

FINANCIAL LITERACY AND FINANCIAL SOPHISTICATION IN THE OLDER POPULATION: EVIDENCE FROM THE 2008 HRS

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Older Americans are not particularly financially literate, as shown by Lusardi and Mitchell (2006) using data from a special-purpose module the authors created for the 2004 Health and Retirement Study (HRS). These findings have been confirmed among Early Baby Boomers, who displayed not only low numeracy, but also a lack of knowledge of fundamental economic concepts such as interest rate compounding. Moreover, particular subgroups of the population suffer even greater deficits in financial literacy; for example, women display much lower literacy than men and are much less likely to plan for retirement. Furthermore, minorities and those with low education and low income are more likely to display low levels of financial knowledge.

These results are troublesome given the increasing complexity of financial instruments and the many transactions households must undertake that require sound economic understanding. For instance, studies found that mortgage borrowers knew little about compound interest and were confused about the terms of their mortgages and that many households failed to refinance their mortgages over the 2001–2003 period, when interest rates were falling. Furthermore, financial illiteracy can have significant long-term financial consequences. For example, those who underestimate the power of interest compounding are more likely to end up with excessive amounts of debt. Those who fail to refinance or to correctly estimate the amount by which interest rates could change will pay significantly more in mortgage interest.

Most prior financial literacy studies have relied on evidence gathered in a short experimental module in the 2004 HRS designed by Lusardi and Mitchell. This set of questions has been used very successfully to explore the links between financial literacy and retirement planning as well as retirement wealth accumulation. Nevertheless, that module included only three questions designed to assess basic numeracy and knowledge of basic economic concepts such as inflation and risk diversification. For this reason, we have sought to expand the scope of investigation into financial knowledge in the older population by designing additional questions. Using this extended information, we can now classify respondents not only in terms of basic *financial literacy* but also in terms of *financial sophistication*.

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An interesting aspect of the 2008 HRS module on financial literacy is its innovative approach to assessing how the literacy questions are designed. Not only is there a richer list of questions compared to the 2004 HRS, but also respondents are presented with alternative question wording to assess whether they are guessing or understanding the questions. Specifically, respondents are randomly selected to be shown the same questions but with reverse wording. For example, one set of respondents is asked whether the following statement is true or false: "If you invest for the long run, the annual fees of mutual funds are important." The second group is asked: "If you invest for the long run, the annual fees of mutual funds are unimportant." Such wording reversal permits us to begin to evaluate the extent of measurement error in responses to financial sophistication questions. This is a very important methodological innovation. Both the Dutch DNB Household Survey and the American Life Panel used a similar approach for a small subset of the questions, and there we showed that question wording does matter, particularly when measuring financial sophistication. In general, if people are financially unsophisticated, it will be difficult to elicit accurate responses to unfamiliar concepts.

The present study finds substantial shortfalls in older persons' levels of financial literacy and financial sophistication. The value-added of the present research is to illuminate key areas where more could be done to inform, educate, and deepen peoples' understanding of what must be done to diversify investments, reduce costs, and make retirement saving more effective. In our sample of Americans over the age of 55, we find that they lack a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees. Furthermore, people that can answer one question correctly are not particularly likely to get others correct, and "do not know" responses are quite widespread. Simpler questions that avoided economic jargon are easier to answer. We also conclude that the way in which questions are framed matters: for instance, 38 percent answered correctly when asked to opine on the following statement: "*It is easy to pick individual company stock that will have better than average returns.*" Whereas, 74 percent answered correctly when the reverse wording was offered: "*It is hard to pick individual company stock that will have better than average returns.*" This suggests that more research is needed on the way in which financial sophistication questions are framed, to evaluate whether and how to help people develop a fuller understanding of the mechanisms of retirement saving and investment.

Our analysis may be of use to policymakers working to enhance retirement security. It is clear that employees and retirees are increasingly being asked to take on tasks requiring financial sophistication, including making saving, investment, and dissaving decisions for retirement. Our research implies that it may be particularly important to build retirement human capital via seminars, educational programs, and retirement planning products. Nevertheless, one-size-fits-all programs are unlikely to successfully address saving shortfalls particularly among the elderly, given the very different patterns we have discerned by sex, age, educational levels, and race/ethnicity. Instead, programs must be targeted so as to address fundamental differences in preferences, saving needs, and financial knowledge, as well as sophistication.

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