Diversified household investment could be the key to economic growth
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By encouraging households to spread their bets, governments could achieve growth beyond anything possible through monetary or fiscal policy.

Does household finance matter? That’s the question Raman Uppal and I set out to answer in our recently published paper of the same name, revisiting a theme we’ve been exploring for some time.

The short answer is yes, it does matter a great deal. Not only for the sake of individual households, but also for the welfare of society as a whole.

We found that households are failing to properly diversify their investments. We all know we should not put all our eggs in one basket, but as households we don’t seem to understand that at all. The consequence is that households fail to enjoy the risk-return trade-off they could expect.

Households invest disproportionately in companies with which they are familiar, or those that operate locally. Even worse (in the US in particular), we see employees invested in their own company’s stock, tying their entire fate to the fortunes of their employer. This can have potentially disastrous consequences: it did for the employees of Enron, who lost their nest eggs as well as their jobs when the company collapsed, because their pensions were invested entirely in the company’s stock.

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Perhaps households believe investing only in familiar names is playing it safe. But the opposite is the case: if households fail to diversify their investments, they hold portfolios that are excessively risky in comparison to those that are properly diversified. Consequently, they might move money from risky assets to safer ones, resulting in lower returns. This will have a knock-on effect as to how much each household chooses to save and how much to spend, with a negative effect on their welfare.

Benefit to society

All these reductions in households’ welfare could be mitigated by simply encouraging them to properly diversify their portfolios. Wider society stands to gain from this. By our reckoning, if households diversified their investment portfolios, then the aggregate gains could result in as much as a fivefold increase in the returns for society as a whole. (And even if there are households to which the idea of contributing to the wider economy does not figure highly, the individual gain should be enough of an encouragement.)

We would go so far as to say that effecting this change at a household level could be a better spur to economic growth than anything that can be achieved through monetary or fiscal policy.

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There’s real impetus, then, for us to seriously think about how we can get households to diversify their investments. There are a few things we think could work, individually or in combination.

Improving financial literacy is one way. In an ideal world, this would happen at high school, but as we don’t live in such a world, we could look at good sense marketing campaigns or employer-led programmes instead (couching the issue in easily understandable terms). This could help address the notion in any given household that deeper financial thinking is “not for them”.

We could try to “nudge” households towards diversification (borrowing from the terminology of Richard H. Thaler and Cass R. Sunstein), gently guiding them to make better decisions for themselves and society alike. Offering default portfolios to households could be one way of doing this, or even some kind of automatic enrolment scheme. In either case, participants could choose from a handful of schemes of varying risk, with a default option in place for those not able or willing to make such a decision. We’ve seen this work in the paragon of good sense that is Sweden, where the default social security plan is diversified internationally.

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Thirdly, it could be through the introduction of legislation to encourage diversification. For example, a requirement that employer-led pensions be diverse (and not own-company stock). It could be through a simplification of investment procedures into mutual funds. Certainly, an obligation to offer plans with limited options could increase uptake – research has shown a negative correlation between the number of investment options and participation in plans. Or a requirement that households invest their wealth in funds rather than individual assets (in a way that didn’t require any great investment of time or effort for the households themselves).

Building the right products

There are already products out there around which we should aim to increase awareness – or even push as default options. Exchange-traded funds in particular can offer households a simple path to diversifying their portfolios.

We should be looking to the financial services sector to help design products that make it easier for households to diversify their investments, or to improve access to those that exist. From high-street banks to emerging fintech app developers, there’s plenty of scope to help people help themselves – with the further economic benefit that engenders.

If we inspect society with a magnifying glass, we will find that it is composed of individual households. If we see to the health of these constituent elements, then we might go some way in improving the health of the whole.

A simple enough concept, but judging by the lack of attention paid to this area, one that seems to have been neglected.