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SAFE Finance Blog

Ignorant Investors, Unimaginative Regulators

04/03/2017

Andreas Hackethal about most frequent investment errors and the benefits of a comprehensive and transparent portfolio reporting



Most retail investors are ignorant about the risk-return profile of their portfolios. This ignorance impedes learning from past mistakes and constructing efficient portfolios fitting to individual risk preferences. One major impediment to learning lies in the way banks and brokerages report past portfolio performance to their clients. Most such individual security account statements feature gains and losses per single investment vehicle but no consistent portfolio perspective that would allow for comparisons with sensible benchmarks or for tracking risk and return over time. Ignorance with respect to underperformance keeps investors from abandoning loss-making investment strategies which gives rise to long-term underperformance of retail portfolios.

Last week, Stiftung Warentest, a German institution conducting consumer product inspections and publishing test reports and product rankings, published a report (<https://www.test.de/Aktien-Typische-Anlagefehler-und-wie-man-es-besser-macht-5153101-0/>) on investment behavior in its magazine „Finanztest“. The article is based on empirical work of Steffen Meyer and myself for the period 2005-2015 and discusses four costly investment mistakes prevalent among German retail investors. The authors from Finanztest conclude that the average investor in our sample of more than 40,000 brokerage clients could have earned five percentage points per annum more in risk-adjusted returns if she had adhered to a low-cost buy-and-hold strategy with broadly diversified and passive investment vehicles. In contrast, a sizable share of investors in the sample opted for a strategy of picking single stocks or narrow active mutual funds resulting in poorly diversified and expensive portfolios. Finanztest urges its readers to quit security speculation and rather buy into ETFs that track global equity and bond indices. This call for efficient retail portfolios echoes myriads of articles in the popular press over the past years that advocate low-cost passive investment.

It is both striking and surprising that still today and despite many such calls, the majority of retail investors holds inefficient portfolios and engages in loss-making trading strategies. The underlying reasons for this persistency can be found both on the demand side (behavioral biases) and on the supply side (conflicts of interests). Market mechanisms alone have not been sufficient to lead to better results. One favorite instrument of policymakers in such situation is transparency and disclosure, e.g. by introducing key investor information documents and mandatory minutes on advisory meetings. However, this kind of disclosure only pertains to the input side of portfolio construction rather than to the output of investment services and the results of customer decisions.


An alternative approach would be standardized portfolio reporting for retail investors in Germany and Europe, so that investors can better evaluate the output of professional financial advice as well as their own decisions and, thus, learn from their past mistakes. A respective proposal has already been made by Roman Inderst and myself in a commissioned report (<http://bit.ly/2nuRHZP>) to the Federal Ministry in charge of Consumer Protection back in 2011. Such a standard report must take on a full portfolio perspective, must feature past portfolio returns net of all cost and an intelligible indicator for past portfolio risk. Such reports should aid self-directed retail investors to iron out their investment biases and advisory clients to better assess the quality of advice. As a second round effect, this kind of disclosure should make retail financial institutions strengthen their focus on client value and also foster competition among different retail investment business models.

Keywords: Household Finance (https://safe-frankfurt.de/news-latest/safe-finance-blog/search-result-blog.html?tx_news_pi1%5BoverwriteDemand%5D%5Bcategories%5D=182&cHash=219248e328a909c6ab29dc8885f8d), Financial Literacy (<https://safe-frankfurt.de/news-latest/safe-finance-blog/tag/financial-literacy.html>), Private Investment (<https://safe-frankfurt.de/news-latest/safe-finance-blog/tag/private-investment.html>), Saving (<https://safe-frankfurt.de/news-latest/safe-finance-blog/tag/saving.html>)




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