EDUCATING **ENTREPRENEURS** FOR THE WORLD

Financial advice as a "credence" service: the role of investor competence

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Motivation: financial products as credence goods?

Credence goods (services) = Goods (services) where an expert knows more about the quality a consumer needs than the consumer himself

Increasing supply of financial products	**Optimal product = Tailored to investor's needs**
More decentralised fin. decisions	

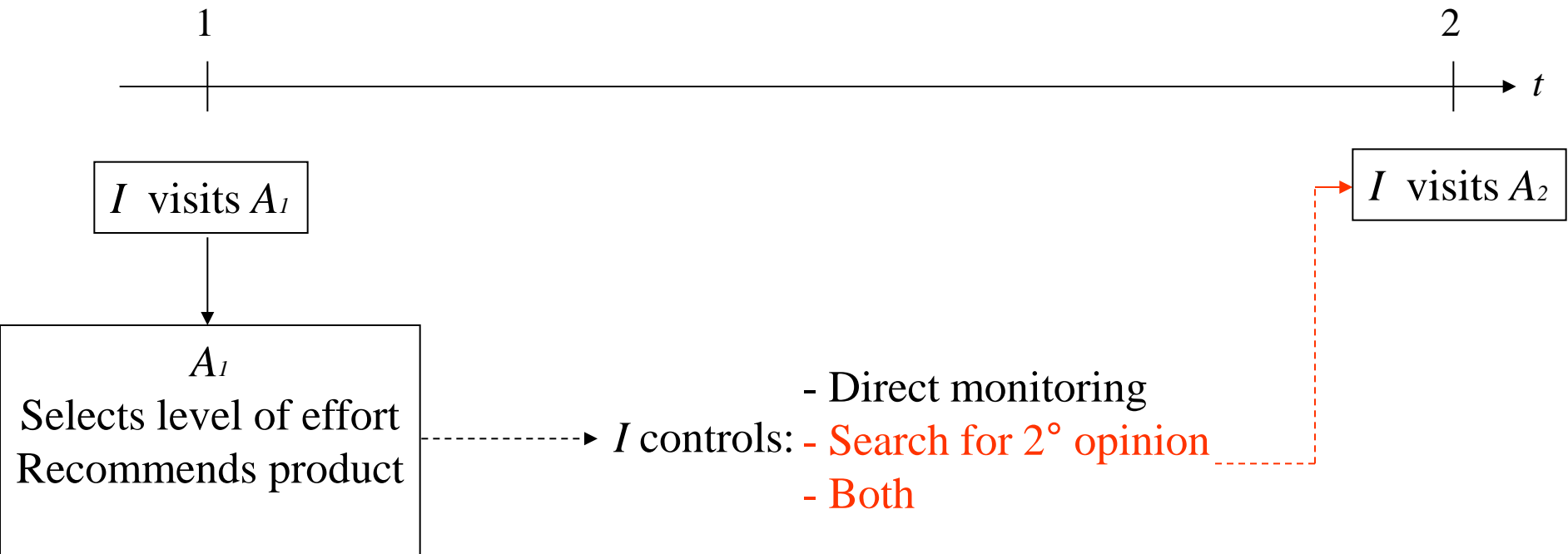- How does the degree of investor's financial literacy affect the relation with the advisor?

Development of the research question and main results

1. If financial advice is a "credence" service, the portfolio of investors demanding for advice may have different characteristics than the one held by investors who do not demand for advice

   ▪ Portfolio sophistication is less related to the investor's competence

2. Investors who demand for advice try to discipline the expert's behavior

   ▪ Searching for second opinions

   ▪ Directly monitoring the expert's effort if their degree of competence is sufficiently high

A stylized model

Pesendorfer and Wolinsky (2003) with the addition of a second verification channel: direct monitoring

1   2

t

I visits A_1

I visits A_2

A_1
Selects level of effort
Recommends product

I controls:
- Direct monitoring
- Search for 2° opinion
- Both

Main Results of the Model and its Empirical Predictions

1. The probability of getting the optimal product is higher for investors asking for advice

   → for them we predict a positive relationship between complexity of needs and complexity of products

2. Investors asking for advice search for second opinions and the intensity of search is related to search cost

3. More competent investors who ask for advice also monitor directly the advisors' activity

   ▪ More competent investors asking for advice can obtain a lower price for the service but not necessarily a better quality one

Data

- ## 2007 UniCredit Survey

  - 1,676 clients of one of the banks of the group

  - Household demographics and education

  - Income and wealth

  - Financial assets holding

  - Attitudes towards saving, investment driver, risk propensity

  - Degree of financial literacy (based on 8 questions)

  - Form of investment (self-selection, full delegation, demand for advice), relation with advisors, sources of information

Test I: validity of the "credence goods" approach

- Complex need requires complex product
  - Through advice investors are likely to obtain the right product
  - Weak correlation between Fin Lit and the degree of complexity of decisions

- Test:
  - No advice: higher Fin Lit associated to more complex portfolio (van Rooij et al. (2011))
  - Advice: weaker (no) relation between Fin Lit and portfolio complexity

Table 3: Portfolio sophistication, financial literacy and advice

	I	II	III FULL SAMPLE	IV TAILORED INV	V HIGH FL
			OLS		
FL (0-8)	0.045***		0.043***	0.063***	0.072**
	(0.004)		(0.009)	(0.015)	(0.034)
Advice		0.037**	0.111**	0.273***	0.532**
		(0.019)	(0.045)	(0.076)	(0.248)
FL*Advice			**-0.019***	**-0.063*****	**-0.090****
			(0.011)	(0.020)	(0.044)

*Robust standard errors in parentheses; * p<0.01, ** p<0.005, *** p<0.001*

Result: Conditional on advice, weaker correlation Fin Lit - sophistication

Test II: search for second opinion and investor competence

- **Pesendorfer and Wolinsky (2003):**
  - search for second opinions is the only discipline device on advisors
  - No relation between search costs and Fin Lit

- **Test:**
  - For investors demanding advice: no relation between Fin Lit and search for second opinions

Table 5: search intensity and Fin Lit

	OLS	2SLS	Probit	IV Probit
	I	II	III	IV
FL (0-8)	0.018**	0.158**	0.103**	0.585***
	(0.007)	(0.070)	(0.043)	(0.099)

Result: highly literate investors more involved in search activity

Test III: direct verification and investor competence

- Our augmented PW model: also direct verification is can be used as a discipline device

  - Verification more frequently used by high Fin Lit investors

- Test:

  - For investors demanding advice: high Fin Lit is associated to a more intense monitoring activity

Table 7: direct monitoring and Fin Lit

	OLS	Ordered Probit	2SLS
	I	II	III
FL (0-8)	0.063***	0.061***	0.202**
	(0.017)	(0.018)	(0.112)

Result: highly literate investors more involved in monitoring activity

All models control for:
- income, wealth, risk tolerance
- age and age squared
- dummy for gender, dummies for marital status
- dummies for educational level

Instrumenting Financial Literacy and more tests (to be done)

1. The regional level of financial literacy (SHIW)

2. Dummy indicating whether head of household was in the group of best students at school (11-14 years old)

- Still to do: selection model for the choice of advice / no advice

Conclusions

- Financial products can be considered as "credence goods"?

- In the subsample of investors asking for advice we find:
  - A weaker relation between Fin Lit and portfolio sophistication than in the non-advice subsample
  - A positive correlation between Fin Lit and the intensity of the search for second opinions
  - A positive correlation between Fin Lit and the monitoring activity

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Thank you for your attention!