Brent Sheather's

RESEARCH

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Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

FINANCIAL ADVICE AND INVESTOR BELIEFS: Part 3

Two weeks ago, in part two of this three part series on financial advice and the extent to which active and passive strategies are pitched to clients, we looked at the NZ scene. Today we finally get around to reviewing the paper which provoked this series: "Financial Advice and Investor Beliefs". It was written by Antoinette Schoar from MIT and Yang Sun from the Brandeis International Business School and published in September 2024.

The authors look at "financial advice and investor beliefs" and how retail investors assess and update their prior beliefs based on different types of financial advice. The focus is on how investors react to advisors who advocate an active, stock picking approach versus a passive, diversified strategy.

First off the authors provide some context as regards the retail financial advice scene:

"Households in the U.S. and other developed economies regularly face complex financial choices, from allocating their retirement savings to insuring against health shocks and beyond. To help consumers with these decisions, a large and almost equally complex market for financial advice has developed alongside. This financial advice can take many forms, from traditional in-person advice by individual advisors, technology-aided (robo) advice tools, to increasingly online financial education resources and videos.

While a large and growing literature has analyzed the factors that shape the supply of financial advice, there is very limited evidence on how the demand side receives and processes the advice. In this paper we address this gap by conducting a randomized control trial (RCT) to investigate how investors process different types of advice, how individuals' perceptions of financial advice are influenced by their prior beliefs about investment strategies, their financial literacy and their self-assessed financial knowledge. We further evaluate the extent to which advice can successfully change people's posterior beliefs and whether people act upon financial advice when making portfolio choices.

We focus the advice on two of the most prominent investment strategies that are available to retail investors: active versus passive investment strategies. These strategies represent one of the oldest debate in the asset management literature. Most of the academic finance literature suggests that passive strategies dominate active strategies for retail investors who have limited time and knowledge to monitor their portfolios. However, active investment strategies still command a significant market share. In 2022, passive strategies held 46% of all fund assets, up from 13% in 2005 (ICI 2022). Our context allows us to analyze how investors assess the quality of advice and update their beliefs when receiving "textbook" advice, i.e., passive investment advice, compared to active management advice."

The paper documents four major conclusions are as follows:

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- What a prospective client thinks of the two types of advice is a function of their prior beliefs. For example, if you have managed your own business in the past and have been successful you might perceive this ability to "win" as being equally applicable to the investment world and thus gravitate to an "active" approach. Conversely a less confident individual with a more cynical view of the world might be more inclined towards a passive approach.

- Despite the existence of prior beliefs, advice that contradicts your view tends to make people reassess their position however the extent to which they update their views depends upon their financial literacy. "More financially literate participants positively revise their beliefs on the receipt of passive pitch but show no change following the active advice. In contrast those with lower financial literacy are strongly influenced by either types of advice."

- People who are confident about their knowledge of the financial world tend to discount financial advice and are less likely to change their minds with respect to the passive/active choice as a result of an advisor's pitch. The research also suggests that confidence sometimes dominates financial literacy when determining the relative attractiveness of passive versus active: highly confident individuals with higher levels of financial knowledge are often more receptive to the narrative of active management. I recall pitching the attractions of a combination of passive and active management to an individual who had been a highly successful residential property investor about 30 years ago and he expressed a distinct lack of interest in doing " as well as the average." Unfortunately I didn't get the chance to determine whether he was suffering from overconfidence or lack of knowledge of the subject.

- Prospective clients are keenly focused on how the advisor is paid so tend to change their prior views if the advisor has less perceived financial conflicts. The authors give the example of a "flat fee" as being good and "commission-based compensation" as being bad. What the research doesn't say however is whether prospective clients are able to discern all the perceived financial conflicts and make an informed judgement as to the extent of total fees and how this impacts prospective returns. Thus this research seems to suggest "how you will be paid" is more important than "how much it will cost". That's consistent with my experience too and many people seem to be oblivious to "how much it will cost" given the complexity, multiple fee streams and the fact that many advisory firms make it difficult to see the total cost implicit in their proposal.