Financial Literacy Assessment

On a recent, global financial literacy assessment, the average individual investor scored 61%, a D-, demonstrating limited understanding of both financial products and concepts.[1] And, although 92% of investors agree that being financially literate is important, only 64% say they are proactively mentoring their children on how to handle their wealth responsibly.[2]

A baseline level of financial literacy can empower you to have a better and more productive conversation with your financial advisor. And good financial literacy can also set a positive example for your family, whose financial competence is critical to the prudent stewardship of wealth. This 13 question assessment reviews the core elements of financial literacy, including investing concepts and financial products. Once you've completed the assessment, you and your advisor can work together to continue to develop any areas that need review.

1. **Suppose you had $100 in a savings account and the interest rate was 2% per year. At the end of each year, the interest earned is deposited into the savings account. After 5 years, how much do you think you would have in the account if you left the money to grow?**
   - A More than $110
   - B Exactly $110
   - C Less than $110
   - D Don't Know

2. **True or False: Typically investments with higher levels of risk yield lower levels of return.**
   - A True
   - B False
   - C Don't Know

3. **True or False: All other things being equal, the lower the fees charged by a fund, the higher its return.**
   - A True
   - B False
   - C Don't Know

4. **True or False: An active fund/investment product is one that tries to beat a benchmark and a passive fund/investment product is one that tries to mimic a benchmark.**
   - A True
   - B False
   - C Don't Know

5. **True or False: Active funds are generally less expensive than passive funds.**
   - A True
   - B False
   - C Don't Know

6. **True or False: Imagine that the interest rate on your savings account is 2% per year and inflation is 3% per year. After 1 year, you can buy less with the money in this account.**
   - A True
   - B False
   - C Don't Know

7. **True or False: Buying a single company's stock usually provides a safer return than a stock mutual fund.**
   - A True
   - B False
   - C Don't Know

8. **Select the correct definition for: Time/Term/ Fixed Deposit**
   - A A deposit held at a bank or other financial institution that generally provides a higher interest rate than a savings account because there is a greater risk of losing your initial investment.
   - B A deposit held at a bank or other financial institution that provides a fixed interest rate and cannot be withdrawn for a period of time. The return is generally higher than a savings account.

9. Select the correct definition for: Mutual Fund/ Investment Fund

A A fund comprised of a variety of assets intended to provide financial security to an individual, typically once the individual reaches a certain age.

B A pool of funds collected from many investors for the purpose of investing in stocks, bonds, money market instruments and similar assets. Each investor retains ownership of his or her portion of the overall investment.

10. Select the correct definition for: Exchange-Traded Fund (ETF)

A An investment that often tracks an index, a commodity or a basket of assets, but trades like a stock on an exchange.

B A type of company listed on an exchange created to buy and own the shares of other companies, real estate or commodities which it then controls and manages.

11. Select the correct definition for: Equity/Stock

A An investment representing an ownership interest in a company. The value of a stock changes over time.

B An investment representing an ownership interest in a company. The value of a stock goes up over time and is considered a diversified investment.

12. Select the correct definition for: Bond

A A loan of money to an entity (e.g. company or government) that is designed to appreciate over time as the entity proves its financial security.

B A loan of money to an entity (e.g. company or government) that borrows the funds for a defined period of time, usually at a fixed interest rate.

13. Select the correct definition for: Hedge Fund

A A high-return investment that is suitable for most investors as it uses hedging techniques to offset potential losses.

B An investment that is only suitable for certain investors who thoroughly understand investment risk and return.

Answer Sheet

1. **Suppose you had $100 in a savings account and the interest rate was 2% per year. At the end of each year, the interest earned is deposited into the savings account. After 5 years, how much do you think you would have in the account if you left the money to grow?**

   A More than $110.

   65% of investors globally got this right.

   This is an example of compounding. Compounding means that your money grows at a faster rate when the interest earned on your principal is added to the principal. So when you invest over time you get the benefit of supercharging your investments.

2. **True or False: Typically investments with higher levels of risk yield lower levels of return.**

   B False.

   66% of investors globally got this right.

   Most investors want to minimize risk, but they also want high returns. Investors are typically unwilling to buy a risky investment unless it offers the potential for high returns, so oftentimes higher risk is associated with the opportunity to achieve higher returns. However, high risk does not guarantee high returns. Meanwhile, low risk investments are usually more predictable, so they typically offer lower return potential.

3. **True or False: All other things being equal, the lower the fees charged by a fund, the higher its return.**

   A True.

   37% of investors globally answered correctly.

   High product fees reduce the amount of money that ends up in investors' pockets. For example, if an investment returns 10% and the fee is 2%, an investor ends up with an 8% gain. On the other hand, if the investment returns 10% and the fee is 1%, the investor will end up with a 9% gain.

4. **True or False: An active fund/investment product is one that tries to beat a benchmark and a passive fund/investment product is one that tries to mimic a benchmark.**

   A True.

   51% of investors globally answered this correctly.

   Benchmarks serve as standards against which the performance and risk of a fund or product can be measured. "Active Management" means that decisions are being made in an attempt to help a portfolio outperform its benchmark. "Passive management" means that the investment product simply mimics the benchmark and attempts to match its return.

5. **True or False: Active funds are generally less expensive than passive funds.**

   B False.

   51% of investors globally were able to answer correctly.

   Active funds are typically managed in a way such as the individual securities in the fund are traded more often than in the case of passive. They require closer monitoring. As a result, active funds tend to cost more than passive funds, which typically hold the same securities as an index or use a buy-and hold approach. However, to ascertain a fund's overall merit, a lot of factors need to be considered in addition to costs.

6. **True or False: Imagine that the interest rate on your savings account is 2% per year and inflation is 3% per year. After 1 year, you can buy less with the money in this account.**

   A True.

   77% of investors globally were able to answer correctly.

   If you start with $100 in your account, after a year at a 2% interest rate, that $100 would be worth about $102. But if the inflation rate was 3%, then an item that started the year costing $100 will now cost about $103. So you will have lost $1 in buying power over the course of the year.

7. **True or False: Buying a single company's stock usually provides a safer return than a stock mutual fund.**

   B False.

   56% of investors globally were able to answer correctly.

   Compare investing $100 in one company's stock versus investing $100 in a mutual fund. A mutual fund is less likely to suffer a large dip in value because of an unexpected event, such as a scandal, which affects an individual company, because mutual funds invest in multiple stocks. This highlights the benefits of diversification.

8. Select the correct definition for: Time/Term/ Fixed Deposit

B A deposit held at a bank or other financial institution that provides a fixed interest rate and cannot be withdrawn for a period of time. The return is generally higher than a savings account.

75% of investors globally were able to answer correctly.

Financial institutions are willing to pay an investor a higher return in exchange for the promise that the investor won't withdraw his or her funds and then reinvest the money elsewhere, hence the requirement on withdrawal. However, the risk of losing the initial investment is typically extremely low, and is the same risk associated with holding the money a savings account. Thus a deposit may be better if the money doesn't need to be put to use right away.

9. Select the correct definition for: Mutual Fund/ Investment Fund

B A pool of funds collected from many investors for the purpose of investing in stocks, bonds, money market instruments and similar assets. Each investor retains ownership of his or her portion of the overall investment.

66% of investors globally answered correctly.

Mutual funds are investment products which can be used by investors of all ages. Shares of mutual funds can be purchased and sold on a daily basis.

10. Select the correct definition for: Exchange-Traded Fund (ETF)

A An investment that often tracks an index, a commodity or a basket of assets, but trades like a stock on an exchange.

67% of investors globally answered correctly.

Exchange traded funds are investment vehicles, not companies. Unlike mutual funds, exchange traded funds can be bought and sold throughout the day, rather than only at the end of the day.

11. Select the correct definition for: Equity/Stock

A An investment representing an ownership interest in a company. The value of a stock changes over time.

78% of investors globally answered correctly.

Stocks represent ownership interest in a company. As the company's stock price rises in value through increasing revenues and/or investor expectations or other factors so does the ownership interest and hence the value of initial investment in stocks.

12. Select the correct definition for: Bond

B A loan of money to an entity (e.g. company or government) that borrows the funds for a defined period of time, usually at a fixed interest rate.

64% of investors globally answered correctly.

Unlike stocks, typically, bonds are not designed to rise in value over time as a company grows. Instead, most bonds are designed to return invested principal, along with interest, to investors.

13. Select the correct definition for: Hedge Fund

B An investment that is only suitable for certain investors who thoroughly understand investment risk and return.

80% of investors globally answered correctly.

Hedge funds are typically unregulated private investment pools made available to only sophisticated investors who are able to bear the risk of the loss of their entire investment. An investment in a hedge fund should be viewed as illiquid and interests in hedge funds are generally not transferable. Therefore, investors need to have a firm understanding of the risks associated with hedge funds before they consider investing.

Next Steps

Understanding your own financial literacy and which areas may need improvement is an important step towards greater mastery of your own finances and a more productive relationship with your advisor. After taking this assessment, you can work together with your advisor to review your results, and start a broader conversation about how to most effectively achieve your investment goals.

[1] State Street Center for Applied Research Study 2014, "The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry."

[2] State Street Global Advisors' Survey, "Money in Motion," June 2015. 400 financial advisors and 560 individual investors were surveyed nationally on multigenerational wealth management.

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