Research Report

Good Financial Advice – Wanted but not followed

THIS STUDY INVESTIGATES WHAT HAPPENS WHEN RETAIL CUSTOMERS ARE OFFERED FREE AND UNBIASED ADVICE. USING A LARGE FIELD EXPERIMENT IT SHOWS THAT THOSE WHO ACCEPT THE OFFER (5%) ARE MORE LIKELY TO BE MALE, OLDER, WEALTHIER, MORE EXPERIENCED AND MORE FINANCIALLY SOPHISTICATED. HOWEVER, EVEN THOUGH THE ADVICE WOULD HAVE HELPED, IT ACTUALLY LARGELY FAILED TO HELP BECAUSE THE CUSTOMERS DID NOT LISTEN TO IT. OVERALL, OUR RESULTS SUGGEST THAT THE MERE AVAILABILITY OF UNBIASED FINANCIAL ADVICE IS A NECESSARY BUT NOT SUFFICIENT CONDITION FOR BENEFITING RETAIL CUSTOMERS.

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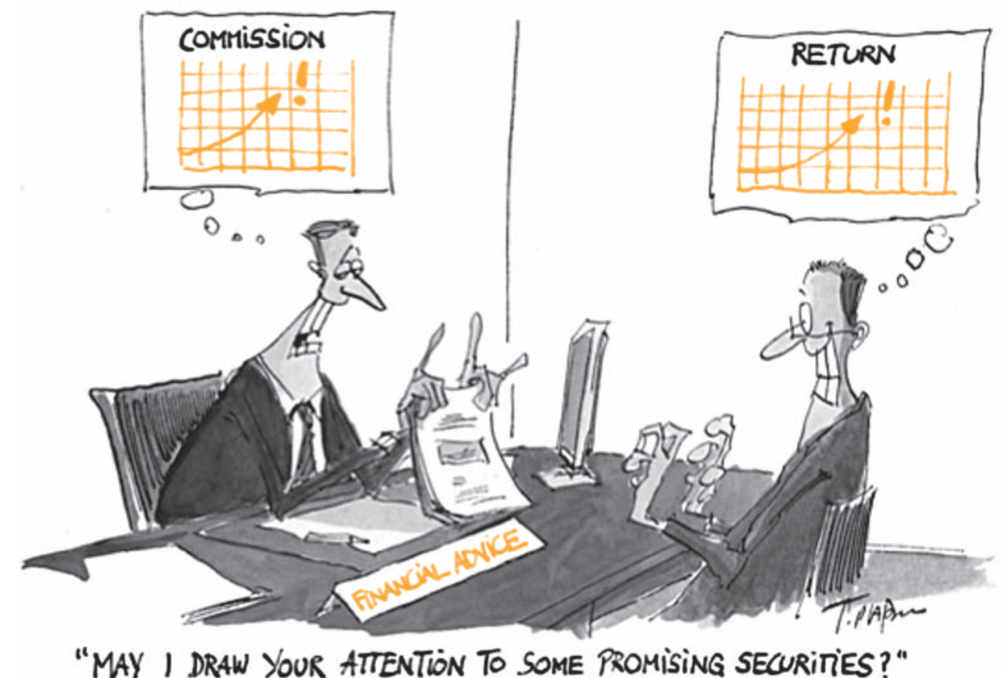
Introduction

Using data from a field study, we are among the first to examine the demand side of financial advice and to show that an offer of free and unbiased financial advice is accepted by only 5% of the clients approached. Of those clients who accept the offer, only very few ultimately follow the recommendations made. Thereby, the study contributes to the current discussion on consumer protection in the context of financial advice and questions the effectiveness of supply side solutions, since better information alone does not seem to improve the decision making of private investors.

There is a large and growing body of literature on household finance, which documents that retail investors make serious investment mistakes by deviating from the prescriptions of normative finance. The majority of households do not even participate in the stock market despite the large equity premium that exists. The few households that do participate in equity markets hold under-diversified portfolios. Under-diversification with regard to geographical diversification is particularly pronounced – investors are found to exhibit both a home bias and a preference for local stocks (for a summary of investment mistakes, please refer to Campbell, 2006).

Other investment mistakes in the trading behavior of private investors have also been documented. We observe inertia, resulting in insufficient portfolio adjustments of individual investors to general market movements. Investors trade too much because they are overconfident. Investors tend to sell winners too early and hold on to losers too long, an investment mistake called the disposition effect.

Are these investment mistakes serious? Barber and Odean (2000), by looking at the consequences of overconfidence, find that overconfidence leads to substantial return decreases after the deduction of transaction cost due to excessive trading. The more people trade, the worse their net returns are. For the aggregate portfolio of individual Taiwanese investors, Barber et al. (2009) document an annualized loss of 3.8%. They find individual investors to be even the worst performing group of all investors in the Taiwanese market.



In his presidential address Campbell (2006) points out that next to financial education, default options or regulation are potential remedies for private household's investment mistakes. Yet, another potential remedy for private households' investment mistakes is financial advice. Thereby, the business of providing financial advice is large all over the world. For example, in the U.S., the Financial Planning and Advice Industry is estimated to equal a size of 37 billion dollars. The Investment Company Institute also remarks that over 80% of respondents state that they use financial advice from professional advisors. The same holds true for Germany. A survey among retail investors indicates that more than 80% of investors consult a financial advisor before making investment decisions.

If you build it, they will come

However, the literature also shows that the professional advice given to retail investors is often conflicted and that retail investors who obtain such advice actually worsen their investment performance, because advisors may have incentives to increase primarily their commissions instead of recommending good products for the client (for example, Inderst and Ottaviani, 2009). An obvious supply side cure to improve portfolio efficiency and mitigate the investment mistakes of retail investors is therefore to offer unbiased and theoretically sound financial advice that brings advisees closer to efficient portfolios. If the abovementioned conflict is resolved, advice may help improve investors' performance. In other words, it could be expected that expressed in colloquial terms: "If you build it, they will come".

The Field Experiment

We test whether this supply side solution works. Can unbiased financial advice steer retail investors towards efficient portfolios? To answer this question, we work with one of the largest brokerages in Europe, which has several hundred thousand active retail customers. This brokerage started offering financial advice to about 8,000 of its customers, all of whom were chosen randomly, in 2009. The clients were contacted via an e-mail to the personal mailbox within their brokerage account. If the customers did not react to the e-mail, they were called and asked whether they wanted to accept the offer.

The advice was free of charge for a limited period of time and, ex-ante, unbiased as it was generated from a commercial portfolio optimizer that improves portfolio efficiency and did not push specific products with high commissions. It was even free of commissions for the period of this field study and terminated automatically. This advice was also sound, because it substantially improved diversification. For example, the share of well-diversified index funds in the portfolios sharply increased and the home bias, i.e., the tendency to excessively hold German stocks, was also reduced. In order to illustrate this point: The share of German stocks amounted to 52 % in the original portfolio of investors and would have been reduced to 31 % if the recommendation would have been implemented. Diversification across asset classes was improved as well. All this left customers with a significantly more efficient portfolio than they had before. This rests on the assumption that they fully implemented the recommendations.

Due to the fact that we have data on all the retail customers in our sample, i.e., for those who accepted the advice and also for those who did not accept the advice, including administrative for the time before the advice was offered and for up to ten months thereafter, we can answer some key questions using a difference-in-difference methodology: How many and which types of customers accept the offer? If customers accept the offer, is the advice provided followed? Does portfolio efficiency improve for the average advisee who accepts the offer? Does portfolio efficiency improve for the average advisee who follows the advice given? Are those investors most in need of financial advice also the ones most likely to get it?

The Findings

By answering these questions, we explore the demand side of financial advice. We link the recommendations of advisors with actual customer behavior after the advice has been given. First, we find that only about 5% of clients accept the offer for free and unbiased advice. These clients are more likely male, are older, have more money, possess a higher level of financial sophistication, and are also more likely to have a longer relationship with the brokerage.

Second, when regarding those who accept the offer, the advice given is hardly followed. The majority of investors do not follow the recommendations at all. More than one third of the investors act even against the advice by buying securities that were not recommended and selling securities that they were advised to keep (see Figure 1). Third, portfolio efficiency improves for the average advisee who follows the advice. But it would have improved even more for those investors who accepted the general offer, but did not subsequently follow the recommendations made. Portfolio performance improves most for the least financially sophisticated investors. Thus, we document that this unbiased financial advice can indeed help investors improve their portfolio performance, but it can only work if people follow the recommendations.

Fourth, it seems that those investors most in need of financial advice are the ones least likely to get it and vice versa. The ones who experienced the worst performance in the past and could benefit much more from the advice are less likely to accept the offer. In other words, to speak colloquially "the sick do not go to the doctor".

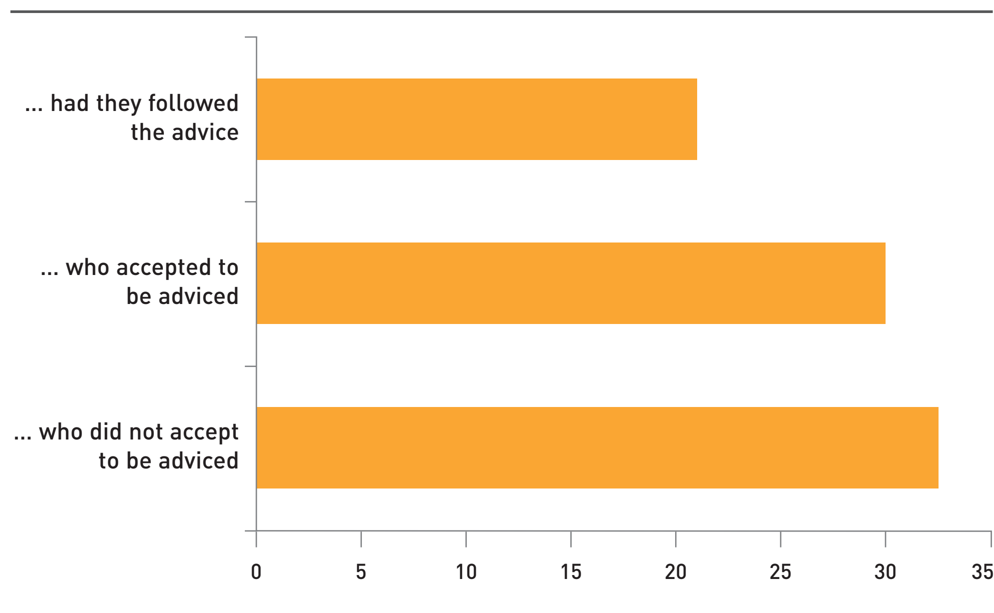


Figure 1: Unsystematic risk share in % of selected investors...

Overall, our results imply that the mere availability of unbiased and theoretically sound financial advice is a necessary but not a sufficient condition for benefiting retail customers. Thus, as the saying goes: "You can lead a horse to water, but you can't make it drink".

You can't make a horse drink

These findings highlight that the optimization of investment decisions made by private investors is to a large extent a demand side problem, while regulators are currently focusing on the supply side.

In the U.S., a new agency called the Consumer Finance Protection Agency was created under the financial reform bill (i.e., the Restoring American Financial Stability Act of 2010) to deal with mostly supply side problems. Likewise, the Markets in Financial Instruments Directive (MiFID) implemented in Europe aims to enhance protection of retail investors by increasing the transparency of financial products. In the UK, the FSA has even launched the Retail Distribution Review (RDR) that, among others, suggests minimizing conflicts of interest by prohibiting commissions or defining minimum qualification standards for financial advisors after 2012. Moreover, in Germany, the new Securities Trading Act forces financial services firms to disclose any fees – kickbacks, bonuses, etc. – related to a (potential) product sale. Yet, more information and disclosure is only valuable if customers are able to translate these into better investment decisions, which is found questionable by this study.

Our results apply not only to financial products, but also to patients' adherence to medical advice, which has been shown to be very low. This is because patients believe they know more than the doctor, are lacking social support, or are simply unreasonable about what they are told. It is up to future research to identify the factors that prevent investors from following beneficial financial advice.

Experimenting with alternative ways to offer advice is therefore a useful avenue to explore in the future. For example, in our study, the advice would require people to turn over 75% of their portfolios on average, since investors' existing portfolios are largely inefficient. Investors in our sample may have found it too complicated or too cumbersome to implement the full list of recommendations, though they did turn over 70% of their portfolios every year during the pre-advice period. Therefore, making the implementation of the recommendations easier might enhance the degree of following.

Moreover, although the information given to our advisees is extensive and clear, it may not be much different from other less theoretically anchored sources of investment advice, to which people might be exposed outside the brokerage. Perhaps future settings could therefore seek to build greater trust with advisees.

To conclude, much more needs to be done to understand why and how financial advice is actually followed and how it can help individual investors. Finally, the question remains: What makes the horse drink?

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