AFR Opinion piece on the Retail Investor Taskforce

21 February 2008

Illiterate investors will hurt us all

We are nearly all retail investors. Because of compulsory superannuation, the vast majority of Australians, even if they don't think about it much, have some investment exposure and exercise investment choice.

In 1989, the collective net worth of retail investors was $1.2 trillion or 337 per cent of gross domestic product. In 2007, that had grown to $5.1 trillion or 485 per cent of GDP.

While the net worth of retail investors has been rising, their lot has become harder – there are so many choices and today's financial products are complex.

This also means that investing still bewilders too many Australians who, as a result, are simply not engaged. This lack of engagement is one of the key factors behind the establishment of a retail investor taskforce within the Australian Securities and Investments Commission. The taskforce aims to help retail investors build long-term wealth through investment, and it will make recommendations to the full commission shortly.

Assisting the demand side of the equation (investors and their behaviour and access to information) is going to be one of our biggest challenges. It is resource-intensive, slow and progress is hard to measure. But the rewards could be significant.

Retail investors often chase recently outperforming investments to the detriment of their long-term wealth. Nothing better illustrates this than the now famous Felicity Foresight and Harry Hindsight parable from *The Economist*.

In this hypothetical tale, each investor started with US$1 on New Year's Day 1900 and switched asset classes on each anniversary for the next 99 years. Felicity was psychic and could tell what was going to be the best asset class every year and that's where she put her money. Harry preferred past performance and so put his money into the asset class that had performed best in the immediately preceding year and did this for the next 99 years.

By the year 2000, Felicity's US$1 would have been worth US$9.6 quintillion. Harry would have had US$783 (or US$290 after transaction costs).

Another big challenge is getting retail investors to choose the right products. There are two inter-related issues.

First, the number of simple and safe products for retail investors has contracted. The retail market for federal government bonds is very small, and has almost no profile, so retail investors chasing yield are increasingly turning to more complex and, often, more risky products. This also means that the benchmark for measuring the risk attached to the returns offered by these other products has become partly obscured for retail investors (as they don't have a bond sitting in their portfolio).

Second, we know that only about 20 per cent of retail investors get financial advice and 46 per cent of Australians can't read well enough to understand financial disclosure documents. It seems to follow that many must be investing in products they don't understand. If so, a solution could be to change the blend, for some investors, of disclosure and advice so that some is embedded in the product.

Fifty years ago, buying and owning a car had a big advice/disclosure component. There was a big owner's manual and lots of tools in the garage. Today, all you need is the key – all the "advice" and "disclosure" has been embedded in the car. The default option in many managed fund products plays this sort of role already, but it is often a pale imitation of what a more "automated" and client-friendly product could do.

Should we create incentives to encourage more products that either do the work for you or are just much simpler in their design? If so, what are those incentives? If the market moved down this path for certain retail investors, an invaluable by-product would be a greater degree of appropriate asset allocation and diversification for them. Getting these last two things right for less financially literate retail investors would make a massive difference.

The taskforce recognises that we must care about retail investors who make the wrong decisions: the economy needs them to pay for their own retirement. In our own way, we are all retail investors and each of us has something to gain from better outcomes overall.

Jeremy Cooper
Deputy Chairman
Australian Securities & Investments Commission