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Events
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Podcast
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Financial literacy

13 Jul 2010

The financial crisis has come and gone...or so we in Asia like to assume.

Ooops -- not so fast, experts warn.

The world is not out of the woods yet and some say Asian investors need to be more mindful now than ever of their money.

Devika Misra explains,

One can be forgiven for forgetting that there ever was a financial crisis.

But that's exactly what we should *not* be doing ...

...especially in places like Singapore where we have a large rapidly aging population.

Professor Mandell is a Professor and Dean Emeritus at the University of Buffalo.

"You're going to need a lot more money in order to retire. Its more important than ever to begin saving early and investing in assets that are likely to grow and the consequence for not doing that in a rapidly aging society means that people may be working until they're seventy five or eighty years old."

So how should we be viewing our own personal portfolios?

After the debacle of last year's financial crisis, many have become wary of risky investments and keen to stick only to the safest of options.

They say that from now on they will stay away from the stock market.

A mistake, says Professor Mandell.

"We know historically of over periods of twenty years or more stocks always greatly out perform all other types of

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investments and they really have to, otherwise people could not get reward for taking risk. If I am so risk averse and so financially illiterate that I do not understand this relationship and put all of my money in very secure investments such as government bonds I'm going to end up with something but had I put at least a portion of that into an index of common stocks I would probably have ended up with a tremendous amount more."

The crisis he says is wake-up call for greater financial literacy.

He defines financial literacy as the ability of people to make consumer decisions in their own best long term interests .

"They should understand something about debt and they should understand the meaning of interest rates and they should also understand the fact that if I use a credit card whats happens in my mind is that I greatly value the pleasure of the purchase but my mind is generally incapable of processing the pain of re paying the debt. Some very good economists at Harvard have actually calculated that the discount rate in our minds for taking on consumer debt is extremely high, its as high as forty three percent."

So thats the problem.

Not only do people tend to discount the full weight of debt -- they also tend to know little about taking out a mortgage, setting up an old age pension scheme or health insurance policies for themselves.

The Professor's own studies have shown that even students of economics and finance are not necessarily either more knowledgeable or more responsible than others.

"Those students who had taken a full course relating to financial management did no better than those students who did not. They did no better in tests of practical financial literacy, things that people should know at that age. Students don't have a high level of motivation at that age because they say Oh it would be ten years before I have to make that kind of decision thats number one and number two in ten years everything is going to be totally different, therefore why should I learn how to take out a mortgage today because in ten years I wont be able to recognise the mortgage of today so theres no reason for students to remember this."

In fact, it wasn't the financial illiteracy of the common man alone that caused the financial crisis.

It can be argued that it was perpetuated by those deemed the most financially literate.

"It was clearly the folks who were expected to be very knowledgeable, the investment bankers, the people from Lehman and Bear Sterns and Citigroup and Morgan Stanley..most of the largest banks in the world that were equally contributory so we might say that even these bankers exhibited a pretty high degree of financial illiteracy."

So what should we as personal investors be doing?

Rather than shun all risk, we need to embrace it ...but in an educated manner.

Most university graduates do have the skills to research their financial products and services.

"Well the first thing to do is probably read the documents that you're given, very very few people will read the documents and try to put in the effort required to understand it. Secondly if they don't understand they probably should not sign. They may want to find someone who is more knowledgeable than they are. There are people in every country who are licensed and accredited as experts in the field and sometimes they may charge several hundred dollars to help with the advice."

That sounds simple enough but Professor Mandell says even today... post-crisis, you'd be surprised at how few people actually do it.

They tend to be reluctant to spend hundreds of dollars for advice that may be worth thousands in the long run.

If nothing else, he says, at least understand your home mortgage document.

If not, the sub-prime fiasco will not be a distant memory for long.

Professor Mandell was in Singapore recently teaching an MBA program at the Singapore Institute of Management.

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