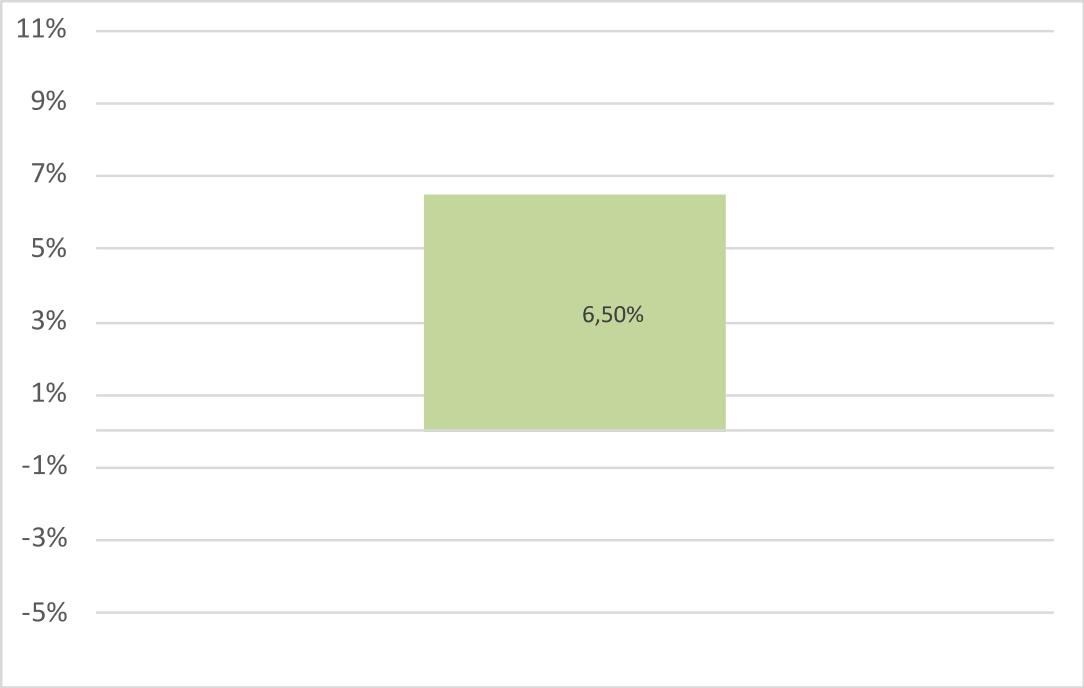
Retail Investors

Paolo Sodini

Retail Markets: Demand



Noisy Environment

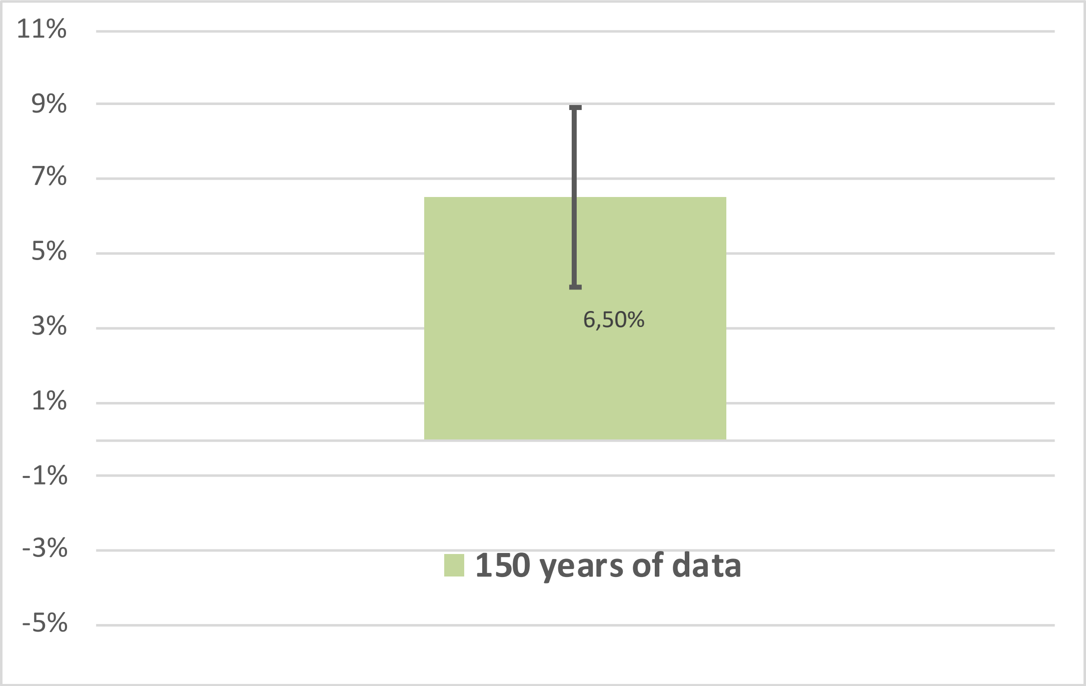
Return of stocks vs bonds is about 6.5% on average

How likely it will be 6.5% going forward?

Let's use all the data available to answer

150 years of data approx

Retail Markets: Demand



Noisy Environment

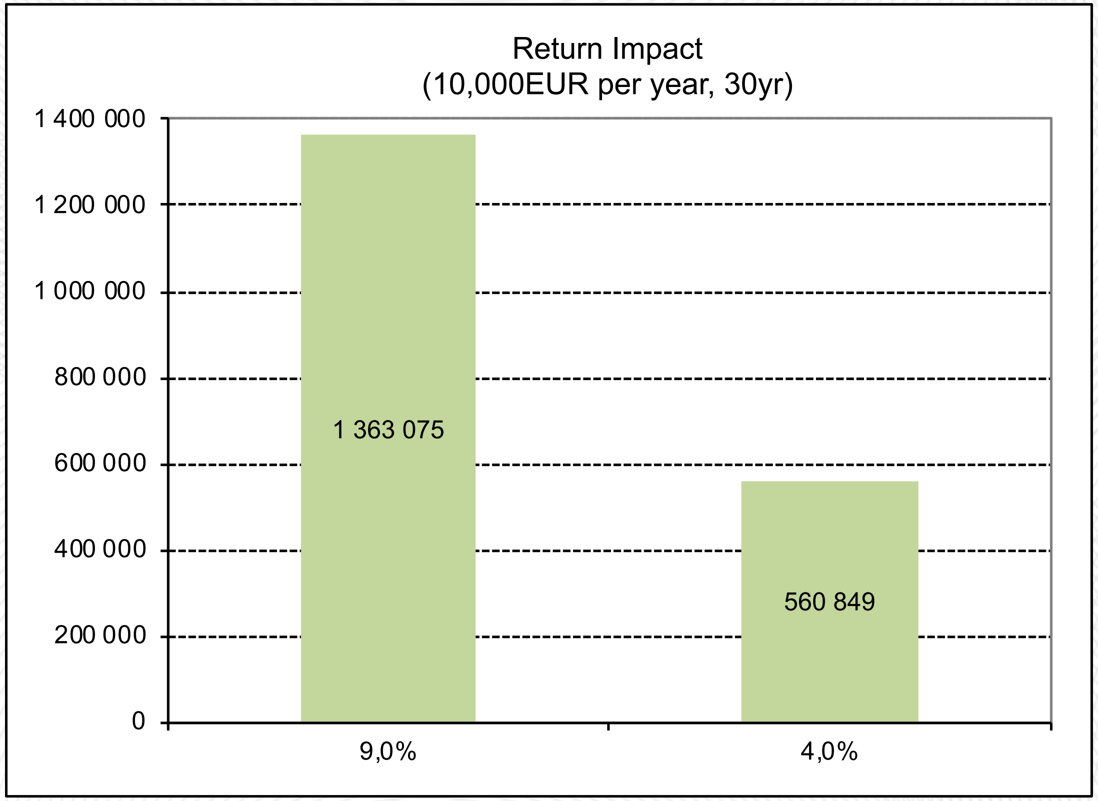
Return of stocks vs bonds is about 6.5% on average

With 95% confidence we can only say it is between 4% and 9%

How much difference does 9% vs 4% make?

Retail Markets: Demand

SWEDISH HOUSE OF FINANCE



Noisy Environment

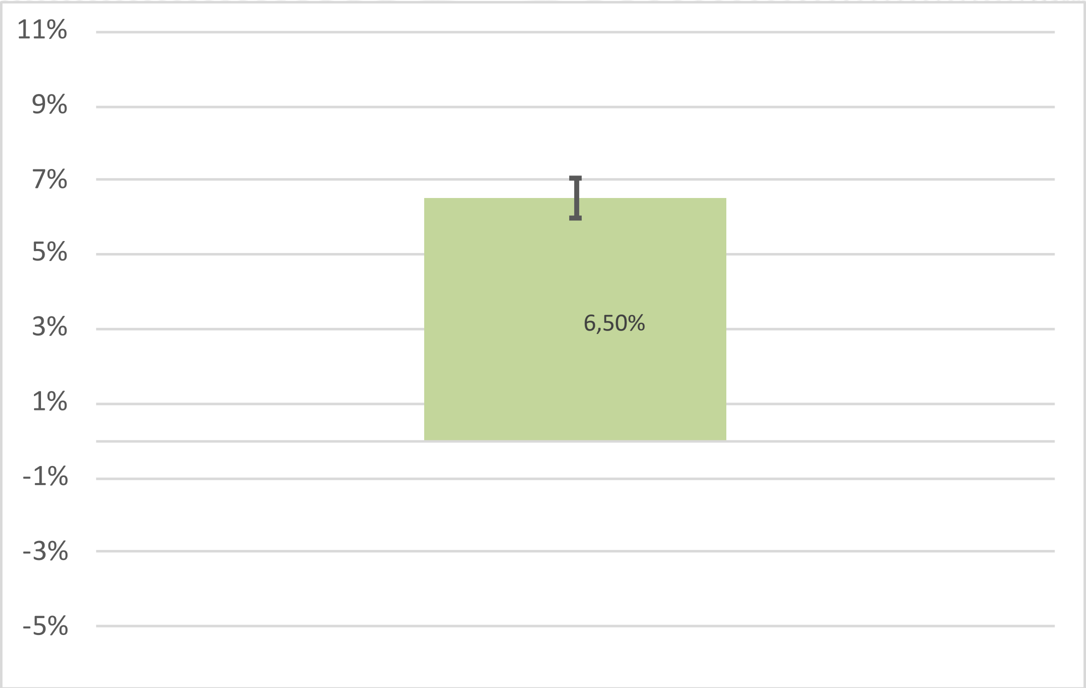
Save 10,000EUR per year for 30 years

9% would yield 1.35M

4% would yield 0.55M

Retail Markets: Demand

SWEDISH HOUSE OF FINANCE | STOCKHOLM SCHOOL OF ECONOMICS



Noisy Environment

How many years of data would it take to have an error band of 1%?

Retail Markets: Demand

Noisy Environment

How many years of data would it take to have an error band of 1%?

We need to go back to Egyptian time!

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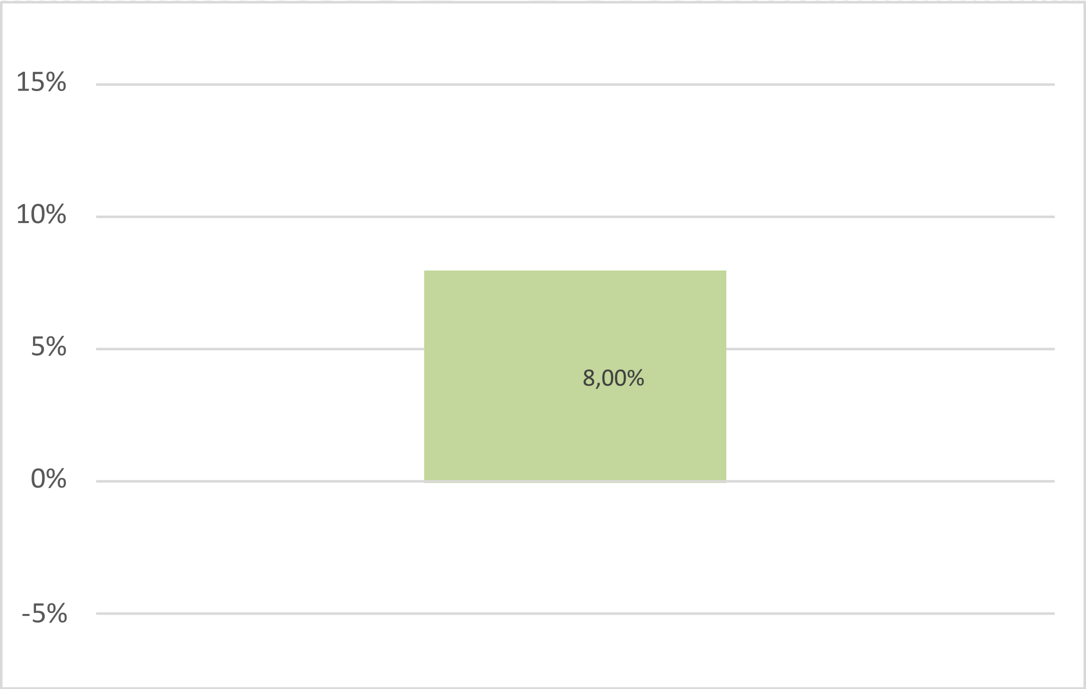

Noisy Environment

But my fund manager had an average performance of 8% per year in the last 15 years

Retail Markets: Demand

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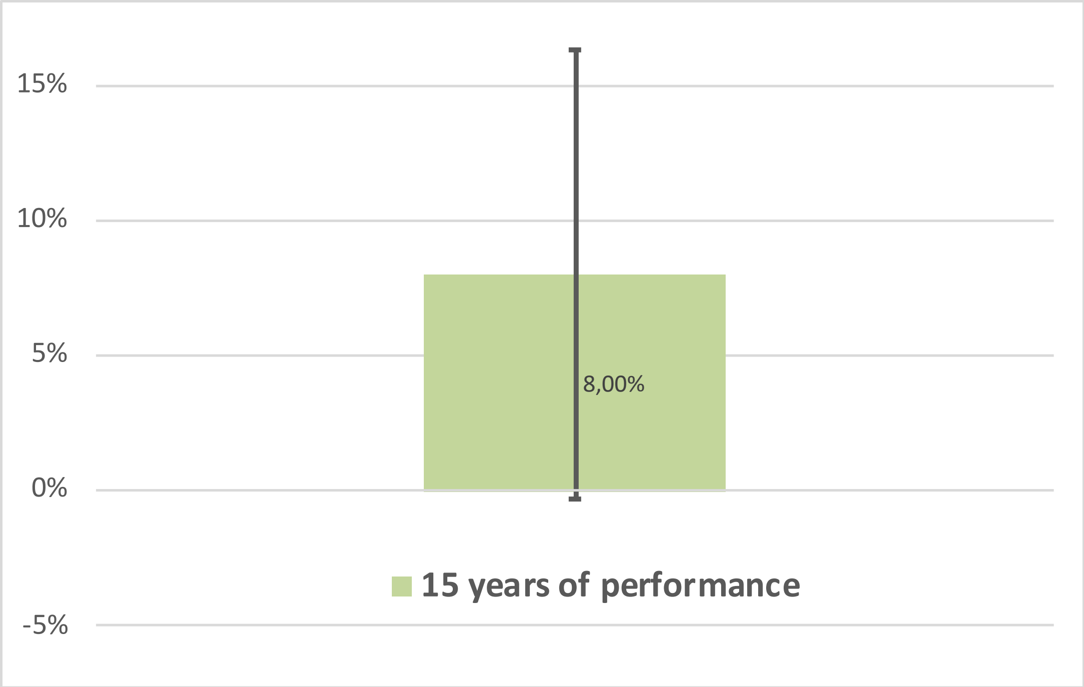
STOCKHOLM SCHOOL OF ECONOMICS



Noisy Environment

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Well ...

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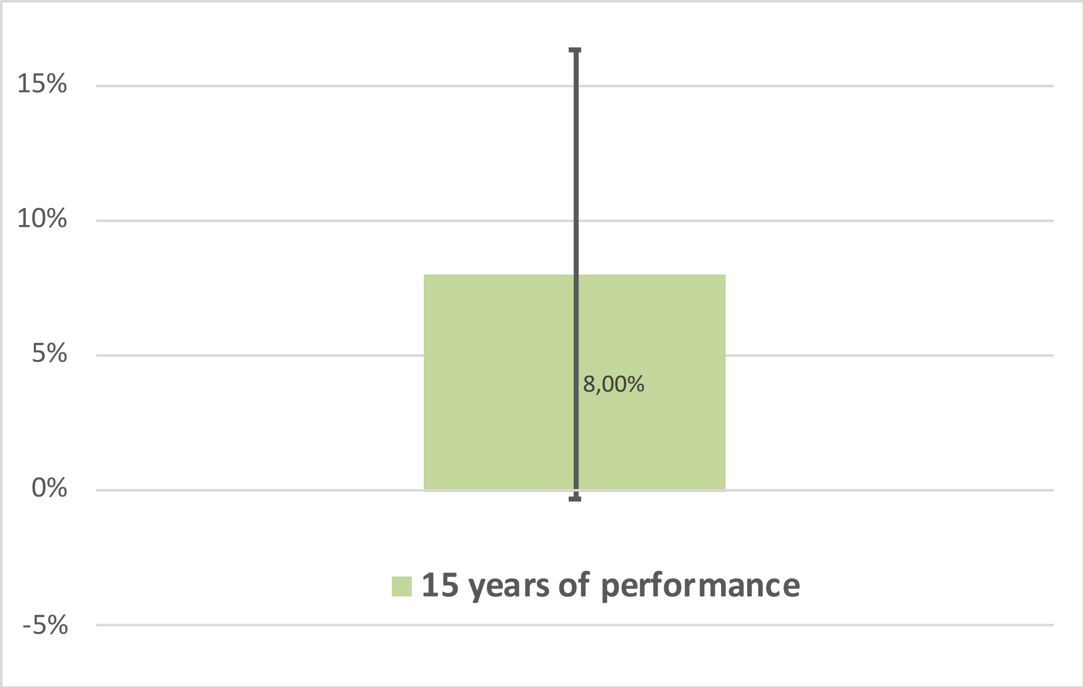


Noisy Environment

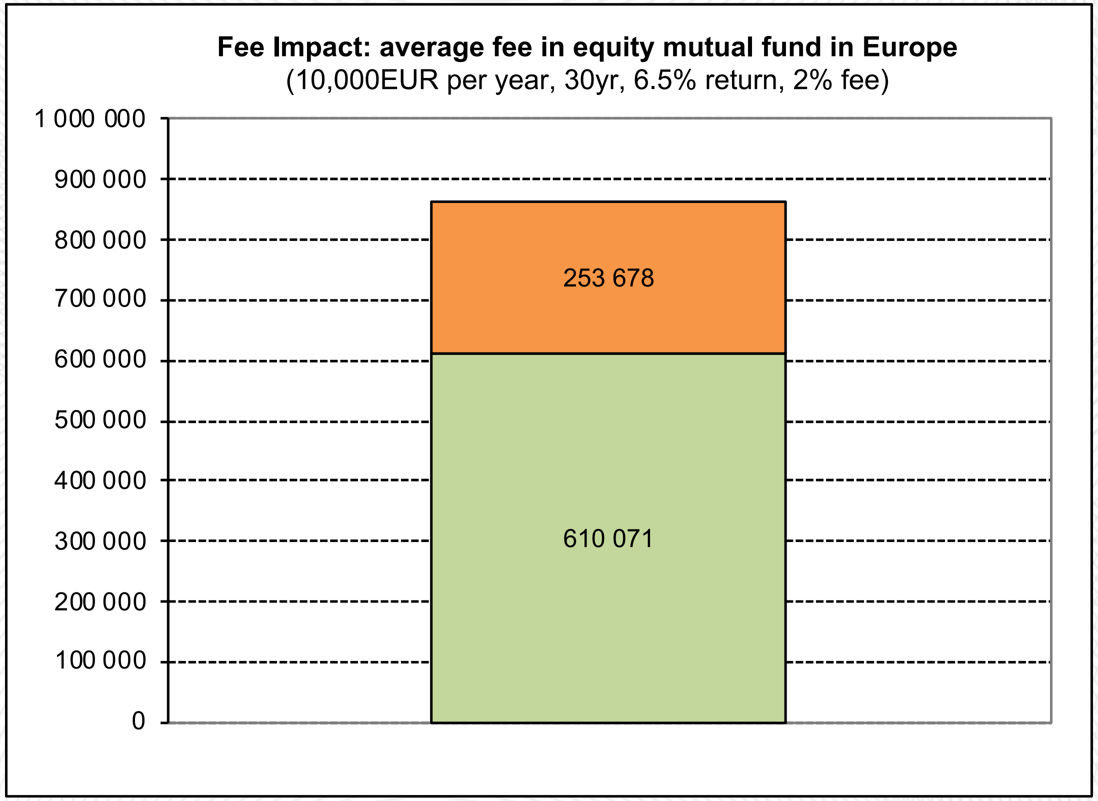
But my fund manager had an average performance of 8% per year in the last 15 years

Well … (Fama and French JF 2010)

This is Statistics 101 …

What about compounding?

Retail Markets: Demand



Difficult

Save 10,000EUR per year for 30 years

6.5% return

What is the impact of fees?

Average equity fund fee in Europe is 2%

Retail Markets: Demand

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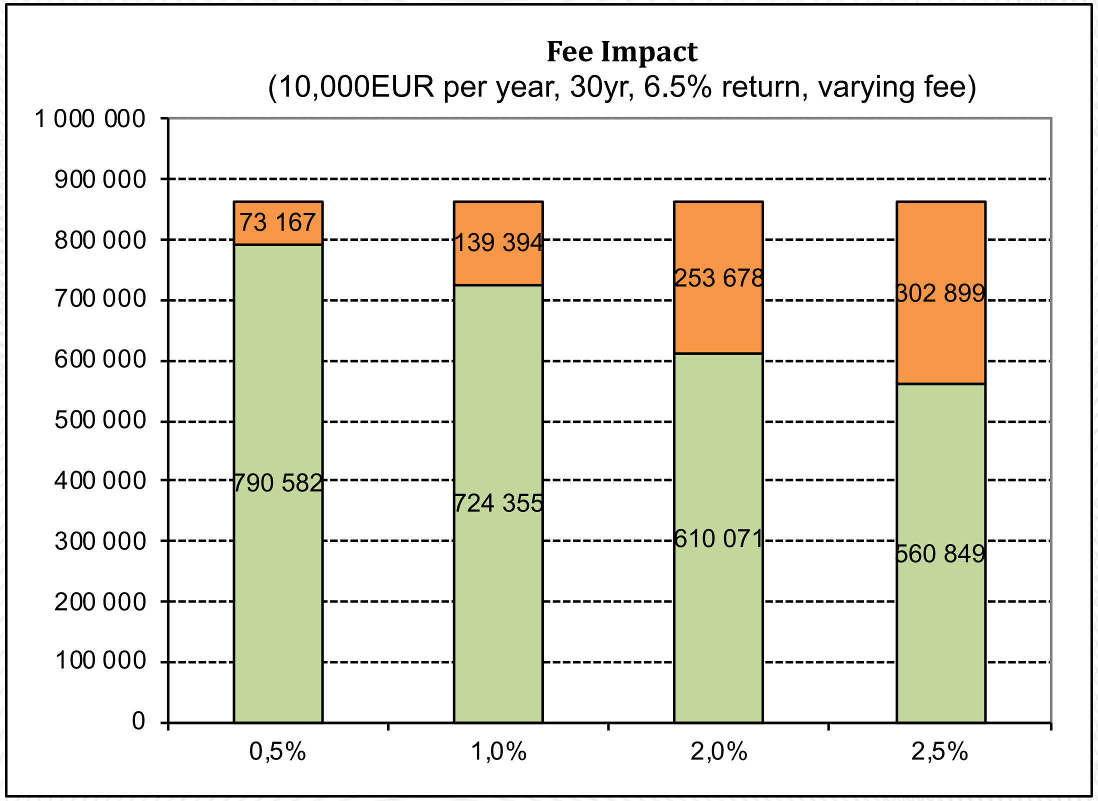

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Average equity fund fee in Europe is 2%

How often impact of fees are disclosed?

Incentive to disclose given commissions?

Retail Markets: Demand

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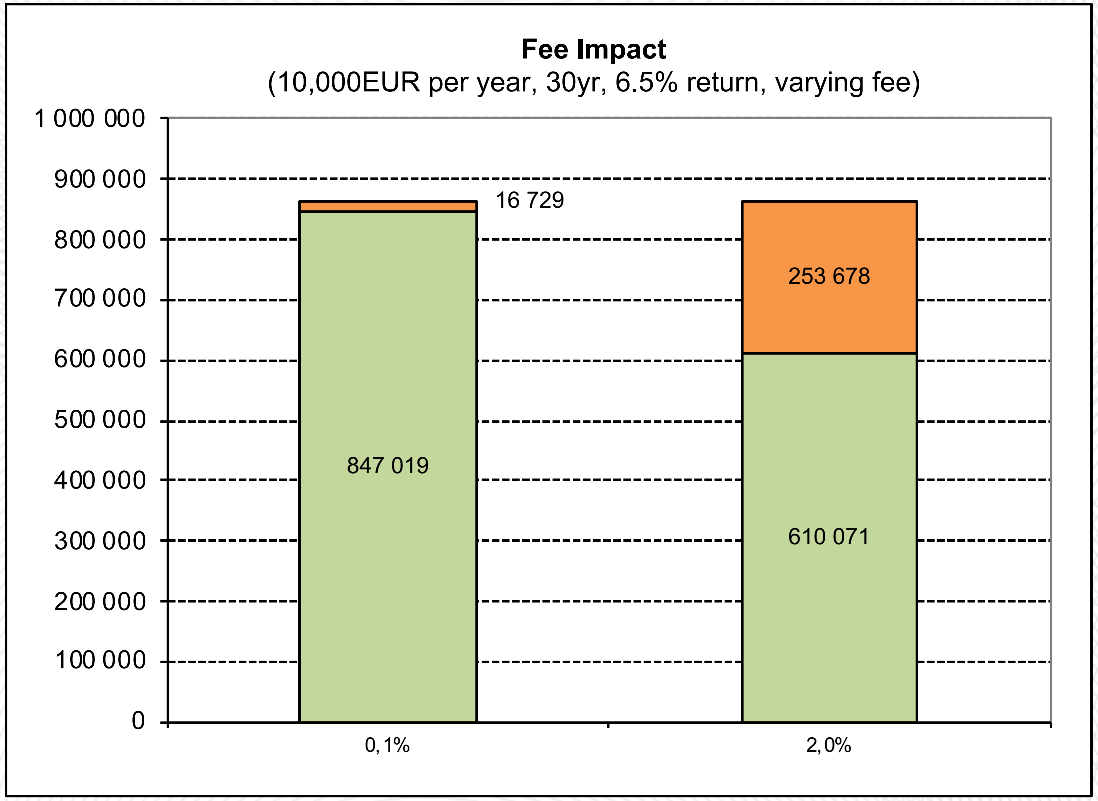

Difficult

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The Default Option in the Swedish Premium Pension system (PPM) has a fee of 0.11%

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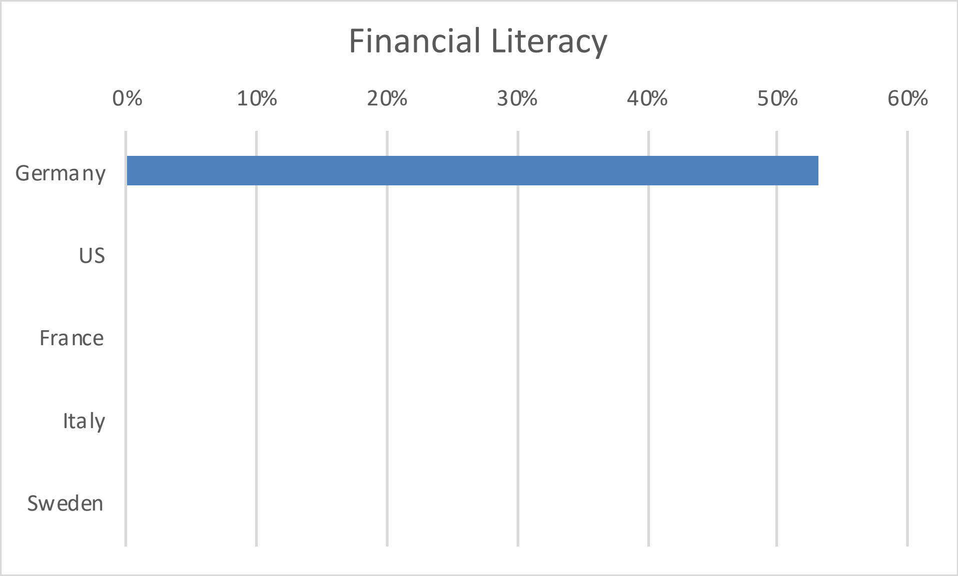

Difficult

Financial literacy is low:

Three basic questions:

1. Interest 2% per year, invest 100EUR, how much after 5yr? >=< 102?
2. Inflation 2%, interest rate in bank 1%. How much can one buy after one year with the money deposited? >=< today?
3. Is it riskier to invest in a mutual fund or a company stock?

How many get all three answers right?

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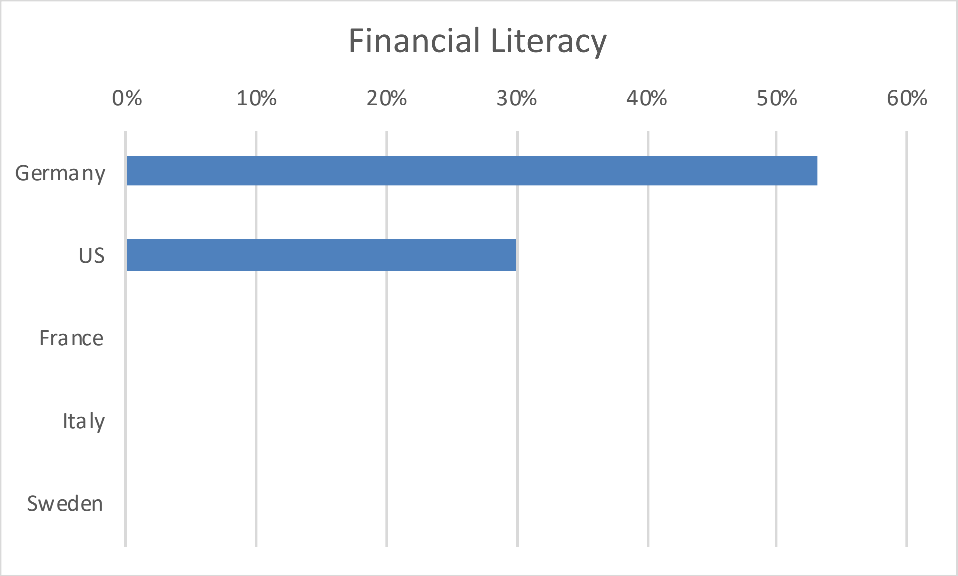

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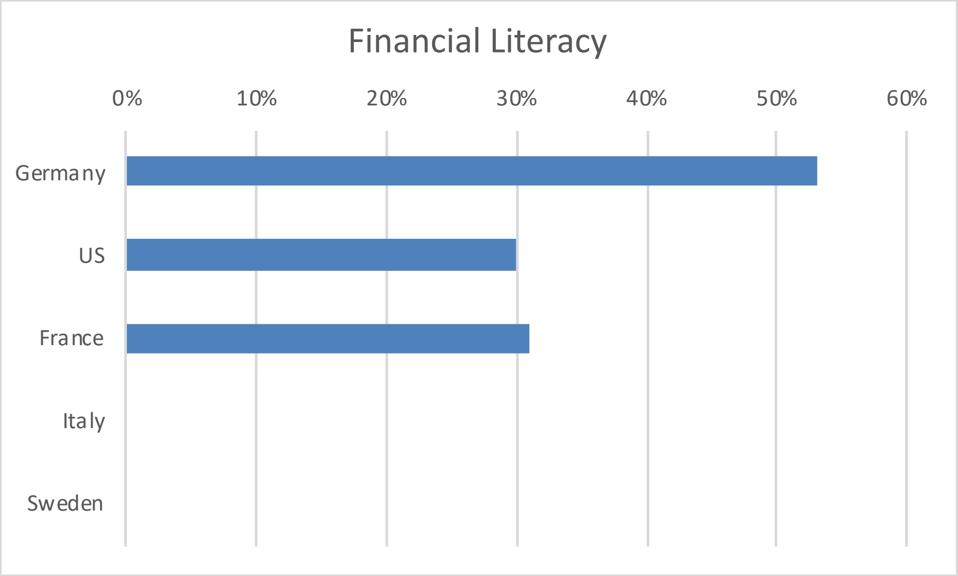

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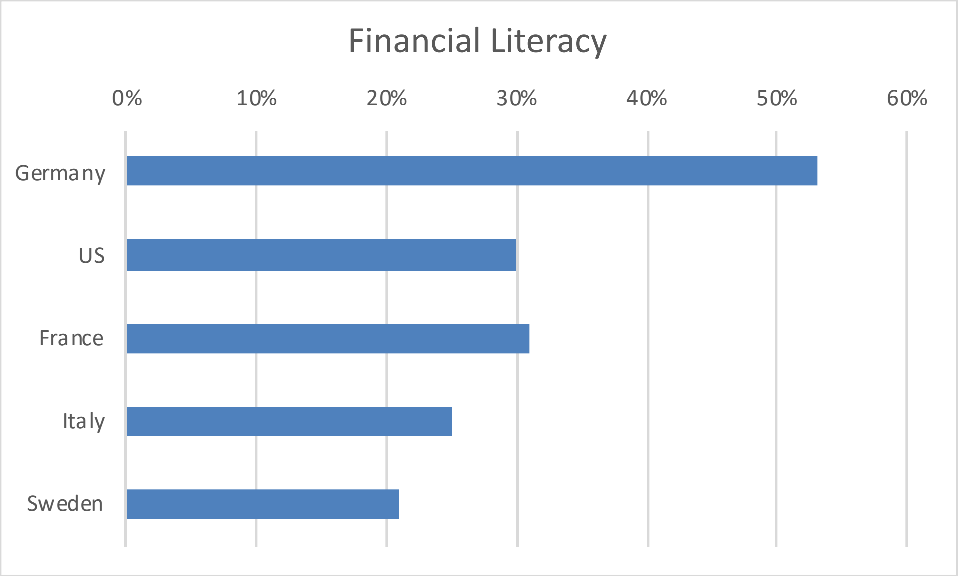

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Lusardi and Mitchell (2014)

Retail Markets: Supply

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- Financial decisions are taken in a very noisy environment
- Consequences of decisions manifest only over long period of time if ever
  - Lack of counterfactual
- Conflicts of interest
  - Commissions system
- Lack of transparency
- Proliferation of products
  - Approx 50,000 listed companies in the world
  - Approx 25,000 equity funds / ETFs
  - 14,000 available in Europe
- Since Markowitz (1952) and Sharpe (1964) we know about the importance of diversification. Why did it take so long for passive funds to be adopted?

Retail Markets: Supply

- Difficult for new entrants to gain market share
  - People trust expert managers not indexes
- Difficult to *de-bias* consumers
- Market with unsophisticated consumers can be stuck in a shrouded equilibrium
  - Gabaix and Leibson (2006)

- Regulation
  - Eliminate conflicts of interests
  - Improve transparency
  - Default options
  - Eliminate barriers to entry
    - Facilitate collection of information to ease robot advice
  - Collect data to evaluate losses from mistakes, product characteristics and adoption