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Investment competence and advice seeking

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ABSTRACT

This study evaluates individuals' abilities to avoid investment mistakes driven by behavioral biases and analyzes the relationship between investment competence and the propensity to seek or rely on professional advice. We use novel survey data collected from a representative sample of Swiss households. We find that – even after controlling for socio-economic and demographic characteristics – investment competence is positively related to demand for financial advice. It appears that investors who are at the highest risk of making investment mistakes are those who are the least likely to seek help from professional advisors. Therefore, supply-side solutions imposed by regulators to protect financial customers may not benefit those who need them most.

1. Introduction

A compelling body of research documents that households make serious investment mistakes. Among various pieces of evidence are findings that households hold under-diversified portfolios (Blume and Friend, 1975; Goetzmann and Kumar, 2008; Kelly, 1995) and exhibit a strong preference for local and home country stocks (Calvet et al., 2007; Huberman, 2001). In addition, households trade too much (Barber and Odean, 2000), sell winners too early and hold losers too long (Odean, 1998; Shefrin and Statman, 1985), and they tend to buy a stock simply because it catches their attention (Barber and Odean, 2008). As a result, the average retail investor tends to underperform the market (Barber et al., 2009).

By and large there is evidence that individuals who are likely to make investment mistakes can avoid poor financial outcomes if they receive help from qualified financial advisors or delegate decisions to them.[2] In fact, the regulation of financial advisors relies, to a large extent, on the assumption that advisors are mainly consulted by unsophisticated investors in need of help. However, protective regulatory measures can be effective only if unsophisticated investors seek the support of professional advisors. Otherwise, regulatory measures will not benefit those who need them most.

In this paper, we assess individuals' abilities to avoid investment mistakes, and we analyze the relationship between investment competence and the propensity to seek

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[2] The question of whether expert financial advice truly benefits retail investors is still under debate, but there is a consensus that financial advice may improve retail investors' portfolio decisions when conflicts of interest are minimized (Bhattacharya et al., 2012). There is evidence that professionally-managed portfolios are more diversified (Gerhardt and Hackethal, 2009) and exhibit weaker disposition effects than portfolios of retail investors (Shapira and Venezia, 2001). Collins (2010) suggests that financial counseling can help individuals develop better financial practices.

or rely on professional advice. To assess individuals' investment competence, we conducted an online survey with questions that address biases in the selection and processing of information. These biases may lead to investment errors, as documented in the empirical literature on behavioral and household finance. We find that – even after controlling for socio-economic and demographic characteristics – the demand for financial advice is positively related to investment competence. Investors who are less able to avoid investment mistakes are significantly more likely to make investment decisions autonomously, whereas investors with higher investment competence are significantly more likely to delegate decisions to advisors. Hence, supply-side solutions imposed by regulators to protect financial customers may not benefit those who need them most. Additionally, our results suggest that educational initiatives, in particular for self-directed individuals, may be beneficial but that such initiatives should provide training in the avoidance of behavioral traps in addition to teaching basic financial knowledge.

To date, the question of whether financial advice is a sufficient remedy for inferior decision-making has received varied answers. One strand of the literature documents a negative relationship between financial literacy and advice seeking. For example, Hackethal et al. (2012) study the behavior of German retail investors and conclude that customers with less interest in and knowledge of financial matters are more likely than others to rely on advice. In a portfolio-choice experiment, Hung and Yoong (2010) find that individuals with low financial literacy (both self-assessed and measured) choose to take advice more often than others. Frederick (2005) shows that individuals with lower levels of cognitive skills are more risk-averse, and both Bluethgen et al. (2008) and Gerhardt and Hackethal (2009) find that greater risk aversion increases the demand for financial advice Kramer (2012) finds that banking clients who view themselves as less financially literate than others are more likely to ask for expert financial assistance. Additionally, Hackethal et al. (2012) find that less sophisticated customers are less aware of the problem of conflicts of interest among financial advisors and therefore are more inclined to consult and follow the advice of advisors.

Other studies, however, suggest the opposite relationship between investment competence and demand for financial advice, arguing that more sophisticated individuals are more likely to seek advice. Lusardi and Mitchell (2006) find that people with higher scores on financial literacy questions are more likely than less sophisticated investors to rely on financial experts when planning their retirement. Using past portfolio performance as a proxy for financial sophistication, Bluethgen et al. (2008) find that wealthier, more sophisticated and more experienced clients are more likely to seek advice. Hackethal et al. (2012) confirm the effect of investment experience and wealth on the propensity to seek advice and suggest that the effect could also be related to the higher opportunity costs of time of wealthier, more experienced investors.

While most previous studies have mainly focused on the deficiency of financial knowledge as a source of adverse decisions,[3] we hypothesize that financial knowledge alone may not be sufficient to avoid investment mistakes. Emotions and cognitive errors in the selection and processing of information can prevent individuals from successfully applying knowledge that is available. To estimate the impact of these factors, we have designed multiple-choice questions addressing some common heuristics that investors may apply when making investment decisions. We call the ability to avoid using these heuristics investment competence. Hence, our measure of investment competence is complementary to other measures used to evaluate general financial knowledge (Brown and Graf, 2013; Calcagno and Monticone, 2014; Kramer, 2012; Lusardi and Mitchell, 2006; Van Rooij et al., 2007). In contrast to studies that infer investment competence from observed trading behavior, our measure of investment competence aims to capture reasoning driving suboptimal trading decisions that is not directly observable in trading data. Additionally, we target retail investors, as they are usually less experienced and face stronger financial restrictions when they decide to invest on the financial markets than banking clients or customers of brokerage firms. Hence, the questions of whether retail investors require an advisor and are willing to demand advisory services are of particular importance for them.

The remainder of the paper is organized as follows. In Section 2, we describe the data, provide descriptive statistics, explain how we assess investment competence and describe our control variables. Section 3 presents and elaborates on our results and discusses endogeneity issues. The results of robustness tests are discussed in Section 4. Section 5 summarizes our findings and concludes the paper.

2. Data description

2.1. The sample

Our dataset was generated by an online survey with 1016 individuals from the German-, Italian-, and French-speaking regions of Switzerland. The participants in our survey were recruited from a pool of individuals provided by a professional market research agency in Switzerland that has experience in conducting surveys on financial topics. In exchange for their participation, individuals answering most of the questions participated in a raffle in which an iPad was awarded to the winner.[4] The questions were originally written in German. We used professional interpreters employed by the market research agency to translate the questions into French and Italian.

The sample is representative of the underlying population with respect to age, gender and geographic location. As Table 1 shows, the respondents were 48 years old on average. Fifty-four percent of the respondents were male, 30% had degrees from schools of applied sciences (''Hochschule''), and 18% had university degrees. Overall, 44% of the respondents stated that their annual disposable

[3] Kramer (2012), in addition, considers cognitive ability but fails to find a significant effect on advice seeking.

[4] Compensation type did not significantly impact respondents' answers. In a separate study, we found that a fixed payment (CHF 10) did not motivate students to answer the questions differently than a chance of winning an iPad, with a market price of approximately CHF 800, raffled off among 100 respondents.