STATE STREET.

Center for Applied Research

# U.S. Regional Snapshot

## THE FOLKLORE OF FINANCE

*The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry* represents the culmination of 18 months of research, conducted by State Street's Center for Applied Research. The study seeks to answer the question, "What does true success look like in the investment management industry?" True success, as defined in this paper, includes not only producing investment performance — perhaps more importantly, it also requires helping investors achieve their long-term goals, sustainably, over time. The findings suggest that the industry as a whole is failing to accomplish this. Long-standing traditions, perpetuated by psychological biases, hinder the realization of true success by investors and investment professionals alike. Ultimately, the paper provides a set of solutions designed to help the industry achieve true success. This document is derived from the overall paper, but offers commentary and data specific to the U.S.

The findings of the research are diverse and far-reaching. Notably, 60 percent of investment management industry spending goes toward the goal of outperformance. However, the majority of investment professionals believe this outperformance is due more to luck than skill. Meanwhile, the needs of investors are not being addressed; only 12 percent of investors across the globe and 20 percent of investors in the U.S. believe that they are wholly prepared to achieve their investment goals.

**GLOBALLY**

**12%** of investors, globally, believe they are wholly prepared to achieve their investment goals.

**USA**

**20%** of U.S. investors believe they are wholly prepared to achieve their investment goals.

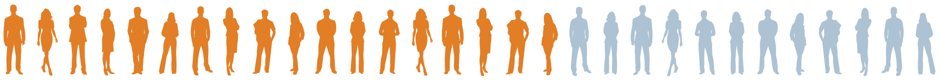
Results are equally weighted between mass market, mass affluent and high-net-worth investors.

All data throughout this document that is not specifically cited originates from Center for Applied Research Study 2014 — "The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry."

**KEY HIGHLIGHTS FOR U.S.:**

- U.S. investors trade in financial markets less frequently than investors in other countries.
- U.S. respondents score slightly worse than the global average on the financial literacy test.
- More so than in other parts of the world, U.S. investors cite retirement as their primary reason for investing.

## OVERCONFIDENCE OBSTRUCTING OPTIMAL DECISIONS



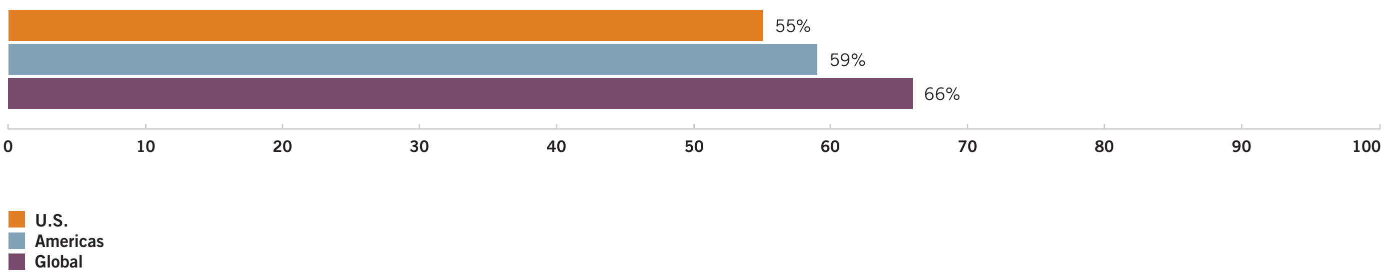
Results are based on 2012 data.[1] Responses include investors who agreed that their level of sophistication was somewhat advanced (11%), advanced (21%) or very advanced (29%).

NEARLY **2/3** of investors, globally, rate their level of financial sophistication as **"advanced."**

Investors are overconfident about their financial knowledge, and perhaps about their investment decisions as well.

**AVERAGE FINANCIAL LITERACY SCORE (100=PERFECT, 60=FAILING)**


**BELIEF THAT BEST INVESTMENT WAS ENTIRELY ONE'S OWN DECISION**




Prior to beginning our *Folklore of Finance* research, we asked investors about their level of financial sophistication. More than 60 percent of respondents categorized their investment acumen as somewhat to very advanced.[1] This result seemed overly optimistic. Therefore, in the *Folklore of Finance* study, investors were asked to complete a financial literacy exam, testing their knowledge of concepts such as diversification, inflation and basic investment options. The results indicated that on the whole, investors are overconfident in their abilities. In fact, the average global financial literacy score is just 61 percent, barely above a failing grade, and far from advanced.

Meanwhile, 66 percent of these same investors believe that their best investment is entirely a result of their own decision. Given their low financial literacy scores, this suggests that investors may be attributing more credit to themselves than is deserved. Alternatively, investors may not realize the importance of soliciting advice from professionals, or of pursuing additional investment education on their own.

U.S. respondents score slightly worse than the global average on the financial literacy test. They are also, however, less likely to take exclusive credit to their best investment decision.

[1]State Street Center for Applied Research Study 2012 — "The Influential Investor: How Investor Behavior is Redefining Performance." Based on responses of 2,725 investors in 14 countries.

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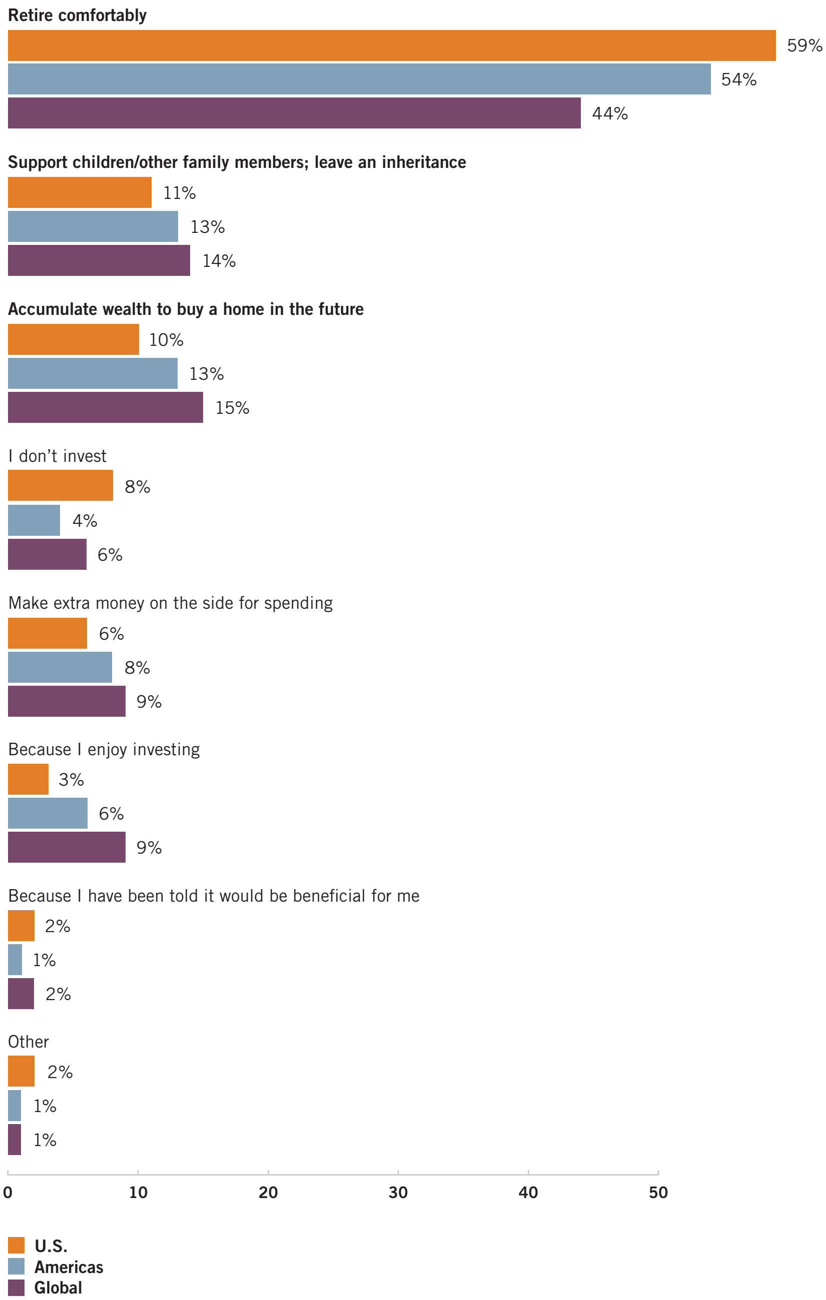
## SHORT-TERM ACTIONS DISTRACTING FROM LONG-TERM MOTIVATIONS

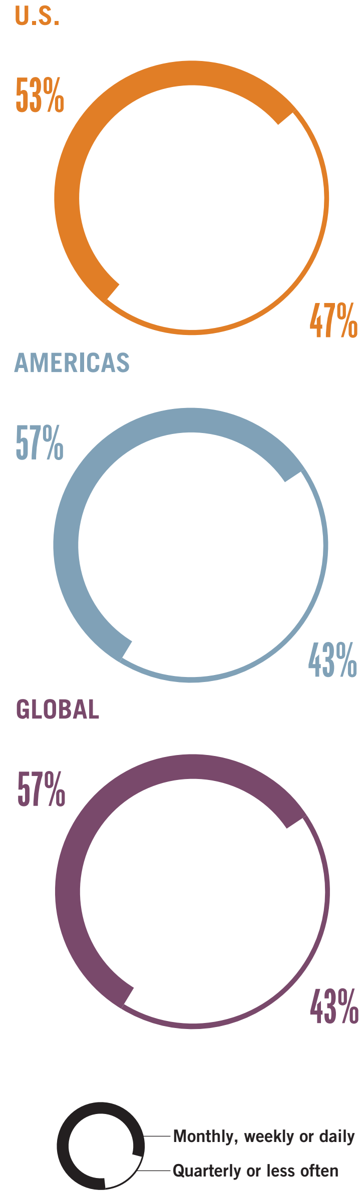
Across the globe, investors say their motivations are long term, yet many engage in short-term trading.

### REASONS FOR INVESTING




Responses highlighted in **bold** reflect long-term reasons for investing.

### TRADING FREQUENCY




Seventy-three percent of investors we surveyed cite long-term goals as their primary reason for investing. Despite their long investment time horizon, 57 percent of investors admit to trading in financial markets at least once a month. Academic research has found that investors who trade less frequently tend to outperform their peers over time.[2]

More so than in other parts of the world, U.S. investors cite retirement as their primary reason for investing. They also trade their portfolios a bit less frequently, although 53 percent of respondents still trade in financial markets at least monthly.

[2] Barber and Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors," April 2000.

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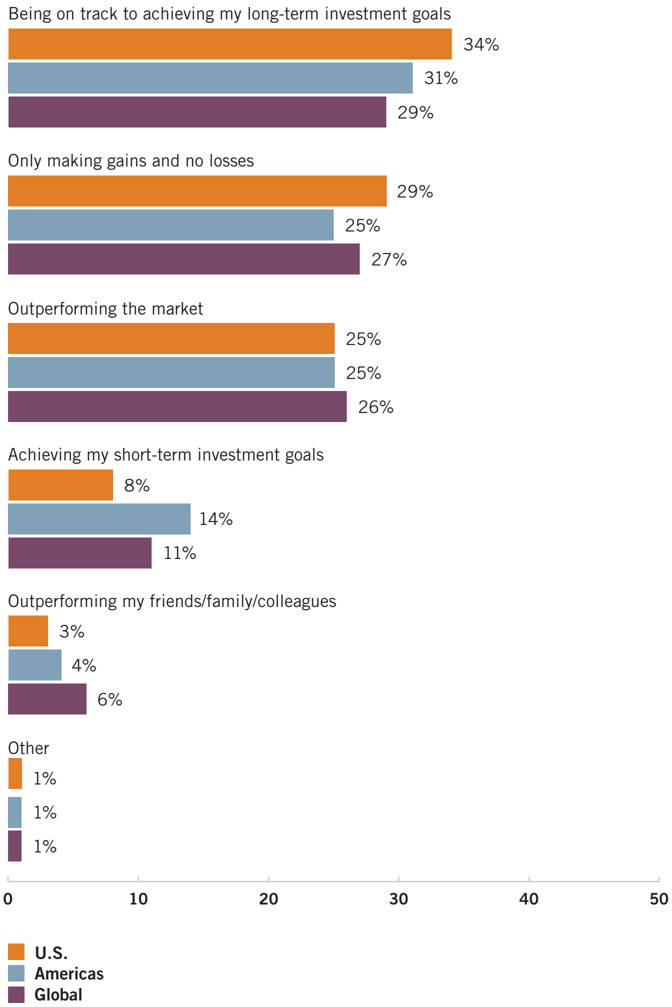
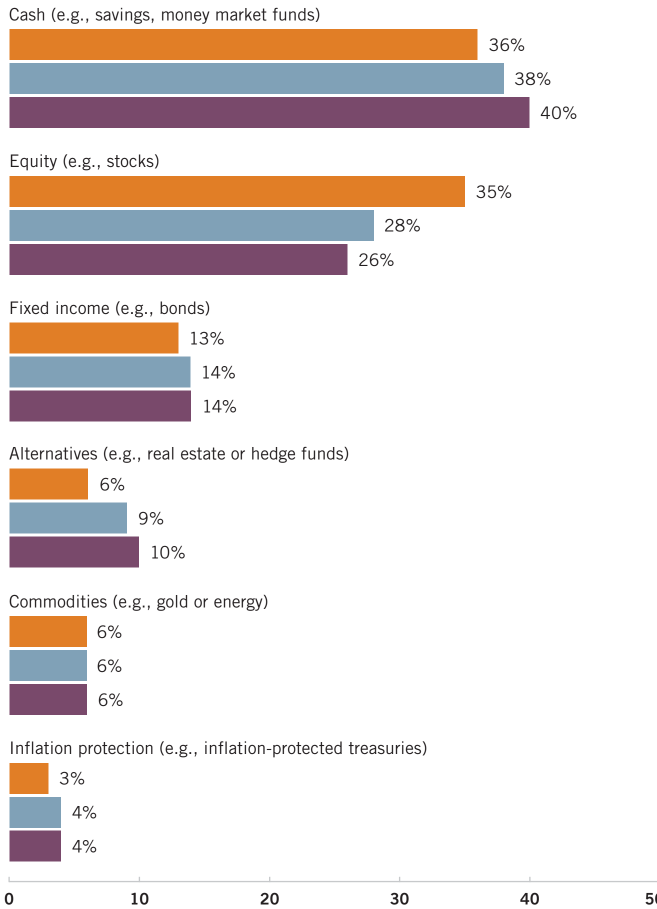
## PREFERENCE FOR CASH STANDING IN THE WAY OF SUCCESS

In order to achieve success, most investors must take risk. A high allocation to cash seems inconsistent with this objective.

### DEFINITION OF INVESTMENT SUCCESS




### PERCENT OF PORTFOLIO ALLOCATIONS




Only 29 percent of investors, globally, define success as being on track toward achieving their long-term investment goals. This is a concern, given that 73 percent of investors cite long-term goals as their reason for investing in the first place.

But even taking investors' definitions of success at face value, an interesting contrast emerges. In order to be on track for long-term goals (29 percent of respondents), outperform the market (26 percent of respondents), or outperform family and friends (6 percent of respondents), investors likely need to accept investment risk. Instead, we found that fully 40 percent of the average investor's portfolio is held in cash. With such high cash balances, investors may find it difficult to reach their goals or even achieve other measures of success.

In the U.S., investors are a bit more likely than investors in other countries to define success as being on track with their long-term goals, which is a good sign. U.S. investors also have a somewhat lower allocation to cash in their portfolios, compared with investors in other parts of the globe.

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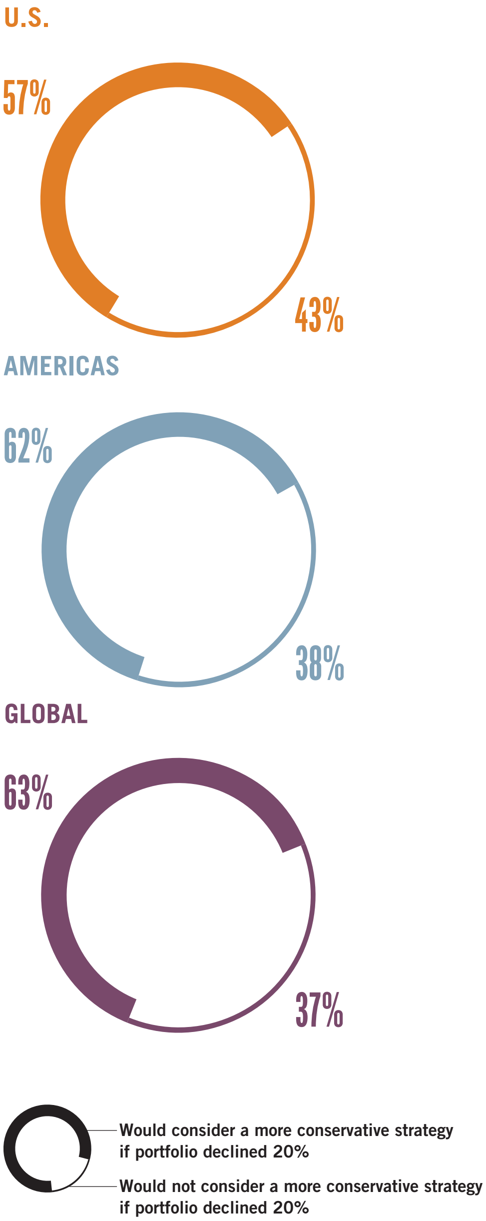
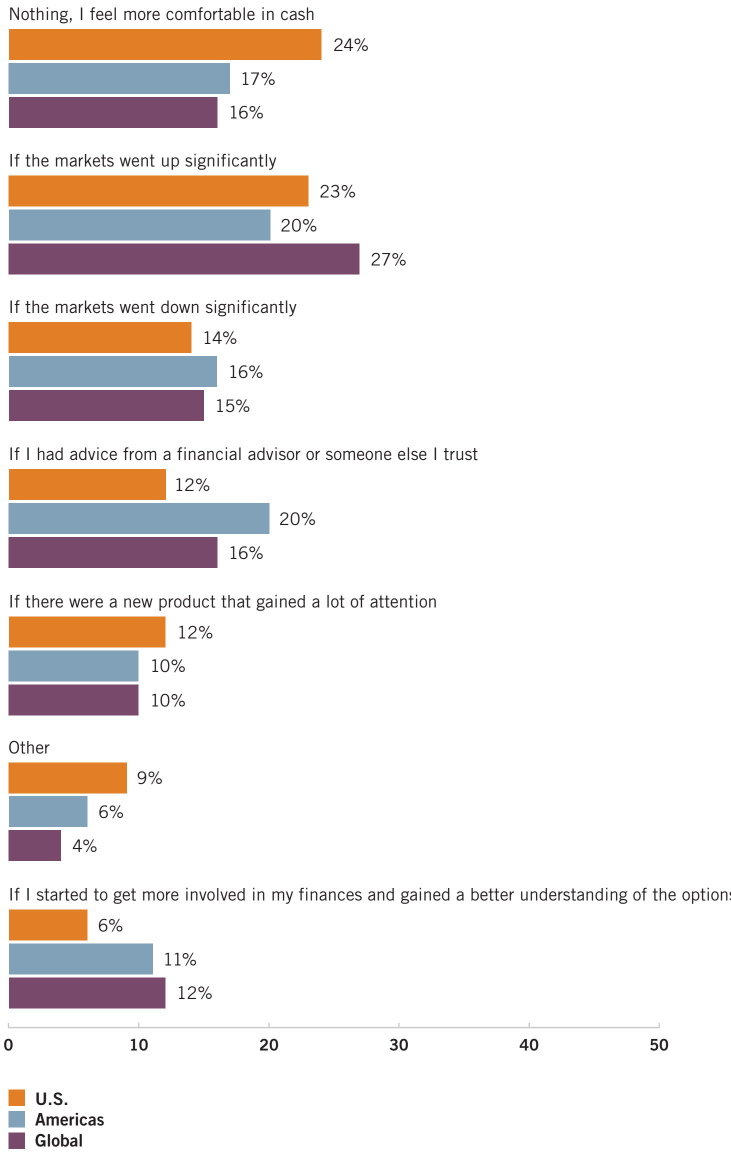
## BUYING HIGH AND SELLING LOW

Many investors run the risk of becoming overly conservative after losses and overly aggressive after gains.

**INCREASED CONSERVATISM AFTER LOSSES**




**MOTIVATION TO INVEST ADDITIONAL SAVINGS**




In total, 63 percent of investors around the world say they would consider moving to a more conservative investment strategy if their portfolio fell by 20 percent. Meanwhile, nearly a third of investors also say they would be tempted to invest additional savings if markets were to rise significantly.

The emotional appeal of selling during tough times and buying when things look better is understandable. However, the effect on a portfolio can often be undesirable because this behavior can result in selling at low points and buying back in after missing a market rebound.

U.S. respondents show a bit of a conservative streak in that a higher percentage of them prefer cash in any market environment compared with investors in other countries. However, U.S. investors are also a bit less likely to abandon their investment strategy after a loss.

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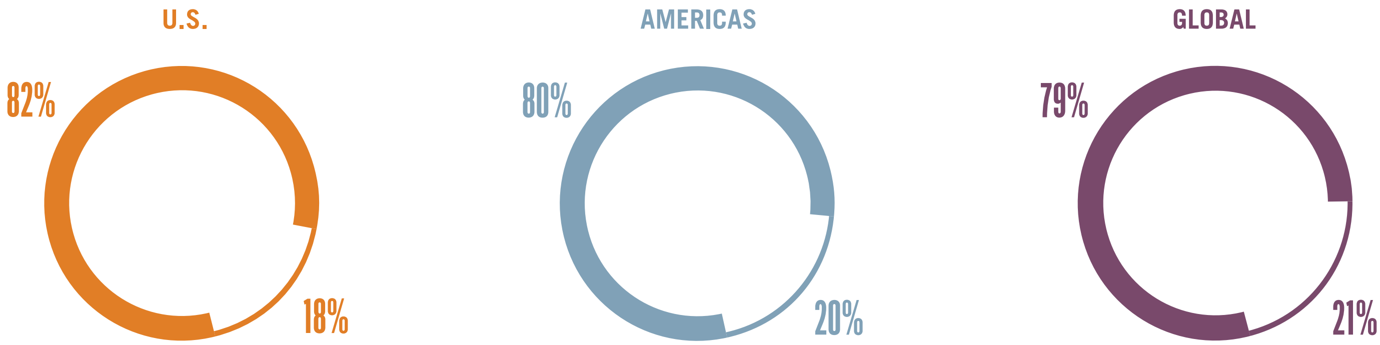
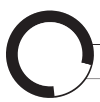
## SEEKING GUARANTEED GAINS, TAKING A CHANCE ON LOSSES

Investors are risk-averse when it comes to making additional gains, but risk-acceptant in the hopes of avoiding losses.

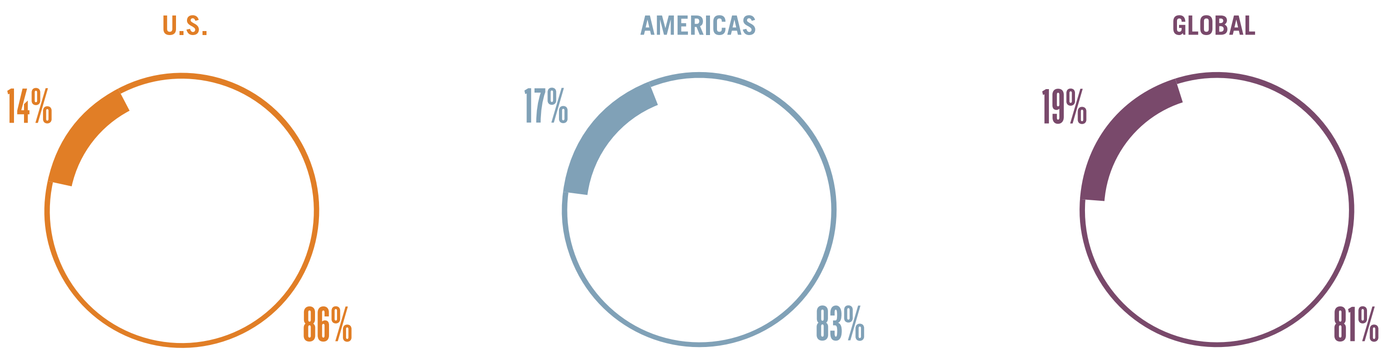
**AVOIDING RISK IN ORDER TO LOCK IN A GAIN**

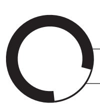




A 100% chance of winning $80,000

An 80% chance of winning $100,000 and a 20% chance of winning nothing

**TAKING RISK IN THE HOPES OF BREAKING EVEN**





A 100% chance of losing $80,000

An 80% chance of losing $100,000 and a 20% chance of losing nothing

The two questions above present two identical but inverse scenarios. The first question gives respondents the option to either accept a guaranteed gain, or risk gaining nothing in the hopes of possibly gaining even more. The second gives respondents the option to either accept a guaranteed loss, or risk a larger loss in the hopes of avoiding losing anything.

From the perspective of mathematic probability, both options have the same expected return. Therefore, a computer will logically always choose to lock in the gain or lock in the loss because these options involve the least uncertainty. Breaking with this logic, 81 percent of investors across the globe prefer to risk a larger loss in the hopes of avoiding losing anything. This way of thinking can sometimes push investors to take on inappropriate levels of risk in the hopes of recouping losses.

U.S. respondents are more likely than the average global investor to be willing to take additional risk in order to have the chance to avoid a loss.

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Underlying data derived from: Center for Applied Research Study 2014 — "The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry."

## METHODOLOGY

### Primary research

The Center for Applied Research obtained input for this study through surveys of 3,744 investors, investment providers, government officials and regulators, across 19 countries. Responses were collected via telephone interview or through an online platform by CoreData on behalf of State Street. In addition, we conducted face-to-face interviews with more than 200 executives and government officials from around the world to gain qualitative insights for our research. The research was completed over a period of 18 months.

Our analysis focused on selected investment community members representing a wide range of perspectives:

- **Institutional investors** — Defined contribution, defined benefit plans, sovereign wealth funds, central banks, insurance companies, endowments, foundation and family offices
- **Retail investors** — Mass market, mass affluent and high-net-worth individuals
- **Asset managers** — Traditional and alternative asset managers whose clients are institutional, retail or both
- **Intermediaries** — Financial advisors and investment consultants
- **Regulatory bodies and government officials**
- **Others** — Academics, think tanks and industry associations

### Geographical breakdown

A wide range of geographies were included.

- Retail: 16 countries were selected for participation; 3 in the Americas, 7 in Europe, the Middle East and Africa (EMEA) and 6 in Asia Pacific (APAC). From a total of 2,880 respondents, 19 percent were from the Americas, 37 percent from EMEA and 44 percent from APAC.
- Institutional and regulators: 19 countries were selected for participation; 3 in the Americas, 10 in EMEA and 6 in APAC. From a total of 864 respondents, 33 percent were from the Americas, 34 percent from EMEA and 33 percent from APAC.

### Secondary research

Secondary research is assembled from both academic literature and from sources with industry expertise. We use this to either support or refute the primary research findings.

### Percentages and weightings

All percentages are rounded.

Results are equally weighted by geographic region.

Within the retail investor results, views of mass basic, mass affluent and high net worth have been equally weighted.

Overall investor results are equally weighted to give retail and institutional investors an equal voice.

Industry results are equally weighted among categories to give industry participants an equal voice.

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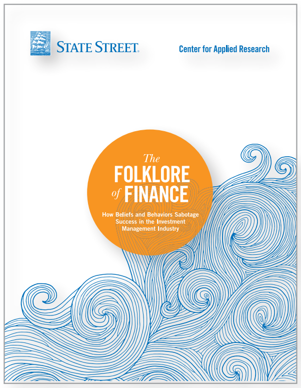
Access the full report at
**statestreet.com/centerforappliedresearch**.




The *Folklore of Finance* study is based on input from more than 3,700 investment management industry participants across 19 countries, representing the Americas, Europe, Middle East, Africa and Asia Pacific. This included both professional and individual investors. The Center for Applied Research also conducted face-to-face interviews with more than 200 executives and government officials globally to gain qualitative insights.

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