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Tackling Investor Ignorance

By KAREN BLUMENTHAL

The financial crisis exposed greed, reckless decisions and regulatory failures. Now we can add another shortcoming to the list: the ignorance of too many small investors.

Just before Labor Day, the Securities and Exchange Commission issued a multipart report, ordered up by the Dodd-Frank financial-overhaul law, that sought to assess the financial literacy of Americans.

Its conclusion: As a whole, it's pretty darn pathetic.

Small investors, the SEC said, "have a weak grasp of elementary financial concepts and lack critical knowledge of ways to avoid investment fraud."

That's a problem for individuals if they buy products they don't understand, accumulate too much debt or take unintended risks with their retirement funds or other savings.

It's also a problem for us as a nation because the unsophisticated—who might even be our own family members—aren't in a position to help discipline the marketplace by demanding better products and lower costs.

"Well-informed consumers will vote with their feet," says Brigitte Madrian, professor of public policy and corporate management at Harvard University's Kennedy School of Government. "They force firms to behave."

Still, people can't be experts about every financial product or investment. So what exactly do they need to know to make good decisions?

Plenty of experts have been wrestling with this. The nonprofit Council for Economic Education is working on standards for students in fourth, eighth and 12th grades in six main subject areas: earning income, buying goods and services, saving, using credit, investing and protecting and insuring assets.

The council hopes to publish the standards and benchmarks early next year, says project director Bill Bosshardt, a Florida Atlantic University economics professor.

The problem: Details taught in school often don't stick. Mortgages and life insurance just aren't relevant to a 17-year-old. Instead, both young and old need to understand broad concepts that can be applied to their current financial needs as well as those that might come along tomorrow.
To test financial knowledge, numerous surveys have boiled down the big issues into simple questions. One set, known as the Big Three, tests the following concepts.

Interest rates and compounding. Compounding, a significant factor in most financial strategies, has been hard to demonstrate in recent years. Parents used to open savings accounts for their children and let the lesson unfold, but with interest rates near zero, many young people have never seen their savings rise. Yet compounding clearly can zap consumers on the debt side, where interest costs can balloon in a relatively short period.

Inflation. Because many financial decisions can take years to play out, people should take rising prices into account. Returns must beat inflation—not some stock-market benchmark—for investors to get ahead. Those who don't understand the impact of inflation will underestimate how much they need to save.

Risk and diversification. True or false: Buying a single company's stock usually provides a safer return than a stock mutual fund. The answer: false, of course. Yet in the 2009 National Financial Capability Study, 48% of respondents got it wrong.

Savers need to understand the direct relationship between higher returns and greater risks, and take steps to be sure investments aren't all in one area. People who don't might invest heavily in their company's stock, or put all their money in tech stocks, heedless of the potential consequences.

Only 30% of survey respondents in the 2009 nationwide survey got all Big Three questions right. And when questions about mortgages and how bond prices respond to interest rates were added in, the number getting all five right dropped to less than 10%.

Annamaria Lusardi, professor of economics and accountancy at George Washington University, who helped devise the Big Three survey, says individuals also need to be savvy about debt. Another survey she worked on asked the following: If you had a credit card that charged 20% annual interest, how long would it take for the amount owed to double if you didn't pay anything off or charge any more?

Just 36% of adults recognized that 20% interest, compounded, would double in less than five years.

Ms. Lusardi also says small investors need to understand budgeting and net worth and to consider the cost of financial services, becoming better comparison shoppers. In another survey, just 37% of respondents said they compared terms when choosing a credit card and only half shopped around for auto loans.

A degree of confidence can give you an edge. Bill Walstad and Sam Allgood, economics professors at the University of Nebraska, found that people who believed they were good at financial issues made better decisions about debt and investing than those who scored higher on financial-literacy tests but lacked confidence.