Putting investors at greater risk

When a little knowledge really is a dangerous thing

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With the advent of financial tools such as credit, debt, insurance and the diversity of investment vehicles available, in addition to the complex nature of the global economy, with influencing factors such as inflation, foreign exchange rates and more, the average consumer now needs a basic knowledge of finance and economics to simply navigate daily life.

However, while quality personal financial education is essential to give individuals the tools needed to manage money, budget appropriately, repay debt, and use credit responsibility, the idea that greater financial literacy education can equip the majority of consumers to navigate the complex world of insurance, investments and retirement planning is flawed.

As these products have become more complex, the inability of consumers to understand them has become increasingly apparent, and the consequences of this inability more dire. In response, policymakers around the world have embraced financial literacy education as a necessary corollary to the disclosure model of regulation.

This education is widely believed to turn consumers into 'responsible' and 'empowered' market players that are motivated and competent to make financial decisions that increase their own welfare. The vision is one of educated consumers handling their own matters by confidently navigating the unrestricted financial marketplace.

Unfortunately, the effectiveness of financial literacy education lacks empirical support, particularly given the dynamism of the financial marketplace. The truth is that there is a gaping chasm between the skills and knowledge among us, and the proficiency required to understand, and take advantage of, today's complex financial products and markets.

The shortcomings of basic financial education have been highlighted in a growing body of research, most notably that of Professor Lauren E Willis, in her paper titled *Against Financial Literacy Education*. Prof. Willis was quoted as saying: "Financial education appears to increase confidence without improving ability, leading to worse decisions."

These sentiments are echoed by Helaine Olen, in her recent book, *Pound Foolish*, which also highlights the fact that available data indicates that fostering financial literacy simply doesn't work; that financial literacy is ineffective in today's complex, modern financial markets.

Given the prevalence of this trend in developed nations such as the US, where financial-literacy programmes are a mandatory part of basic scholastic education, it is understandable then that the gap between financial prosperity and financial literacy is even greater in developing nations.

Whether due to the heavy influence of sentiment, or the lack of awareness of various financial instruments available, or the financial markets in general, there is a disturbing trend locally of underperformance in funds where members are provided with the option to make their own investment choices, commonly termed 'member choice'.

Yet, financial education is still advocated over other methods of regulation, even though research shows that unless it's your professional focus, average investors underperform when managing their own funds. And when it comes to investments such as retirement funds and insurance, this underperformance can be catastrophic.

Underperformance is generally attributed to the fact that these decisions are often heavily influenced by sentiment, because making financial decisions that impact on the future well-being and financial security of an investor, their family and dependents, are influenced more by bias, emotions and the fear of uncertainty, rather than sound financial reasoning. For many of these reasons, Prof. Willis states that when "left to their own devices, many consumers choose not to choose".

The intermediary market has and should continue to play a central role in guiding long-term financial and investment decisions. While the debate around the upfront cost implications and fees associated persist, the fact remains that poor financial decisions, in spite of a perceived degree of adequate financial literacy, cost more in terms of lost earning potential and underperformance.

In an age when defined-benefit pension plans are no longer the norm, replaced by defined-contribution plans that require individuals to decide how much to save, and how to invest, the need for guidance, consultation and qualified advice has never been greater.

Financial product providers can play a role in helping to mitigate the deleterious effects of member choice, by keeping products as simple as possible. Whether individual or group risk business, structuring products that help manage risk and still deliver value, with minimal investor input, removes the opportunity for bias, sentiment and a lack of adequate knowledge to erode investment returns.