Informal Investors' Risk Perception and Risk Management Capabilities in Hungary: Theory and Empirical Evidence

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Abstract

Informal investment is still an under-researched topic (Harrison and Mason 1999, Mason 2006) living in exile far from the fields of classical finance. While the amount of informal investment is "guesstimated" to exceed 8-15 times that of the classical venture capital, the real magnitude of informal investment is not known. Despite the elite group of informal investors, the so-called business angels, is relatively well examined, a potentially large part of the informal venture capital market is hidden behind the veil of intimacy. Informal investors within family are mostly expelled because of irrational behavior where kinship and not rational economic calculation determine potential investment. This type of financing is frequently labeled as "love money" or "sweet equity" (Mason 2006).

Informal investment is typically an empirically oriented field of research. Most studies are descriptive, normally relying on a small sample containing a few dozen, at best a few hundred informal investors, and they basically repeat previous surveys in another country. These investigations can be important, but rigorous data collection is mainly missing, with the exception of the Global Entrepreneurship Monitor (GEM) survey. Even this latter one suffers from the lack of a proper reference group in the sense that the reasons of not becoming an informal investor are not investigated and revealed. Despite the fact that in an editorial note of the recently started Venture Capital Journal Harrison and Mason (1999) called for rigorous theory development, not too much has been done over the last decade. The few exceptions (e.g. Van Osnabrugge 2000) mainly rely on the agency theories in explaining traditional business angel behavior and neglecting other types of informal investors. To the best of our knowledge there has been no research trying to identify the different types of risk associated with informal investment. Most studies consider "risk" as a general, loss potential phenomenon not making a difference amongst business, liquidity/financial and agency risk. Despite the well developed agency theory achievement, agency connections are only vaguely identified as a specific form of risk.

The modern portfolio theory (MPT) discusses two kinds of *market risk*, the *systematic risk* that affect the whole market and the *nonsystematic* one that influences only the particular business. The MPT claims that the business specific risk can be minimized by diversification, i.e. creating an investment portfolio. The systematic risk can be mitigated only by hedging. We do believe that all informal investors face these types of risks, too. However, the risk management techniques of the informal investors can differ greatly from that of the stock market players since most informal investors, except business angels, cannot apply the portfolio diversification strategy because of having only one or a few investee businesses. Some people have not even a clue about systematic market risk, and they consider it too high and unknown to be able to handle. These persons generally refuse to invest in other people's business even if it belongs to a close relative.

The unexpected fluctuation of the generated income causes *business risk.* While business angels require some form of written business plan to be able to identify business risk, friends and relatives can be convinced orally by the business owner looking for informal source. *Liquidity risk* can also emerge due to the late payment of the buyers that jeopardize informal investment repayment. It is particularly relevant in Hungary where increasing number of businesses go into bankruptcy. It should be realized by the informal investor that in the case of bankruptcy debt-holders have a priority over equity holders. Without a written contract or collateral the informal investor can find himself at the end of the claim-list.

Relying on Ajzen's theory of planned behavior we attempt to develop a general model to explain how the perception of all the above-mentioned types of risk influences the informal investment decision. The theory is subject to test by a 650 sample size Hungarian adult population data. According to our hypothesis, risk management capabilities influence the decision to become an informal investor. The magnitude of the perceived risk is also dependent on the risk management capabilities of investors.