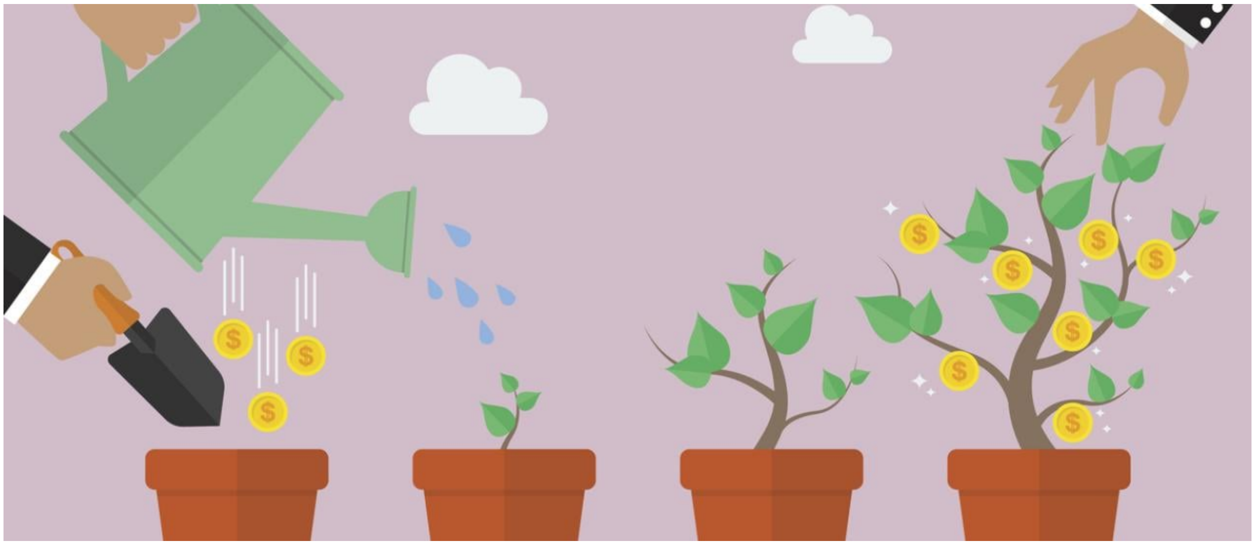
The Stock Market's Potential as a Wealth Equaliser



By Theo Vermaelen , INSEAD Professor of Finance

Nudging people to invest in the stock market could reduce wealth inequality.

Currently one of the greatest sources of inequality is the huge disparity between the returns from holding stocks and holding cash. Interest rates are extremely low so that they hardly compensate for inflation, while stock markets are booming. Finance theory would argue that people should invest a significant fraction of their wealth in a diversified portfolio of stocks, as investing in the stock market will be compensated by a risk premium.

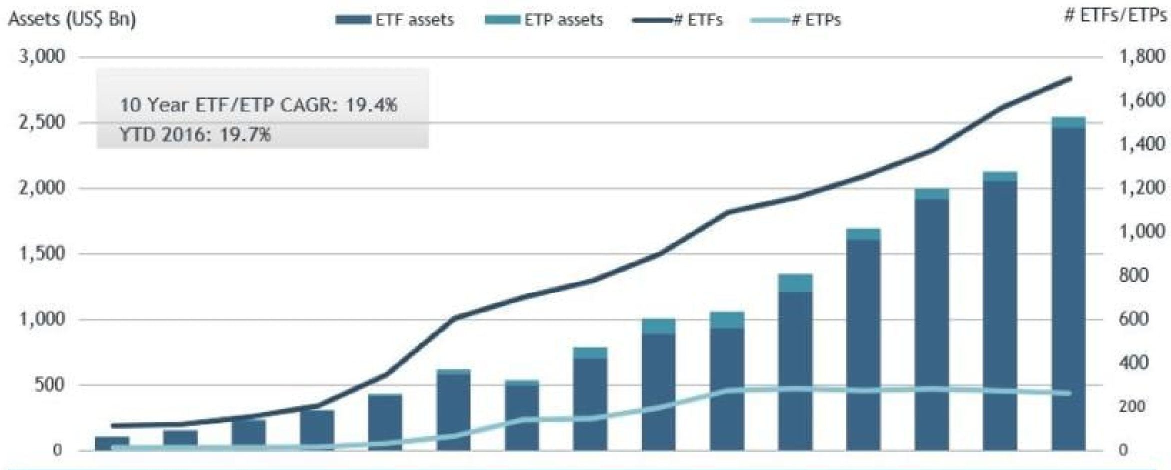
The size of this risk premium is a question of debate but, if the past is a good predictor of the future, one could expect to earn a 5 percent risk premium above the risk-free rate, which at a risk-free rate of 2 percent translates into 7 percent per year. At 7 percent, an investor is expected to double her wealth every 10 years. The fact remains, however, that a large number of individuals don't invest in stocks, they save their money instead. The poor, however, are net borrowers; poverty is alleviated by lower interest rates. In order to reduce poverty, one should not increase interest rates but improve the asset allocation of those who can save by encouraging investment in equities. But this idea is typically met by two concerns.

It’s not about how much you know

When I ask people why they don’t invest more in stocks the typical answer is that “I know nothing about the stock market”. The implication is that you must be smart to invest in stocks and that wealthy people can hire advisors so that they make better investment decisions. So, the rich will always earn higher returns than the poor. This view is supported by Thomas Piketty in his famous book “**Capital in the Twenty First Century**”. On page 447, he gives the example of university endowments. He ranks endowments by their size and concludes “the greater the endowment, the larger the return”. He explains this by the fact that the wealthier endowments can afford to pay the salaries of top portfolio managers but the smaller ones cannot. Hence his conclusion that the stock market is not a level playing field.

However, **Barber and Wang (2013)** examined the performance of university endowments during a 21-year period ending in 2011. They conclude that the superior performance of some endowments is purely a result of differences in risk taking, not the result of the quality of the portfolio manager. This result is consistent with the asset management literature which shows that most actively managed funds don’t beat their risk-adjusted benchmark. So, an investor who invests in a diversified portfolio through an index Exchange Traded Funds (which means low fees) can earn the same risk-adjusted return as the wealthy who have allocated their funds to actively managed portfolios. The poor performance of most portfolio managers explains the growing importance of ETFs, seen in Figure 1.

Figure 1



Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Dec-16
# ETFs	117	123	157	207	350	608	704	778	902	1,093	1,161	1,259	1,377	1,570	1,705
# ETFs/ETPs	128	134	169	221	381	673	845	925	1,099	1,369	1,447	1,536	1,662	1,845	1,969
ETF assets	102	151	228	305	416	586	498	706	893	938	1,212	1,612	1,918	2,060	2,465
ETF/ETP assets	106	157	237	311	433	621	539	790	1,009	1,060	1,347	1,698	2,002	2,130	2,549

Source: ETFGI data sourced from ETF/ETP sponsors, exchanges, regulatory filings, Thomson Reuters/Lipper, Bloomberg, publicly available sources and data generated in-house. Note: "ETFs" are typically open-end index funds that provide daily portfolio transparency, are listed and traded on exchanges like stocks on a secondary basis as well as utilising a unique creation and redemption process for primary transactions. "ETPs" refers to other products that have similarities to ETFs in the way they trade and settle but they do not use a mutual fund structure. The use of other structures including grantor trusts, partnerships, notes and depositary receipts by ETPs can create different tax and regulatory implications for investors when compared to ETFs which are funds.

Source: Valuewalk.com

In short, the stock market represents the ultimate equalising opportunity: Unlike the labour market, where the returns on investment in human capital depend a lot on your skills, your gender, your connections, your looks, the success of the company you are going to work for, etc., the returns in the stock market are, on a risk-adjusted basis, roughly the same for everyone, rich or poor, dumb or smart, ugly or good-looking.

How to improve risk tolerance

A second concern about stocks is that they are risky. Although an investor is expected to be compensated for this risk, people are risk-averse. In practice, this means that when you lose a dollar, the pain you suffer is larger than the happiness you experience when you make a dollar. One obvious way to reduce the negative consequences of volatility is to reduce the frequency of observing the returns of your investment. Imagine an investor who invested US$1000 in 1980 in the S&P 500. In 2017, her wealth would have grown by 8.4 percent per year, more than US$18,000 today. If she had not paid attention to the value of her investment over time, she would have avoided the suffering from various crashes along the way, including the October 1987 crash and the Financial Crisis of 2008. Ignorance about your wealth changes will improve your willingness to take risk. This was confirmed in **an experiment** conducted by Richard H. Thaler, the winner of the 2017 Nobel

Prize in Economics. With some of his behavioural finance colleagues, he found that participants who saw their results eight times per year only put 41 percent of their money in stocks compared to 70 percent of those who only saw their results once per year. While policy makers seem to believe that giving more information to investors improves welfare, more information makes people more risk averse and, as a result, lowers their long-term wealth. My advice, therefore, is: If you want to plan for retirement, invest in a diversified portfolio then forget about it until you are ready to retire.

Policy implications

Policy makers may be concerned about inequality. The common remedy is the Piketty one: Take money away from the rich and give it to the poor. Side effects of this policy, i.e. it reduces incentives to become rich, are usually ignored. An alternative policy is to improve the investment choices of the poor. Policy makers should encourage or “nudge” (a term made popular by Thaler) to invest in diversified portfolios of stocks with minimal transactions costs such as ETFs. For example, one could exempt all such “model” portfolios from capital gains, wealth and inheritance taxes.

In order to minimise irrational investment choices, Professor Thaler recommends that companies that offer defined contribution pension plans to “nudge” their employees to invest in diversified portfolios by default. In other words, your pension contributions will be invested in a diversified index fund unless you explicitly insist on investing in something else. Employees are still free to choose but sometimes people like to be nudged when they have to make seemingly complicated decisions.

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