

The benefits of personal financial planning

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It's just a fact of life: some people possess more knowledge and information than others. While this simple truth may be benign in many areas, it can lead to severe distortions in financial markets. When certain people have more knowledge, superior analysis or faster

access to information than others, we call it information asymmetry. Exploiting information asymmetry can give one actor in the marketplace an unfair advantage over others by enabling insider trading and market manipulation.

Lawmakers all over the world have enacted regulations to prevent or minimize information asymmetry. Examples include the European Union's market abuse directive and the markets in financial instruments directive (MiFID). And of course, information asymmetry is an important contributing factor to our current global economic crisis.

Times like these make it even more important to limit information asymmetry. A deep financial crisis leaves investors shaken, disappointed and even betrayed. What started as a relatively narrow loss

of faith – the so-called subprime crisis – expanded quickly during 2008 into a full-blown financial meltdown that left Wall Street in shambles.

In 2009, the crisis reached the real economy. Huge fortunes were devastated literally overnight. For a number of reasons, investor psychology now ranges from disappointment to complete lack of faith in financial intermediaries – and this mistrust is perhaps most acute in regard to financial advisors.

Myopic loss aversion

Investors generally tend to think in very short time frames and show very low tolerance for short-term losses. This means that they may focus, for instance, on the risk of loss over a one-year time frame even when investing for retirement in 30 years. In behavioural finance, such behaviour is called “myopic loss aversion.”

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Investments are made not only to make money per se, but also to reach certain goals. This was once fairly straightforward. With or without insights from modern portfolio theory, investors could trust that asset management achieved returns at least equivalent to those of a market portfolio. But now this simple truth is in doubt, leaving investors uncertain.

Most advisors – and commentators – tend to forget that investors normally hold more than the asset class of securities and/or derivatives. Clients are invested in assets such as commodities, real estate, art and antiquities. They are looking for solutions for certain needs, such as personal risk analysis to deal with potential illness, disability or death, or they are in search of estate solutions.

