATUS * SEX - Cross tabulation

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MARTIAL STATUS * ANNUAL INCOME - Cross tabulation - TABLE 6

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