

Restoring Trust in Financial Markets: Why We Need Financial Literacy and Simple Portfolio Solutions

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What do we know?

- Often the **quality of households' portfolios** does not reflect rational choice, but overconfidence, limited information, and psychological biases
- In the new scenario, what should investors do? How can appropriate policies help investors to diversify risks?
- **Financial literacy, advice and regulation** are key to restore trust in financial markets

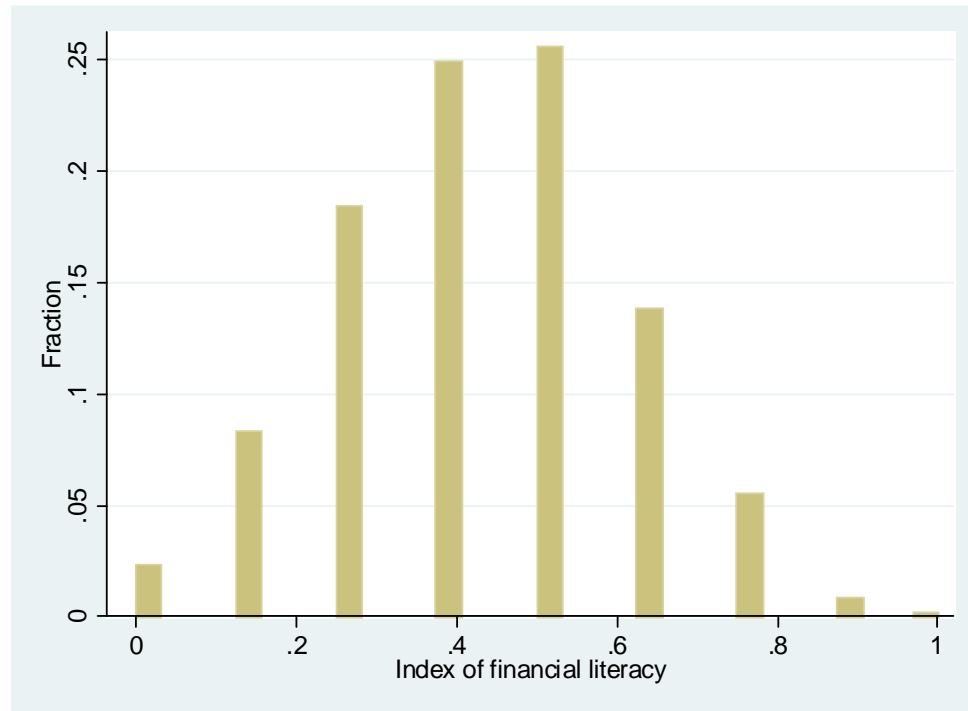
How to restore trust in financial markets?

- **Align investors' and intermediaries' objectives and incentives**
- **On the investors' side:** raise financial literacy and ability to evaluate financial risks
- **On the intermediaries' side:** promote regulation favoring transparency in financial markets and help investors to diversify risks providing good financial advice

Financial portfolios are not well diversified

- **Many investors are poorly diversified:** nearly half of them have only 2 or 3 stocks, home bias, distance from the efficient frontier
 - **Traditional explanation:** transaction, search and information costs
 - **Behavioral finance:** psychological factors
 - **Lack of financial literacy:** many investors ignore benefits of portfolio diversification

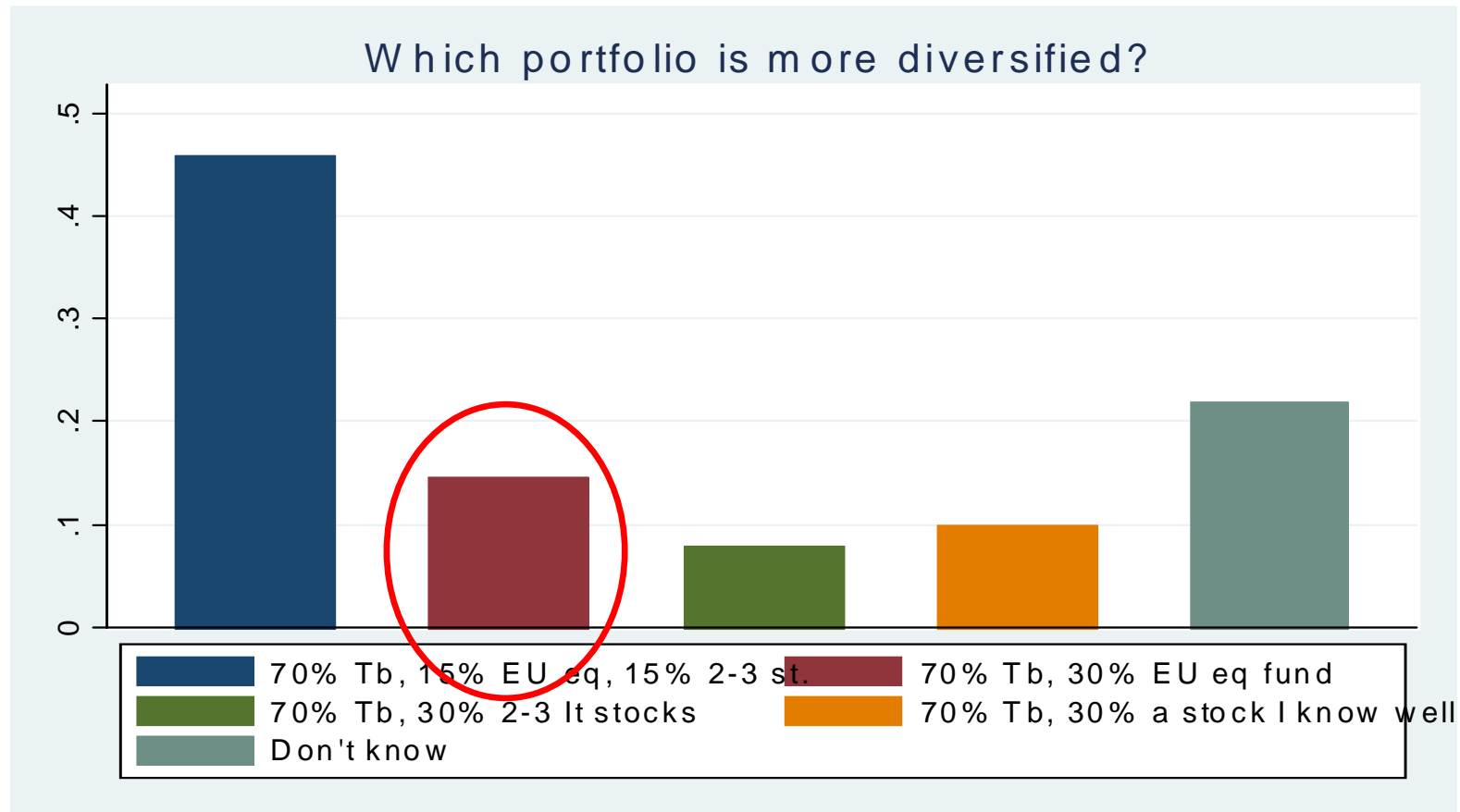
Financial literacy is low



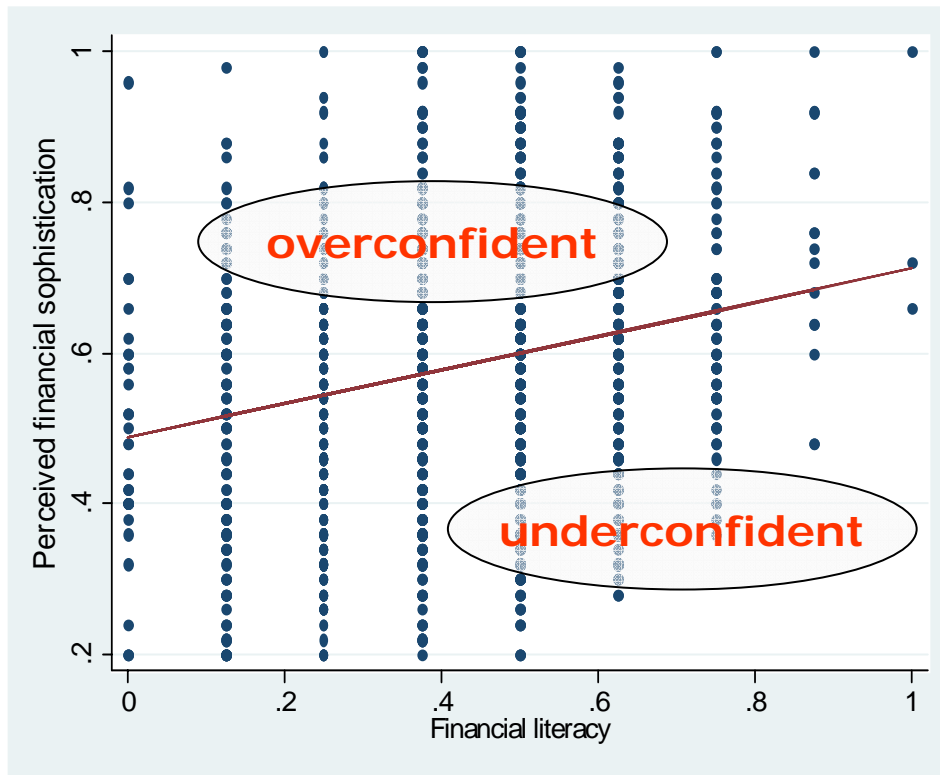
Based on ability to:

- Rank financial risks
- Understand meaning of:
 - Diversification
 - Impact of interest rate changes
 - Inflation and nominal vs real returns

Only a few are able to pick the most diversified portfolio

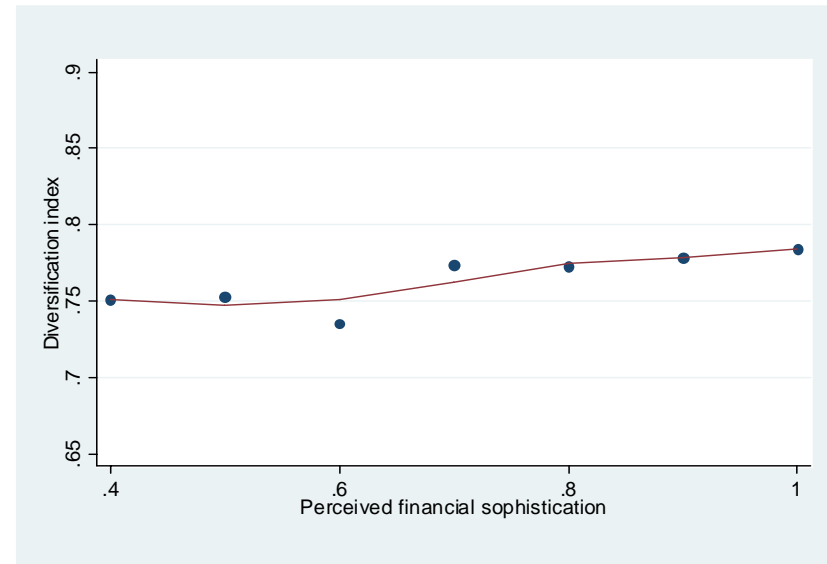
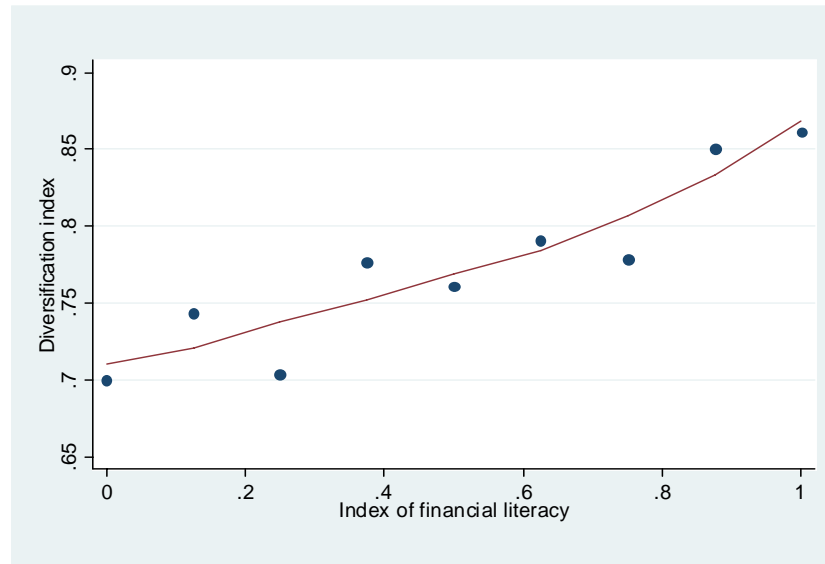


Ability to understand finance and self-confidence are poorly correlated



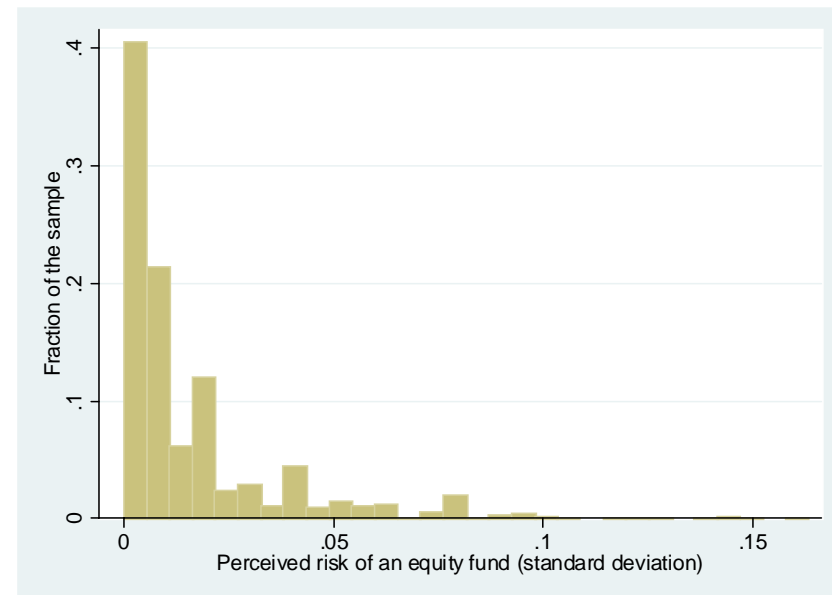
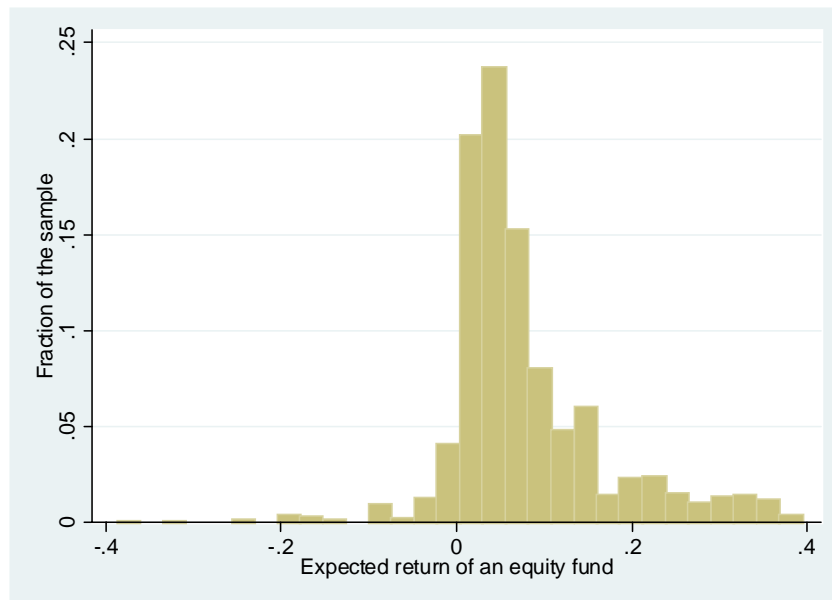
- Weak relation between the two variables
- 50% with low financial literacy claims to have good or even very good knowledge of finance
- 15% of those with high financial literacy claims to know little about finance
- Important implications for Market in Financial Instrument Directive - MIFID

Financial literacy improves risk diversification; self-confidence does not



- The degree of portfolio diversification is correlated with financial literacy (even taking into account income, wealth, education, age, risk aversion, etc)
- It is not correlated with self-confidence

Investors have underestimated financial risk: Perceived risk is much lower than historical volatility of equities



- Think of investing today 10.000 euro in an Equity Fund performing like the Italian Stock Exchange. At the minimum, how much will be worth your investment next year? And at the maximum?
- Median expected return: 5%. For 25% it is greater than 10%
- Median expected risk: 1.5%. For 25% it is less than 1%

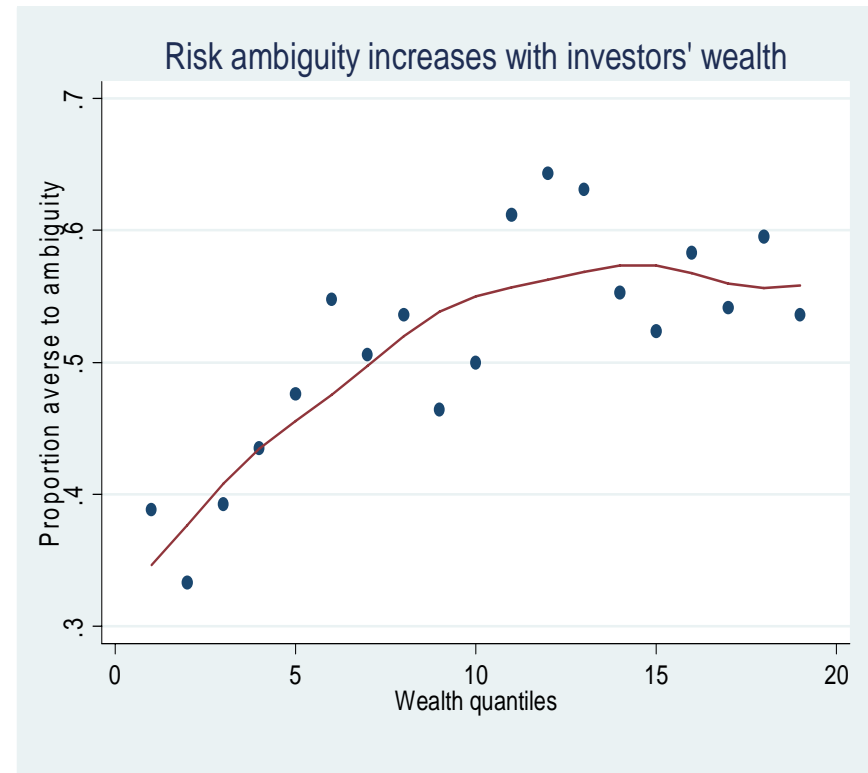
Implication (1):

Intermediaries should offer simple portfolio solutions...

- 50% of investors **overestimate his/her level of literacy**
- Self-tests don't measure financial literacy
- Financial literacy improves portfolio quality, but self-confidence doesn't
- Investors vastly **underestimate financial** risks
- They are **strongly averse to ambiguity**:
 - dislike lack of knowledge of the probabilities of the outcomes (assets for which they cannot evaluate return probabilities)

...and non-ambiguous products

- Distinction between **risk** (dislike of variability of outcomes with known probabilities) and **uncertainty** (inability to attach probabilities to outcomes)
- **Characterizes current financial crisis.** Ambiguity aversion is **higher** for rich households (contrary to risk aversion)
- The rich tolerate risky assets, but not assets with returns that are difficult to compute



Implication (2):

A different interpretation of MIFID

- **MIFID is** a great opportunity
 - It is a substantial **cost for intermediaries** in terms of time spent with clients, training, paper work
 - Through client contacts it is a **unique opportunity for building long-term relationships**
- What should be done:
 - Application of **MIFID** should be related to objective knowledge of investors' characteristics and needs, not rely on self-assessment
 - A **financial license?**

Implication (3):

A different role for financial advice

- Introduce **simple and transparent financial products:** standardized contracts establishing a level-playing field for intermediaries
- Promote **financial literacy** to help people understand the benefits of diversification
- **Tie financial advisors' incentives** to the quality of the clients' portfolios, rather than to specific financial products