Perceived versus Actual Investor Sophistication; A Behavioral Study

Dr. Stuart Michelson, Roland and Sarah George Professor of Finance
Stetson University 421 N. Woodland Blvd Department of Finance
Deland, FL 32723 386-822-7376 smichels@stetson.edu

This research utilizes the National Financial Capability Study (NFCS) funded by the FINRA Investor Education Foundation. The national and state-level data are extracted from the 2015, 2012 and 2009 NFCS State-by-State Surveys, each of which employed nationwide online surveys of over 25,000 American adults.

This survey solicits information from individual investors on retirement and non-retirement account investments, actual level of investment sophistication, and self-perceived level of investment sophistication, along with many demographic variables. This study investigates the relationship between actual and perceived investor sophistication to determine retirement preparedness of investors, as well as whether investors understand their level of financial preparedness. It is hypothesized that most investors are not as prepared for retirement nor as sophisticated investors as they believe. Additionally, it is hypothesized that there will be a difference in results related to age, education, and gender.

Literature Review

FINRA initiated the NFCS survey in 2009 and several investigators implemented research streams using this data. The following is a brief summary of relevant research using NFCS data. Xiao, Chen, and Sun (2015) find that older consumers show higher levels of financial literacy, perceived financial capability, and overall financial capability compared to younger consumers. They also find that financial capability is positively associated with age and that accumulation of financial capability occurs as consumers age. Bucher-Koenen, et al (2017), using NFCS data, the authors find similar gender differences in financial literacy across countries. When responding to questions on basic financial concepts, women are less likely than men to answer correctly and more likely to indicate that they do not know the answer, for women of all ages. These gender differences are present for very basic as well as more advanced measures of financial literacy. Xiao and O'Neill (2016) use NFCS data to test the hypothesis that financial education is positively associated with financial capability. Regression results show that, after controlling for demographic and financial variables, respondents who ever received financial education had higher scores in all financial capability indicators. In addition, high school, college and workplace financial education variables showed positive associations with these financial capability indicators.

Xiao and Porto (2016) find that subjective financial literacy, desirable financial behavior and a financial capability index are strong mediators between financial education and financial satisfaction. Porto and Xiao (2016) examine potential effects of overconfidence on seeking financial. Using NFCS data, their results show that a high percentage of respondents display financial literacy overconfidence and they score higher than the average on perceived financial knowledge but are unable to answer the majority of financial literacy questions correctly. These overconfident consumers are less likely to seek professional financial advice, but are more likely to exhibit demand for advice related to debt counseling and tax planning. Seay, et al, (NFCS data) shows the important role financial advice plays as a compliment to financial knowledge; higher (lower) levels of financial knowledge are associated with initiating and maintaining (dropping) use of a financial planner for retirement planning. They find that current clients that are better equipped to understand the value of investment advice are more likely to adopt and use a financial planner, while also being less likely to stop using a financial planner.

Prior research found an inverse relationship between overconfidence and seeking professional financial advice. Conversely, those with higher levels of financial knowledge are more likely to use a financial planner. Additionally, researchers found that higher levels of education, age, and gender are related to higher levels of financial literacy. This study investigates the relationship between perceived and actual investor financial sophistication. Additionally, the relationship between investor financial sophistication and retirement preparedness is investigated, along with several explanatory variables (age, gender, and level of education). These results provide important behavioral information relevant for financial education, financial planners, and individual investors.