Your Clients Are Less Financially Literate Than You Think

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A FINRA survey suggests your clients are ‘a lot less’ literate than they let on, says Morningstar's Sarah Newcomb

Clients are still confused about financial issues like interest rates and mutual funds. (Illustration: Robert Saunders/Theispot.com)

Lack of financial literacy is “not limited to lower income, lower education [consumers]. It is quite pervasive across all income ranges.”

Those sobering words came from Sarah Newcomb, behavioral economist at Morningstar, who said recently that regulators and other stakeholders dedicated to boosting Americans’ financial literacy “have a tough challenge ahead.”

After speaking at a financial literacy event held at the Treasury building in Washington, Newcomb told me that a good start for advisors would be “to understand that clients likely know a lot less than they let on.”

While FINRA's seventh annual National Financial Capability Study found an increase in the nation's adults who report not having difficulty covering their monthly expenses, financial literacy levels continue to be low, with only 37% of respondents considered “highly financially literate,” meaning they could answer four or five basic questions correctly on a five-question financial literacy quiz.

Advisors are familiar with the “nudge economics” features in defined contribution plans that encourage participation and help investors overcome inertia...

Overall financial literacy, the survey found, is down slightly since 2009.

SEC Chairwoman Mary Jo White noted at a mid-July event at George Washington University in Washington that the survey's financial literacy quiz revealed there continues to be “a lack of some basic investor knowledge.” For instance, she said, most Americans are still not aware that market interest rates and bond prices move in opposite directions or that a mutual fund usually provides a safer return than a single company's stock, two of the questions on the FINRA quiz.

White stated that the clear “headline” lesson from the study “is a familiar and critical one: In today's increasingly complex world, Americans need the financial skills to tackle life's everyday challenges,” and they should have “an understanding of how savings and investing can help meet their life goals and achieve a secure retirement.”

Investors must be “well-informed” in order to understand risk and to detect and avoid fraud, White said. Improving literacy is not simply a financial issue, White said, but also a “moral imperative.”

Among the study's most notable findings:

- More than one in five Americans (21%) have unpaid medical debt, and women are more likely than men to put off medical services such as seeing a doctor, buying needed prescriptions or undergoing a medical procedure due to cost.
- Nearly half (45%) of respondents with a high school education or less could not come up with $2,000 in 30 days in the event of an emergency, compared to only 18% for respondents with a college degree.
- Twenty-nine percent of 18- to 34-year olds with a mortgage have been late with a mortgage payment, compared with 7% for the 55-plus age group.
- Hispanics and African-Americans are much more likely to use high-cost forms of borrowing like pawn shops and payday loans compared to whites.

As Richard Ketchum, FINRA's outgoing CEO, noted at the event at GWU, debt continues to be a problem for many Americans, with more than one in five having unpaid medical debt. What's more, he noted, more than one in five Americans with credit cards have been contacted by a debt collection agency in the last year.

The College Debt Issue

College debt is another big worry that has gotten the attention of lawmakers as well as the Treasury Department.

Deputy Treasury Secretary Sarah Bloom Raskin said at the GWU event that while the National Financial Capability Study reveals “cracks in many Americans’ sense of financial security,” the results also point out the opportunities “for addressing these cracks.”

She noted how the survey results “resonated” with the findings of Treasury's student loan team, which has been conducting field surveys for more than two years of college students and their experiences with college loans. Too many student loan borrowers still in school don't know how they will pay off their loans, Raskin said, which has the effect of “stigmatizing student loan borrowing — to the point that students might consider dropping out of school.”

The resulting combination of not gaining a degree while still holding high levels of debt reduces those former students’ financial capability for years to come.

Today, Raskin continued, more than a quarter of American adults, and nearly half of those under age 34, have student debt. Among those with student loans, nearly half are concerned that they will not be able to pay them off, she said.

She noted initiatives by the Obama administration, including the expanded repayment plans that base affordable monthly payments on income, low student loan interest rates, as well as a College Scorecard to help students compare the quality of various higher educational institutions.

The administration is also working to ensure that loan servicers “help borrowers stay current and receive the information they need to repay their loans responsibly,” Raskin said.

US Ranks Poorly in Financial Literacy

Labor Secretary Thomas Perez noted at the Treasury event that the U.S. has “a lot of work to do” in promoting financial literacy, as the U.S. ranks 14th in the world in terms of financial literacy scores.

Morningstar's Newcomb stated that while there's a definite “intersection” between psychology and financial decision making, “behavioral economics goes much deeper than that.” (Morningstar has a new behavioral finance department headed by Steve Wendel, who blogs regularly for ThinkAdvisor.com.)

She stressed that while defaulting workers into 401(k)s has had “some success,” ongoing guidance is needed to help them become “better decision makers,” especially when they enter the withdrawal phase.

Advisors, Newcomb said, are in the best position to ascertain when clients need to learn specific financial concepts, what she said researchers have called “just in time” financial education: efforts that teach principles of finance at the precise time in life when that knowledge is needed.

“By anticipating the major life events and financial decisions their clients will be facing, advisors have the opportunity to employ just-in-time financial education very effectively.”

For instance, Newcomb said, people who are planning to buy a home in the near future are more likely to retain information about loan options than their peers.

Helping clients and prospective clients navigate the myriad advisor designations is also part of the financial literacy challenge, noted Marilyn Mohrman-Gillis, executive director of the recently formed CFP Board Center for Financial Planning.

She said the Board will soon release an analysis of the 140 designations on FINRA's website, many of which she called “essentially meaningless.” She argued, “It's often difficult for people to figure out which advisors have the expertise to give advice.”