

INVESTORS' FINANCIAL EXPERTISE AND RATIONALITY: A CANADIAN STUDY

**CIRANO note on a study by Cécile Carpentier and Jean-Marc Suret,
November 2011**

Two fundamental components are at the root of investors' financial competence. The first is knowledge and the competence required to capitalize on it, which is often identified with literacy. The second is rationality, which can be equated with the absence of significant biases, such as overconfidence. To assess investors' level of knowledge and rationality, we asked individuals who independently administer personal stock portfolios to complete an online questionnaire. A total of 1814 individuals qualified for the survey, in that they own shares in corporations listed on the exchange and are the principal decision-makers in their management. These individuals administer a portfolio worth approximately \$200,000, of which most is invested in the stock of large or small firms listed on the exchange.

The first phase of the survey confirmed that Canadian investors' overall level of knowledge is limited. Only 5 % obtained scores exceeding 66 %; the vast majority fell between 40 and 57 %. Significant shortcomings are observed in the comprehension of risk and the yields associated with different asset categories. Knowledge of the historical yields of the broad categories is strikingly absent. This poor grasp of the performances of the categories and of the notion of risk premiums has disturbing ramifications for investors' ability to plan.

The second phase of the questionnaire is designed to test the extent to which behavioural biases affect Canadian investors.

The most surprising result appears to be in the expected yields of individually managed portfolios. Most of the investors we canvassed expect a yield that falls below the reference index. Overconfidence is reflected in the presumed ability to detect exceptional values: 77 % of investors claim to be able to identify the outstanding security from a selection

of 20. Investors also demonstrate overconfidence in that most of them believe that the average forecasts of experts are wrong. Finally, an excess of optimism is also observed: one-half of investors significantly overestimate the probability of obtaining windfall gains when investing in a firm on the TSX Venture Exchange.

We asked the respondents to rate their own skill level in three key elements of portfolio management: securities selection, market trends, and the timing of buy and sell operations. We compared investors' self-assessed competence with their actual competence, as measured with a score. In general, for these three elements, investors consider themselves to be much more competent than their scores bear out, and there is only a weak correlation between perceived and measured skill levels.

A considerable proportion of these investors, approximately 30 %, prefer securities with the attributes of lottery tickets, which is consistent with our observations of negative yields on issues of small-cap stocks.

Our observations thus confirm the presence of some behavioural biases—of which the principal ones appear to be excessive optimism and an exaggerated confidence in their possessing the knowledge and skills required to obtain a high yield. In particular, in all likelihood investors overestimate their ability to select winning securities. The study draws on a detailed questionnaire that could eventually be reused to measure investors' progress subsequent to literacy initiatives.

The complete study can be found on the CIRANO Website at the following address (French only):

<http://www.cirano.qc.ca/pdf/publication/2011RP-10.pdf>