

## Meeting of the Securities and Exchange Commission Investor Advisory Committee

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Speaker:

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### Discussion Regarding SEC Investor Research Initiatives, FINRA Foundation 2016 Financial Capability Study, and Academic Research on Financial Literacy

Good morning and thank you for the opportunity to speak before the Securities and Exchange Commission Investor Advisory Committee. My name is Annamaria Lusardi and I am the founder and Academic Director of the Global Financial Literacy Excellence Center at the George Washington University School of Business. Through its research and expertise, the Center seeks to inform policy as well as develop and promote financial literacy programs around the world. At GFLEC, we seek to make research findings more accessible to policymakers and practitioners in order to help shape national and international dialogue around financial literacy. Our mission is driven by the awareness that financial literacy levels around the world have reached a crisis point. People are increasingly expected to take responsibility for their own financial security, yet they are unequipped to do so.

My presentation today will focus on several findings from the 2015 National Financial Capability Study (NFCS). In particular, my area of discussion will be the level of financial knowledge of Americans, with a special focus on investors.

- Americans are asked to make many more financial decisions than in the past, and they need a basic level of financial literacy to make appropriate choices. Financial knowledge is consequential especially for people who have investments in stocks, bonds, or other securities, and for people who get to choose how to invest money in their retirement pension accounts.
- A set of three questions addressing the concepts of numeracy, inflation and risk diversification was developed by Lusardi and Mitchell to evaluate the level of financial literacy in the US (the exact wording of the questions can be found in the Appendix). Known as the “Big Three,” these questions and several variations have been incorporated into multiple surveys to measure financial literacy in the United States. These questions have also been used in 15 countries that participated to the Financial Literacy Around the World (FLAT World) project.
- The “Big Three” questions aim to measure a basic level of financial knowledge, i.e., whether people know the ABCs of personal finance. These questions have been asked in the FINRA Foundation’s NFCS. As the survey has been conducted

every three years since 2009, we are able to assess the evolution of financial literacy of Americans over time. Data from the three waves show that financial knowledge did not increase since 2009; if anything, it shows a small decline: Thirty-nine percent of respondents showed a basic financial literacy level in 2009, and the percentage decreased to 34% in 2012 and 32% in 2015.

- Considering all the financial literacy questions that were asked in the three waves of the NFCS (five to six questions) a slight downward trend in financial knowledge since 2009 is observed. For example, the percentage of respondents who answered 4 or more quiz questions correctly out of 5 decreased from 42% in 2009, to 39% in 2012, and to 37% in 2015.
- Consistent with the findings of previous research, data from the 2015 NFCS shows that financial literacy tends to increase with age, even though this happens at a slow pace. In fact, less than one third of respondents under the age of 40 answered the “Big Three” questions correctly. Hence financial understanding is very low among young adults even though many financial decisions are made well before that age.
- Comparing responses among the “Big Three” questions, we find that risk is the most difficult concept to grasp. The workings of interest rates are a relatively well known topic (75% of respondents answered the interest rate question correctly), while risk diversification is the least known (46% of respondents answered the risk question correctly). “Do not know” responses are very high when considering knowledge about risk: Forty-four percent of respondents answered with a “don’t know” to the risk diversification question; the percentages of “do not know” to the interest rate and inflation questions are 12% and 20% respectively. Analysis of “don’t know” responses is important as they indicate lack of confidence by the respondent, in addition to a lack of knowledge. This result is consistent with our data from 10 European countries, collected in 2016 and showing that risk-related concepts are the most difficult for individuals to grasp.
- Financial knowledge is consequential for people who have investments in the financial market, but is their level of financial literacy higher? People who have investments in stocks, bonds, mutual funds, or other securities, not including retirement accounts, are more likely to answer the basic questions correctly, with respect to the general population. However, on average, only one in two investors (51%) answered the “Big Three” questions correctly.
- We also looked at a broader definition of investors. For example, we considered not just people who have investments in bonds, stocks, mutual funds and other securities, but also people who have retirement plans where they get to choose how the money is invested. Financial knowledge of this broader sample of investors is slightly lower than the knowledge of investors considered before. Overall, data shows that basic financial literacy among investors is not much higher than in the general population.
- In addition to the “Big Three” questions, some surveys included other questions addressing more sophisticated concepts, many of which we have helped design. For example, the NFCS asked questions on asset pricing, mortgage payments, and, more recently, knowledge of interest compounding. We have also added a set of questions measuring financial sophistication in the Rand American Life Panel and the Health and Retirement Study.
- As one could expect, the knowledge of sophisticated concepts is even lower than the knowledge of basic notions. For example, just 43% of people who have investments in stocks, bonds, mutual funds, or other securities gave a correct answer to the asset pricing question. The percentage is even lower among the general population: twenty-eight percent of respondents answered this question correctly (the exact wording of the question can be found in the Appendix).

- One reason why financial sophistication is low, both among the general population and among investors, is that people do not understand economic and finance jargon. Our studies show that the number of “don’t know” responses increases substantially when such jargon is used. Moreover, there are subgroups of the population—especially women—for whom this terminology is hard to comprehend and this results in very low rates of correct answers to jargon-laden questions.
- Despite low levels of financial literacy, most Americans have high self-perceptions of their financial knowledge. When asked to assess their own financial knowledge, over three-quarters of respondents (76%) gave themselves high marks (5 to 7 on a 7-point scale where 1=“very low” and 7=“very high”).
- The mismatch between actual levels of financial literacy and self-assessed levels of financial knowledge is present among investors too. In fact, while less than half (47%) of people with investments or self-directed retirement accounts showed a basic level of financial literacy, 87% of them reported a high self-perception of financial knowledge.
- The results I have shown you today and findings from a lot of our academic research have several implications:
  1. They highlight the need to step up the effort on financial education. Financial literacy levels are critically low, especially among young people who have to make financial decisions that will impact the rest of their lives. It is particularly important to educate and prepare the next generation of investors.
  2. As many studies documented, risk-related concepts are particularly difficult to grasp, so it is necessary to think about new strategies to inform and teach people about risk. Our research shows that visualization tools and simplifying information using stories and narratives may help.

3. When communicating with investors it’s important to keep the message free of complex terminology and jargon. Moreover, it is important to target messages to specific population subgroups.

I would like to thank again the Securities and Exchange Commission Investor Advisory Committee for the opportunity to speak today, and I look forward to hearing your comments.

## Appendix

1. Interest rate question: *“Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?”*  
Possible answers: More than \$102; Exactly \$102; Less than \$102; Don’t know; Prefer not to say.
2. Inflation question: *“Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?”*  
Possible answers: More than today; Exactly the same; Less than today; Don’t know; Prefer not to say.
3. Risk question: *“Please indicate whether this statement is true or false. ‘Buying a single company’s stock usually provides a safer return than a stock mutual fund.’”*  
Possible answers: True; False; Don’t know; Prefer not to say.
4. Asset pricing question: *“If interest rates rise, what will typically happen to bond prices?”*  
Possible answers: They will rise; They will fall; They will stay the same; There is no relationship between bond prices and the interest rate; Don’t know; Prefer not to say.