

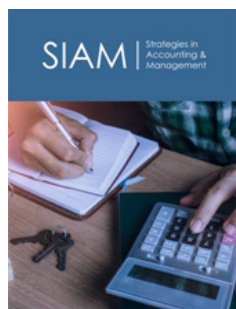
# Financial Literacy is Important

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## Introduction

Evidence suggests that financial literacy is a major problem in the U.S. Workers appear to be unable to make educated retirement-oriented investment decisions; consumers do not seem to understand the true cost of credit; college students often borrow to finance their education without knowing how they will be able to pay off their indebtedness. Poor financial decisions by individuals not only hurt themselves and their families but also the rest of society as a result of government intervening to help those that have put themselves in a financial bind. Thus, financial ignorance in its broadest sense causes a misallocation of individual and societal resources.

## Sources of financial information and advice

Attempts have been made by a number of institutions to help alleviate this problem. For example, educational institutions (e.g., colleges, high and even elementary schools) have created personal finance courses, banks and similar institutions offer easily accessible computer software to address the financial needs of their patrons, and the Chartered Financial Analyst (CFA) institute creates and distributes useful financial information. Importantly, the need for financial advice has led to the creation of a financial advisory industry with some of its participants only providing financial advice and others not only provide advice but also sell products in an effort to meet their clients' perceived objectives. The individuals in the first group are said to have a fiduciary responsibility to the client, meaning that to the best of their ability they must act in their client's best interests. Adults (60 years of age and older) tend to be the major clientele (at least in numbers) for financial advisors. The is most likely a result of their acquiring a variety of assets over their working life and are now trying to make sure that they can employ these assets in such a way so that they are financially secure for the rest of their lives. They may also want to have enough left over to leave a significant inheritance to members of their families or gifts to institutions of their choice.

## Does an older adult need an advisor?

In most case, we believe that the answer to this question is "Yes" because they should be generally familiar with the older adult's current assets and they have a broader knowledge of the markets than a typical individual. However, despite the perceived quality of the advisor, the investor should still strive to be financially literate so that she can get the most out of the advisory experience and make decisions with which she is comfortable. To illustrate our point, consider the situation that the investor thinks that it may be a good idea to review her common stock portfolio and possibly increase its size. The advisor proffers a list of possible stocks along with their alpha and beta scores and says these numbers will guide her toward an appropriate decision. The investor asks how these numbers accomplish the selection. The advisor responds that alpha measures abnormal returns and beta measures volatility. Exactly how do these two measures do that she inquires? Oh, the advisor responds, this is technical stuff and is handled by my firm's statisticians. All we need to do, the advisor continues, is to fill out this questionnaire so that we can get an handle on your risk tolerance. Then, our team can construct a portfolio of stocks for you that will meet your needs.

Would it have been harder to say that alpha is the excess return of at stock (or portfolio) over a market index and beta is a measure of volatility (systematic risk) of a stock (or portfolio)

relative to the market index? Would it have been harder to provide a brief explanation Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM) both of which are the foundations of alpha and beta? Would it have been harder to mention that alpha and beta estimates are often assumed to be constant but in reality, change over time? Would it have been harder to discuss the idea that the distribution of returns may be asymmetric, and it might be useful to consider the left (negative) tail of the distribution when thinking about risk? Would it have been harder to mention that the frequency of the data being used might affect the parameter estimates and not be appropriate for the client? Finally, would it have been harder to discuss the notion randomness of stock picking given the success that dart throwers have had in selecting high performing stocks?

## Concluding Remarks

If the financial advisors response in our example seem superficial, we fully agree. In fact, we have had similar conversations with individual advisors over the years. In fact, in one instance, the financial advisor wanted to change the responses of the risk questionnaire so that they were consistent with the composition of the stock portfolio selected. The end result of our individual conversations with them often has resulted in an unpaid and probably unwanted lecture on MPT, the CAPM and how their prescriptions different from those of individual stock picking. So. "YES" the ability to understand the reasons why one's assets are invested as they are in indeed important. The financial advisor should be the client's financial partner with the sole objective of meeting the client's financial goals.

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