Financial illiteracy costs Americans tens of billions

By Editor Test *Wed, Aug 24, 2011*

If they were more financially sophisticated, Americans could be paying much less in mortgage interest and mutual fund fees, says financial literacy scholar Anna Lusardi.

Lack of financial sophistication costs Americans tens of billions of dollars a year in unnecessary mortgage interest and investment costs, according to research recently published by Anna Lusardi, a George Washington University expert in financial literacy.

The paper, entitled "Financial Literacy, Retirement Planning and Household Wealth," was based on surveys in the Netherlands but the results are considered applicable to the U.S. Co-authoring the paper were Marteen van Rooij of the Dutch Central Bank and economist Rob Alessie of the University of Groningen. The paper was published this month by the National Bureau of Economic Research (NBER).

Regarding excess mortgage fees, the paper said, "Suboptimal refinancing among US homeowners result in mortgage rates that about 0.5–1% higher on average. Given the current size of the U.S. mortgage market, this is equivalent to $50–100 billion additional annual interest costs paid."

In the matter of investment costs, the paper said that U.S. investors could save billions by investing in index funds instead of actively managed funds.

"US investors are estimated to have foregone 0.67% of average annual equity return because of fees, expenses and trading costs of active investment strategies in an attempt to beat the market," the paper said. "This amounts to a total annual cost of about $100 billion that could have been saved by passively following the market portfolio.

Based on data gathered in the Netherlands, the researchers estimated that people with high financial literacy have a median net worth of € 185900 ($268,210), or about quadruple the median net worth of those with lowest financial literacy (€ 46700; $67,377).

"The net worth difference associated with the difference in the 75th and 25th percentiles of the advanced financial literacy index"—those at the top and bottom of the middle 50%—"equals € 80000 ($115,426), i.e., roughly three and a half times the net disposable income of a median household," the paper said.

People who are financially literate tend to accumulate more money over their lifetimes because they do more financial planning, invest in stocks, and diversify their assets, the researchers wrote. People who are less financially literate are discouraged from planning or acting on their plans because they are constantly faced with a high learning curve.

As Lusardi and her co-authors put it, "Financial literacy lowers the costs of collecting and processing information and reduces planning costs, thereby facilitating the execution of financial decisions and bringing down economic and psychological thresholds for stock market participation or retirement savings calculations and subsequent development of retirement plans."