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Your Money

What You Think You Know About Money, but Don’t, Can Hurt You

Strategies

By JEFF SOMMER JULY 23, 2016

Misplaced self-confidence about finances is putting millions of people at risk.

Americans have grown more confident about their financial acumen since the market meltdown that ended in 2009. Yet they seem to know less about the subject than they did then.

And most people didn’t even know much about it in 2009.

These troubling conclusions arise from the latest data in a long-running study by the Finra Investment Education Foundation, which has been assessing Americans’ financial knowledge, attitudes and well-being for years. The “Financial Capability in the United States 2016” study is based on an online survey of more than 25,000 people. While it contains some positive news about household finances, many of its findings are discomfiting.

In fact, they suggest that misplaced self-confidence is putting millions of people at risk. They are vulnerable to major missteps — and to exploitation by industry pros who may not have their best interests at heart.

Over all, the study found that most Americans have “relatively low levels of financial literacy.” It included the results of a six-question quiz on fundamental financial issues that may be taken online. The questions were intended to be very basic and thus easy. Yet the average person got only about half the answers right.

Five of the questions have been on the quiz for years, making statistical comparisons possible. The trend is not encouraging. Only 37 percent of the people who took the quiz were able to get four of these five questions right in 2015. That compares with 39 percent in 2012 and 42 percent in 2009.

The worst performance was on a question about how bond prices respond to rising interest rates. Only 28 percent of people in 2015 got that one right.

The correct answer is that bond prices will fall. That’s because interest rates and bond prices move in opposite directions, like children on a seesaw (known in some playgrounds as a teeter-totter), as I explained in an earlier column.

This isn’t just academic. It’s the core explanation for why bond mutual funds, on average, returned 2.6 percent in the second quarter of this year, a very handsome performance and one that was better than that of stock mutual funds, which gained 2.2 percent, according to Morningstar. Falling interest rates drove bond prices higher.

What's more, it's critical to understanding the effects of one of the more important and puzzling phenomena of current markets: the proliferation of negative interest rates. The rate-bond seesaw is why negative interest rates — which have been spreading as central banks seek to stimulate a still sluggish global economy — can produce positive returns, when rates are still dropping further. Should you buy a bond with negative interest rates? Certainly not if you don't understand bond basics.

The new question in the quiz focuses on a problem that lands many people in trouble when they pay only the minimum amount each month on their credit card balances: compound interest.

"Suppose you owe $1,000 on a loan and the interest rate you are charged is 20 percent per year compounded annually," the quiz asks. "If you didn't pay anything off, at this interest rate, how many years would it take for the amount you owe to double?"

The correct answer is two to four years (actually, it is about 3.6 years, but it's a multiple-choice quiz). Most people thought it took much longer than that, grossly underestimating the impact of interest charges. As the study points out, this lack of knowledge hurts now and could become lethal: When interest rates rise, if you ignore compound interest, you can drown in debt.

An alarming aspect of the study is that although most people knew very little, they felt great about what they knew — or thought they knew. "Americans tend to have positively biased self-perceptions of their financial knowledge," the study said. And the positive bias has been increasing.

The study found that 76 percent gave themselves a "very high" rating on financial knowledge in 2015, compared with 73 percent in 2012 and 67 percent in 2009. And while 81 percent of Americans rated their own financial behavior positively, the study found a "potential disconnect between perceptions and actions in day-to-day financial matters."

Large numbers of people, for example, said they were running up late fees and interest payments on credit cards, overdrawing bank accounts and borrowing money from costly nonbank sources.

The good news is that many households are in better financial shape than they were in 2009 — but then, they ought to be, because financial conditions are much better. In 2009, the prices of homes and most other assets had fallen sharply, foreclosures were rife and unemployment was soaring. People had been taking financial risks, and they paid for it. In that period, as an example, only 24 percent of home buyers paid more than than 20 percent of the purchase price as a down payment. By 2015, people were behaving more conservatively: a third managed to make that big a down payment. And in 2015, fewer people were having trouble paying their bills and more people said they were comfortable with their financial condition.

Still, the survey found that significant hardships continued, "Large segments of society continue to face financial difficulties, particularly minority populations and those without a college education."

Most Americans are still worried that they won't have enough money to retire, but only 39 percent have ever tried to figure out how much they will need. When financial conditions worsen — and whenever the next recession hits, they certainly will — indicators of financial well-being will certainly decline. But unless the state of financial literacy improves radically by then, vast numbers of people won't be equipped to deal with these problems.

Financial literacy programs in schools are helpful, and they are expanding, but most students still aren't required to learn about these subjects.

Government efforts to require financial advisers to follow a fiduciary standard — to put the interests of ill-informed clients first — are likewise underway, but they are still incomplete. In the world we live in, misplaced self-confidence is dangerous. The reality is that a great deal more needs to be done.