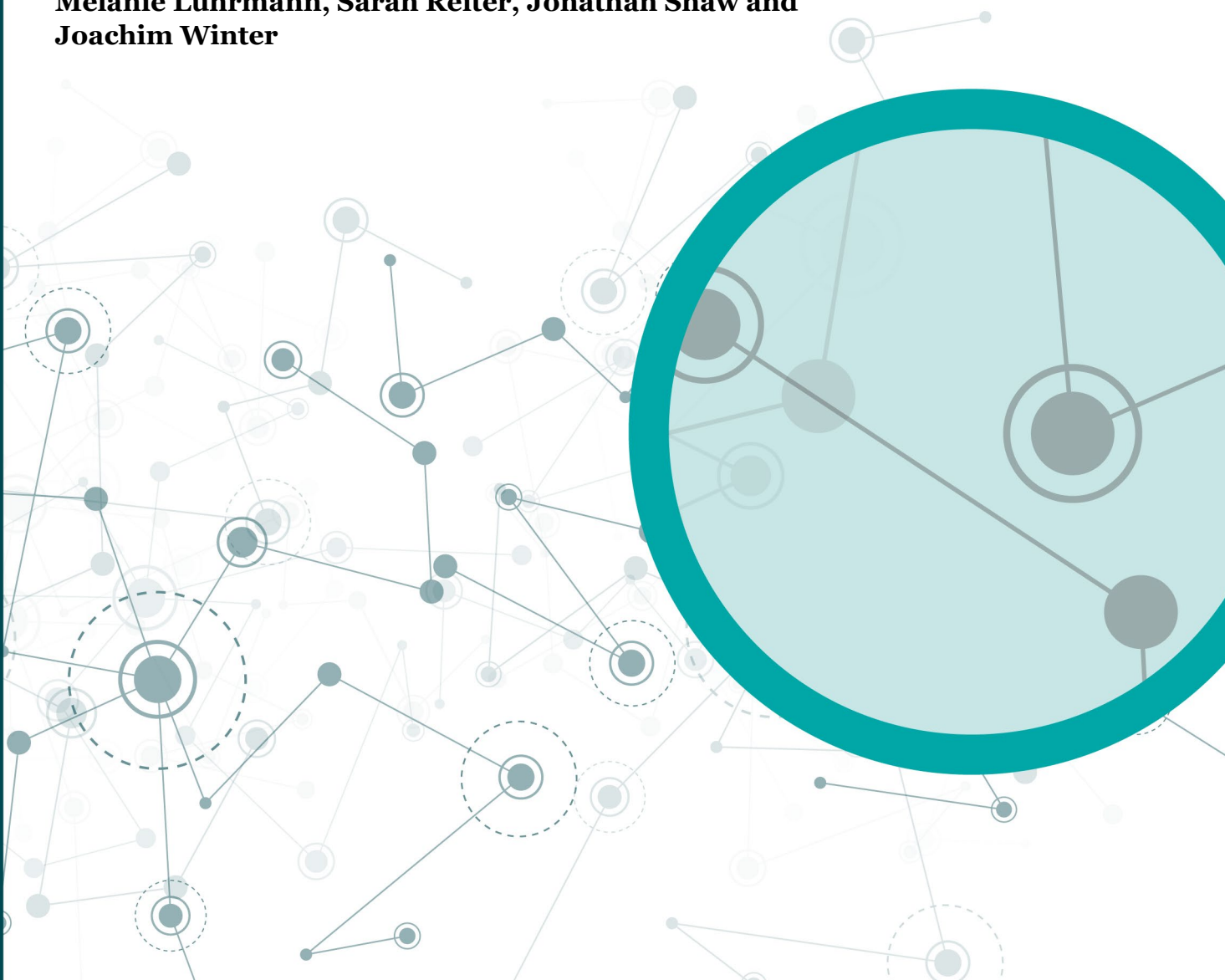


Research Note

March 2022

Do consumers understand
the risks associated with
different ways of saving?

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Joachim Winter



FCA research notes in financial regulation

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Summary

For consumers to be able to make good saving decisions, it is important that they understand the risks and potential returns associated with different ways of saving. We use a special module of the FCA's latest Financial Lives survey to explore the extent to which consumers understand these risks and potential returns.

Good decision-making involves being able to make good *quantitative* assessments of risks and returns, not just whether an outcome is more or less likely. For this reason, we focus on consumers' ability to assess the likelihood of future returns using *probabilities*. For example, the percent chance that a stock market investment will have gone down by 10% a year from now.

Our results indicate that 73% of the UK adult population are able to make such probabilistic assessments. 52% of these adults demonstrate a high degree of financial sophistication in terms of knowing about past returns, understanding relative returns and riskiness and forming reasonable beliefs about future asset returns. Another 40% show a moderate degree of financial sophistication.

This means that, overall, 38% of consumers are able to assign probabilities to future outcomes and show a high degree of financial sophistication. 29% of consumers are able to assign probabilities and show a moderate degree of financial sophistication. The remaining 33% of consumers are either not able to assign probabilities or show a low degree of financial sophistication.

Consumers with characteristics of vulnerability (eg poor numeracy skills or low knowledge or confidence in managing finances) are more likely to lack the ability to assign probabilities to future returns and – among those who are able to assign such probabilities – to be less financially sophisticated.

It's important to remember that having a characteristic of vulnerability doesn't, by itself, mean that a consumer will have additional or different needs or will suffer harm. That's why the FCA's [Guidance on the fair treatment of vulnerable customers](#) says that firms should understand what customers are vulnerable to, and the impact that circumstances or characteristics can have on them.

A substantial number of consumers with specific characteristics of vulnerability show considerable financial sophistication. This suggests an approach that tries to target support towards those specifically with low sophistication might be more effective at improving saving decisions than focusing exclusively on other characteristics of vulnerability.

1 Introduction

Consumers can save in several different ways, for example putting money in a bank account, investing in the stock market and buying property.

It seems reasonable to assume that most people want their savings to grow as fast as possible, without suffering big swings in value. The problem is that no one knows for certain what will happen to interest rates, stock markets or house prices in the future, which makes saving decisions hard.

It also means that what people think will happen – their subjective expectations – will be a key driver of saving decisions. For instance, several studies show that having higher stock market return expectations is associated with higher stock ownership. And whether such subjective (and not necessarily well-informed) expectations are reasonable may be an important decisive factor in whether consumers save in ways that are best for them and meet their saving goals.

This raises an important set of questions: are consumers able to make a reasonable assessment of the returns associated with different ways of saving? Do they understand that outcomes are uncertain and that some ways of saving are riskier than others, with a greater chance of falls in value? In short: are consumers able to assess uncertainty about future returns?

Results of the FCA's latest Financial Lives survey, published in February 2021 – and analysed by a team of researchers from the FCA, Royal Holloway, LMU Munich and ifo Institute – help answer these questions. The Financial Lives 2020 survey was conducted between late August 2019 and mid-February 2020, with over 70% of the interviews conducted in 2020, ie fieldwork finished shortly before the start of the Covid-19 pandemic. The survey included a set of questions that elicited the subjective expectations of just under 4,000 individuals across the UK about interest rates on savings accounts, and about housing and stock market returns. Survey results were weighted to be representative of all UK adults.

2 Who is happy to use probabilities to describe risks and returns?

Naturally, nobody could have foreseen the stock market and house price fluctuations that the pandemic – hopefully a once-in-a-lifetime event – would bring. But even though unexpected events do happen from time to time, people with reasonable expectations about the future are in a better position to make sensible financial choices. Being able to think in probabilistic terms about possible future states is a crucial first requirement for forming such expectations. The second requirement is that these probabilistic assessments are ‘reasonable’, ie that they are based on knowledge of past market performance and general market dynamics, taking into account typical fluctuations in financial markets – a concept we label financial sophistication. If both requirements are met, we consider people to be more likely to make good saving decisions.

First, we assess whether individuals are happy to assign probabilities to a range of possible future outcomes. For example, in one scenario, respondents were told to imagine that they received an unexpected inheritance of £100,000 which they put in a savings account. They were then asked to assess the probabilities associated with earning different interest rates on that money. Similar questions were also asked for buying a house in their local area, and for investing in the FTSE 100 stock-market index (for the exact wording of the survey questions, see Table 1).

Table 1: Probabilistic expectation questions in the Financial Lives 2020 survey

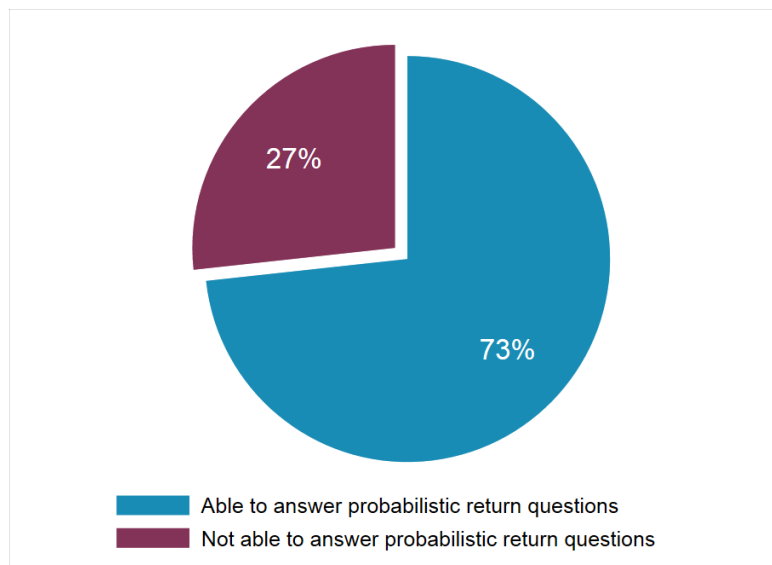
Way of saving	Survey questions	Response options
Introductory text	Imagine you receive an unexpected inheritance of £100,000...	
Savings account	...Imagine you put the £100,000 in a bank/savings account and you search hard to find the highest interest rate. What do you think are the percentage chances that you will have earned the interest rates given below in 12 months’ time?...	0 to 1% 1.1 to 2% 2.1 to 3% 3.1 to 4% 4.1 to 5% 5.1% or more
Local housing investment	...Imagine instead you put the £100,000 towards buying a house in your local area. What do you think are the percentage chances that the house will have gone up or down in value by the amounts given below in 12 months’ time?...	-10% or less -9.9 to -5% -4.9 to 0% 0.1 to 5% 5.1 to 10% 10.1 to 15% 15.1% or more
Stock market investment	...Imagine instead you invest the £100,000 in the FTSE 100, which is the main UK stock market index. What do you think are the percentage chances that your stock market investment will have gone up or	-10% or less -9.9 to -5% -4.9 to 0%

	down in value by the amounts given below in 12 months' time?...	0.1 to 5% 5.1 to 10% 10.1 to 15% 15.1% or more
Closing text	...Write a percentage chance in each box to reflect how likely you think different outcomes are. Make sure your percentages add up to 100%.	

Source: Financial Lives 2020 survey questionnaire.

When asked to assess the uncertainty associated with different ways of saving by assigning probabilities to possible future outcomes, respondents had the option to say they really don't understand how to answer these types of survey question. Figure 1 shows that almost three-quarters (73%) of UK adult consumers were able to assign probabilities to possible future outcomes. That leaves just over a quarter of the population who said they didn't understand the probabilistic task given to them, indicating a lack of ability to think about the future in probabilistic terms. Of course, some people may have struggled because the questions were not explained well enough, although carefully scripted examples should have helped to minimise this problem. To the extent that comprehension of the survey questions remains an issue, our results will overstate the share of the population who lack the ability, by their own self-assessment, to provide probabilistic assessments of future returns.

Figure 1: Ability to answer probabilistic return questions



Notes: Question RISK4. Unweighted base 3,843 (all UK adults).

UK adults who are not able to assign probabilities to future returns are more likely to be female, and to have left school without academic qualifications (Table 2, Panel a). In line with previous literature, we find that with respect to age, the ability to answer probabilistic questions follows an inverted U-shaped pattern, indicating that the very young and the very old age groups particularly struggle. The same holds true for students; these results may not come as a surprise given that younger consumers usually have fewer investible assets, and therefore are generally less experienced in making savings and investment decisions. Our results also reveal a lower ability to assign

probabilities among individuals with low socio-economic status (as measured by being unemployed or by having low levels of savings).

(Panel b of Table 2 is discussed below once we have described our measure of financial sophistication).

Table 2: Variation across socio-demographic and socio-economic characteristics

	(a) Not able to answer probabilistic survey questions	(b) Low financial sophistication*
Gender		
Female	33%	11%
Male	20%	7%
N	3,800	2,900
Education		
Higher education	16%	6%
Other education	30%	11%
No education	56%	15%
N	2,900	2,851
Age		
18 to 34	35%	10%
35 to 54	22%	8%
55 to 64	22%	7%
65+	28%	9%
N	3,843	2,925
Employment status		
Employed	24%	8%
Self-employed	16%	5%
Unemployed	47%	22%
Retired	26%	8%
Student	40%	9%
Other	40%	15%
N	3,843	2,925
Low level of savings*		
Yes	33%	15%
No	18%	5%
N	3,421	2,677

*Notes: Financial sophistication is defined as low if financial sophistication index < 3. A detailed description of the financial sophistication index (ranging between 0 and 7) is available in Table 4.

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Low level of savings: 'Yes' if the main source of household income were lost, their household could continue to cover living expenses for less than three months, without having to borrow any money or ask for help from friends or family. Unweighted bases shown in table (all UK adults in panel (a); all UK adults who are able to answer the probabilistic return questions in panel (b)).

3 Is there a link between financial vulnerability and the ability to answer probabilistic return questions?

As a financial regulator, the FCA pays close attention to the financial decision-making of consumers, particularly those in vulnerable circumstances who may require additional safeguarding. To be counted as having characteristics of vulnerability under the FCA's Financial Lives survey vulnerability algorithm, one must exhibit low resilience or low capability, have recently gone through a negative life event, or have an ongoing health condition that affects day-to-day activities heavily (for a detailed description of the FCA's vulnerability measure, see Table 3).

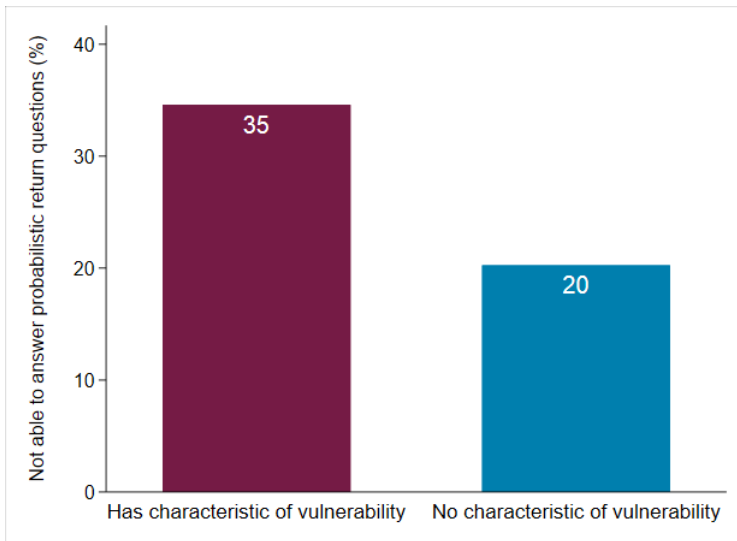
Table 3: The FCA's Financial Lives survey vulnerability measure

Drivers of vulnerability	Underlying characteristics
1. Health	Those with a physical disability, severe or long-term illness, hearing or visual impairment, poor mental health, addiction or low mental capacity or cognitive difficulties that reduce their ability to carry out day-to-day activities a lot.
2. Life events	Suffering a recent negative life event such as a bereavement, an income shock (eg losing their job or a reduction in working hours against their wishes) or a relationship breakdown; or becoming the main carer for a close family member.
3. Resilience	Over-indebtedness, low savings, or low or erratic income.
4. Capability	Low confidence or knowledge in managing financial matters, or poor or non-existent digital skills (the 'digitally excluded').

Notes: individuals are counted as having characteristics of vulnerability if they exhibit at least one driver of vulnerability. Source: [Financial Lives 2020 survey: the impact of coronavirus, Annex B \(FCA, 2021\)](#).

Using the FCA vulnerability measure, adults with characteristics of vulnerability are more likely not to be able to answer probabilistic questions than consumers who do not show characteristics of vulnerability (35% vs 20%, see Figure 2).

Figure 2: Inability to answer probabilistic return questions, split by whether exhibiting characteristics of vulnerability (red) or no characteristics of vulnerability (blue)

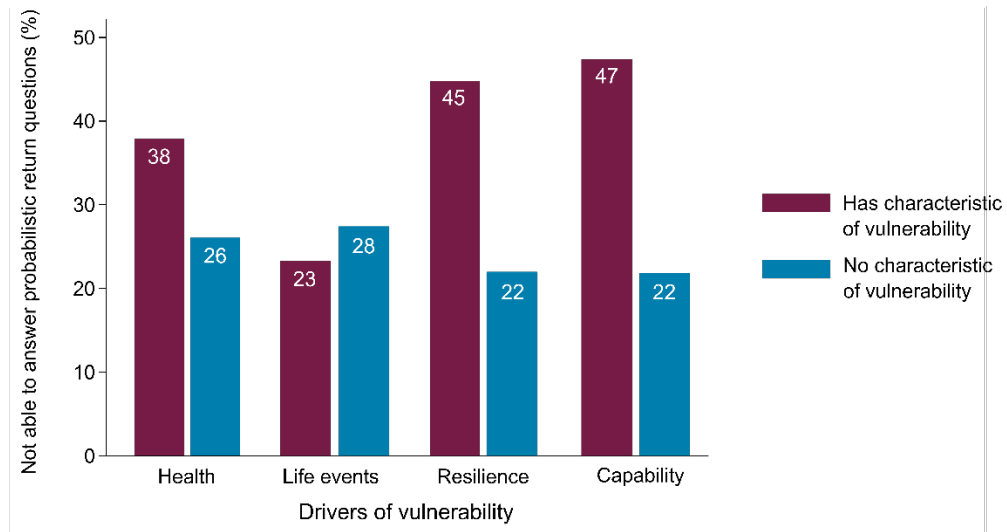


Notes: Question RISK4 and banner Vul_13. Unweighted base 3,843 (all UK adults).

However, it’s important to understand that different characteristics can impact customers’ needs and engagement with financial products and services in different ways. So we need to take care to consider the drivers and characteristics further and not to assume that all customers with a characteristic of vulnerability will have the same experience.

Not surprisingly, almost half (47%) of consumers with low capability (ie low financial knowledge and confidence, and/or digitally excluded) are not able to assign probabilities to future returns, while the same is true of only 22% of consumers who do not have low capability (Figure 3). We also find that about 45% of consumers with low resilience, ie low savings, irregular incomes or being over-indebted, are not able to assign probabilities to future returns. As a consequence, there is a clear overlap between lack of financial resilience to deal with financial shocks and inability to make probabilistic assessments which may act as an additional barrier to making sensible financial choices.

Figure 3: Inability to answer probabilistic return questions, split by the different drivers of vulnerability



Notes: Question RISK4 and banners Vul_heal, Vul_cap, Vul_lif, and Vul_res. Unweighted base 3,843 (all UK adults).

4 Financial sophistication

Among the subgroup of consumers who can assign probabilities to future returns, we can investigate how knowledgeable they are about past financial developments, and how reasonable their beliefs about future asset returns are – given what we know about how different financial markets work. People who can conceptualise the uncertainty of future returns in a financially sophisticated manner will be better equipped to make sound financial decisions.

We assess financial sophistication against seven criteria: three relate to past financial developments and four to future expectations. These include awareness that returns in both housing and stock markets may go up or down (see Table 4, criteria 3 and 4), and that these assets are riskier than depositing money in a savings account (criterion 1). In addition, it is highly unlikely that interest rates in savings accounts would have exceeded more than 4% in the twelve months after the interviews were conducted (criterion 2), given the low interest rate environment in the recent past (criterion 5). The criteria also include awareness of whether past stock market and local housing returns were positive or negative (criteria 6 and 7).

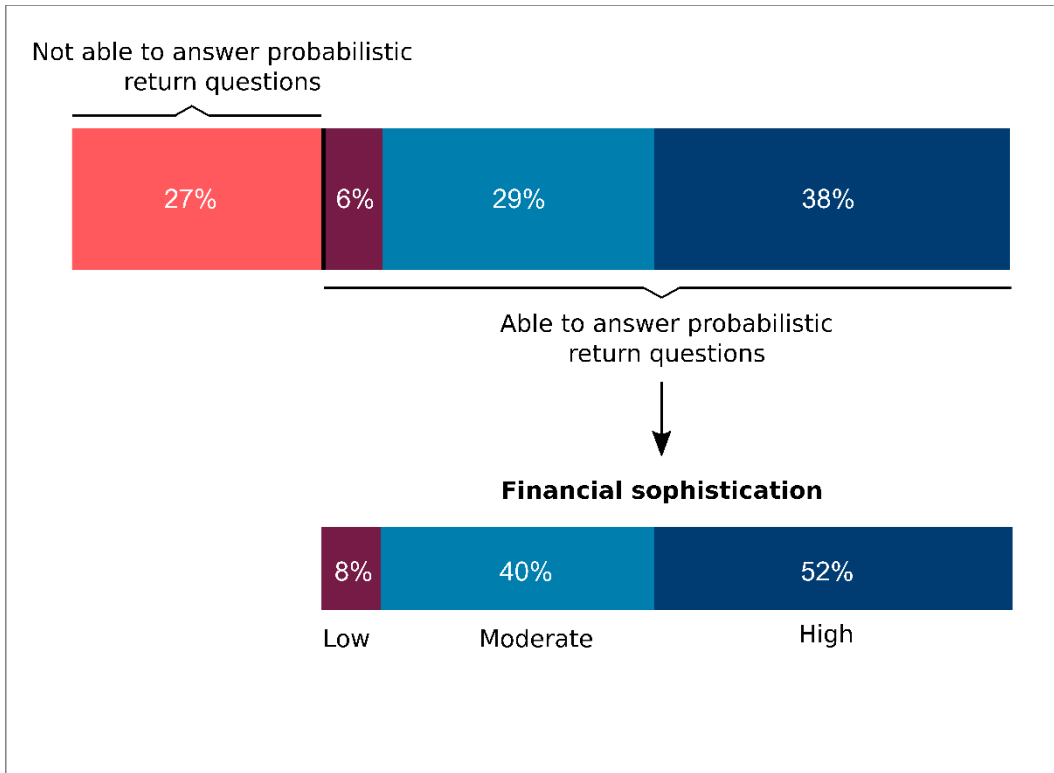
Table 4: Financial sophistication index

	A person is considered financially sophisticated if...
Expectations About Future Asset Risks and Returns	
1. Expected relative risk of different ways of saving	...they believe that over the next 12 months, keeping their money in a savings account will be less risky than investing in the stock market or in their local housing market.
2. Expected interest rates on savings accounts	...they think there is no chance of earning an interest rate of 4.1% or more on money kept in a savings account over the next year.
3. Expected returns on local housing investments	...they understand that the value of housing in their local area is neither guaranteed to go up nor down over the next year.
4. Expected returns on stock-market investments	...they understand that the value of an investment in the FTSE-100 (the main UK stock-market index) is neither guaranteed to go up nor down over the next year.
Knowledge About Past Asset Returns	
5. Knowledge about past interest rates on savings accounts	... they know that the interest rate on a savings account was not higher than 2% over the last year.
6. Knowledge about past returns on housing investments in local area	... they know whether or not the value of housing in their local area has gone up or down over the last year.
7. Knowledge about past returns on investments in stock market	... they know whether or not the value of an investment in the FTSE 100 has gone up or down over the last year.

Notes: A detailed explanation of how we construct the financial sophistication index is available from the authors.

The financial sophistication index relies (in part) on people’s answers to the questions about the probabilities of future returns, and therefore we are only able to measure the sophistication of people who were able to answer those questions. Among this subsample, we distinguish people displaying low, moderate, or high financial sophistication (for an overview, see Figure 4).

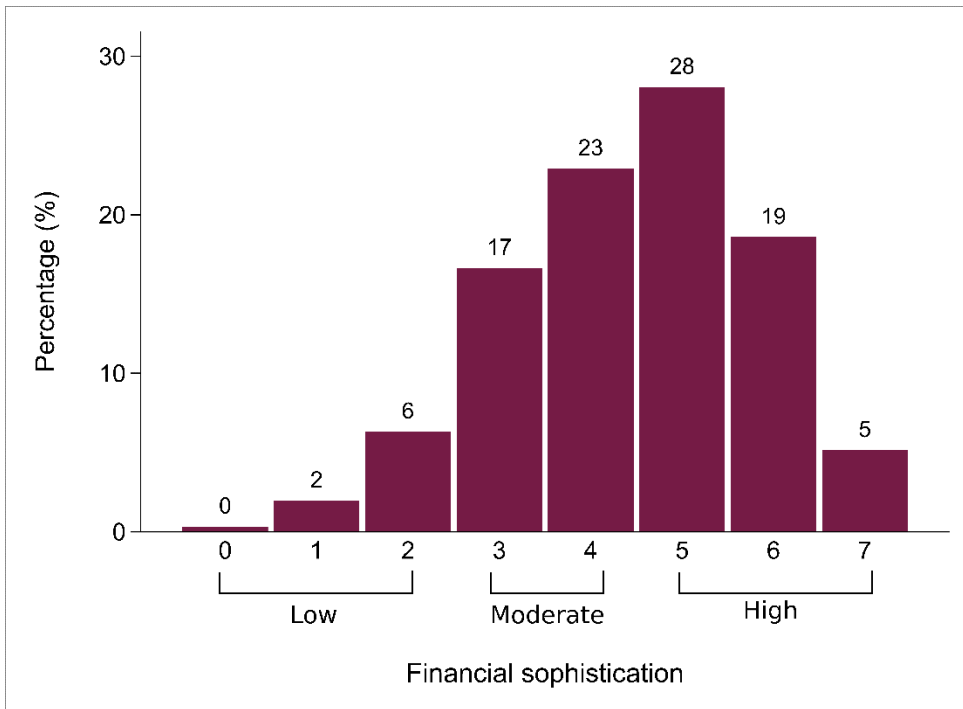
Figure 4: Overview of the financial sophistication classification



Notes: Percentages in the top bar refer to all UK adults; percentages in the bottom bar refer to UK adults who were able to answer the probabilistic return questions.

Half (52%) of those who answered the probabilistic return questions also display high financial sophistication, defined as satisfying at least five of the seven criteria (Figure 5). This is good news, since these people are in a better position to plan for uncertainty and, ultimately, to make sensible savings decisions. Another 40% display moderate financial sophistication, ie fulfilling three or four of the criteria, and fewer than one in ten (8%) display low financial sophistication, ie satisfying two or fewer of the criteria. Similar to those who were not able to assign probabilities to future returns, individuals with low financial sophistication are more likely to be female, unemployed, and to have no formal educational qualifications and low levels of savings (Table 2, Panel b). These individuals may have trouble making well-informed financial choices for the future. Mandatory advertising banners such as ‘Investment at risk’ or ‘Returns may vary’ may be perceived as a reminder of investment risk by financially sophisticated consumers but may be too shorthand to change the understanding of investment risk for those with low financial sophistication. If the latter group can be identified at the point when they are making real saving decisions, they might benefit from additional decision support. This could include providing some basic information about the way different assets work and what reasonable expectations for future returns might be.

Figure 5: Distribution of financial sophistication



Notes: The figure shows the distribution of the number of criteria in the financial sophistication index (ranging between 0 and 7) individuals satisfy. A detailed description of the index is given in Table 4. Unweighted base 2,925 (all UK adults who are able to answer the probabilistic return questions).

In Table 5, we study which criteria in the financial sophistication index are best/least understood. Among those who answered the probabilistic return questions, over 80% were aware that returns in the stock market can go up and down (criterion 4), and 73% knew that depositing money in a savings account carries less risk than investing it in housing or in the stock market (criterion 1).

Knowledge of last year’s returns was considerably lower: less than half (47%) knew whether or not the value of housing in their local area had gone up or down in the year prior to the interview (criterion 6), and only half (51%) knew this for an investment in the FTSE 100 (criterion 7).

Looking at Panels (b) to (d) in Table 5, we see that, regardless of whether individuals have low, moderate, or high sophistication, the thing they understand best is that returns in the stock market can go up and down (criterion 4). In contrast, they are least knowledgeable about past asset return developments. In the group with low financial sophistication, less than 20% know basic facts about past asset returns (criteria 5-7).

Overall, consumers display a good understanding of the principal risks encountered in investing, while their state of knowledge about specific asset returns is more varied.

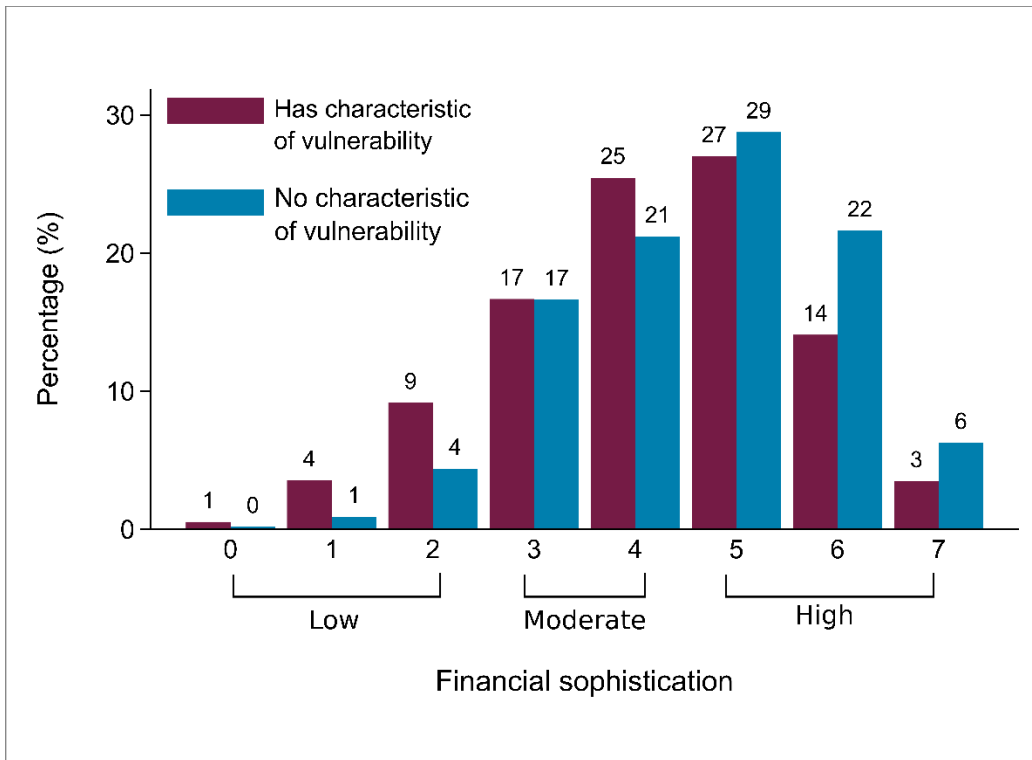
Table 5: Proportion who successfully answered each criterion of the financial sophistication

	Financial sophistication criterion						
	1	2	3	4	5	6	7
Panel (a): Individuals who answered the probabilistic questions	73%	62%	66%	81%	64%	47%	51%
Panel (b): Individuals who (i) answered the probabilistic questions and (ii) who have low financial sophistication	24%	33%	27%	43%	14%	19%	11%
Panel (c): Individuals who (i) answered the probabilistic questions and (ii) who have moderate financial sophistication	62%	47%	56%	73%	48%	36%	37%
Panel (d): Individuals who (i) answered the probabilistic questions and (ii) who have high financial sophistication	91%	79%	81%	93%	85%	60%	68%

Notes: This table shows, for different subgroups (left hand column), the proportion who successfully met each of the seven criteria of the financial sophistication index. Financial sophistication is defined as low if financial sophistication index is 0-2, moderate if financial sophistication index equal to 3 or 4, and high otherwise. A detailed description of the financial sophistication index (ranging between 0 and 7) is available in Table 4. Unweighted base 2,925 (all UK adults who are able to answer probabilistic return questions).

Individuals who show characteristics of vulnerability are not only less able to make probabilistic assessments but are also more likely to lack financial sophistication: Figure 6 shows that, among consumers who have characteristics of vulnerability and who are able to assign probabilities to possible future asset returns, 14% have low financial sophistication, ie they give responses that satisfy two or fewer criteria. In contrast, 42% display moderate financial sophistication, and 44% display high financial sophistication. It may not seem surprising that consumers with characteristics of vulnerability are over-represented in the low financial sophistication group since financial capability enters the definition of vulnerability (see Table 3). But financial capability is a measure of self-assessed knowledge and financial confidence, whereas our measure of financial sophistication is an objective measure of knowledge about the dynamics of financial markets and past returns, so the two need not necessarily coincide. Moreover, consumers with characteristics of vulnerability are still over-represented in the low financial sophistication group even when financial capability is removed from the definition of vulnerability. The fact that a substantial number of these consumers display considerable financial sophistication suggests that we can't assume that all consumers with characteristics of vulnerability will struggle to make good investment decisions – an approach that tries to identify those specifically with low sophistication might be more valuable.

Figure 6: Distribution of financial sophistication, split by any characteristics of vulnerability



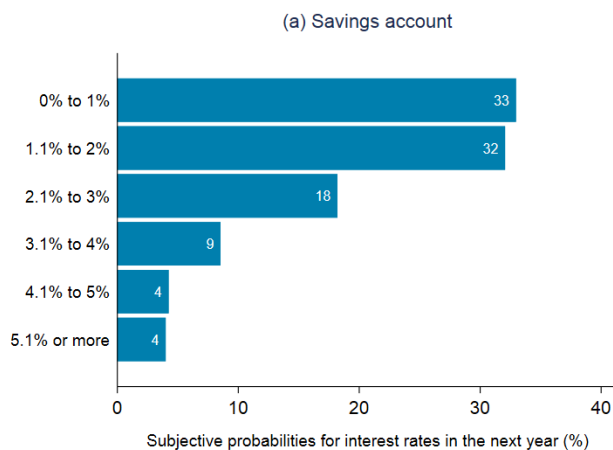
Notes: A detailed description of the financial sophistication index (ranging between 0 and 7) is available in Table 4. For a definition of vulnerability, see Appendix B in FCA (2021). Questions RISK2, RISK4, RISK5, RISK6, RISK9a, RISK9b, RISK9c; banner Vul_13; and information on historical asset returns. Unweighted base 2,925 (all UK adults are able to answer the probabilistic return questions).

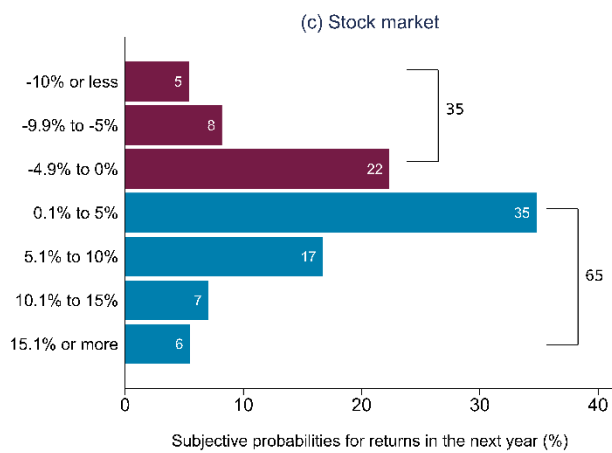
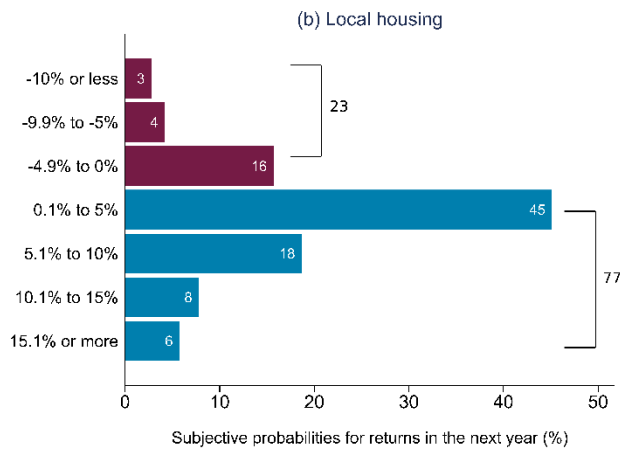
5 Subjective expectations

So, what were people’s expectations about future returns on different ways of saving at the end of 2019/early 2020? Here, we focus on individuals who answered these questions (see Figure 4).

The average expectations are consistent with the past distributions of returns. For example, in line with the low interest rates on savings accounts of around 0–2% over the last ten years, individuals reported on average a probability of 65% for a realisation of the interest rate between 0 and 2% over the following year. They assign a low average probability of only 8% to realised interest rates of 4.1% or above (Figure 7a).

On average, they are also aware that housing and stock market returns may go up or down, but they attribute – in line with observed past returns – higher probabilities to positive local housing returns (77%) than to positive national stock market returns (65%) (Figures 7b and 7c). In addition, modest positive returns between 0.1 and 5% are deemed most likely for both stock market and local housing returns. In contrast, extreme stock market gains (of 15.1% or more) or losses (-10% or less) are deemed almost equally likely with average probabilities around 5–6%, while the average probability of a high local housing return at 15.1% or more is – at around 6% – twice as large as that of large losses (-10% or less) that has an average probability of circa 3%.





Notes: Subjective return expectations for (a) savings accounts, (b) local housing investments, and (c) stock-market investments in the FTSE 100. Negative (positive) return probabilities are summarized in red (blue). Questions RISK4, RISK5, and RISK6. Unweighted base 2,926 (all UK adults who are able to answer the probabilistic return questions).

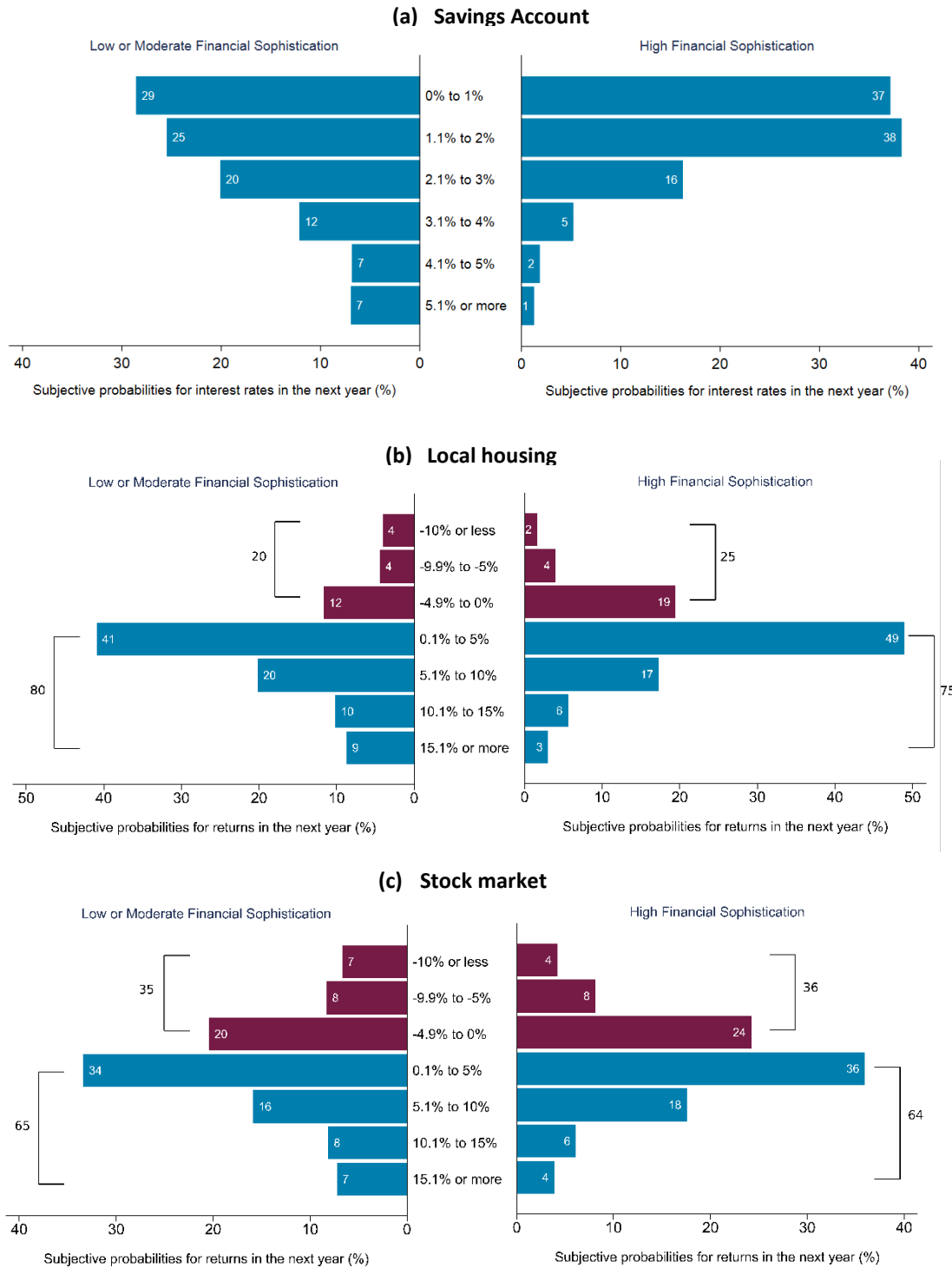
Aspects of people’s subjective expectations vary tremendously with their degree of financial sophistication, which has knowledge about past returns as one of its criteria (Figure 8). Those with low or moderate financial sophistication are much more likely to expect implausibly high interest rates on savings deposits (Figure 8a). They assess the probability of receiving interest rates above 3% at 26% on average, while those with high financial sophistication deem it very unlikely, with a probability of around 8%, to receive such high interest rates on savings.

Those with low or moderate financial sophistication are more optimistic about housing returns than those with high financial sophistication (Figure 8b). While they generally assign higher probabilities to extreme gains or losses, they think that increases in local house prices above 5% are very likely (carrying an average probability of 39%, compared to 26% among those with high financial sophistication). Similarly, they assign larger probabilities to falls in stock market returns by more than -10%. Interestingly, both groups assess the probability of moderate stock market gains between 0.1 and 5% similarly, at around a third (Figure 8c).

Hence, despite their relatively low knowledge about past returns and the comparative risk-return profiles of the three broad asset classes, even consumers with low or moderate financial sophistication display expectations that seem sensible in a pre-

pandemic environment. In comparison to those with high sophistication, they overestimate the interest rate of savings accounts and tend to perceive both local house prices and stock market returns as very volatile.

Figure 7: Subjective return expectations, split by financial sophistication



Notes: Subjective return expectations for (i) savings accounts, (ii) local housing investments, and (iii) stock-market investments in the FTSE 100. Financial sophistication is defined as low if financial sophistication index < 4, and high otherwise. Negative (positive) return probabilities are summarized in red (blue). Questions RISK2, RISK4, RISK5, RISK6, RISK9a, RISK9b, RISK9c; and

information on historical asset returns. Unweighted base 2,925 (all UK adults who are able to answer the probabilistic return questions).

6 Conclusion

Based on data from the FCA's Financial Lives 2020 survey, we have shown that 73% of the UK population are able to make probabilistic assessments of future returns on different ways of saving. Half of these adults demonstrate a high degree of financial sophistication in terms of knowing about past returns, understanding their relative returns and riskiness, and forming reasonable beliefs about future asset returns. Overall, 38% of consumers do both: they are able to assign probabilities to future outcomes and they show a high degree of financial sophistication.

Consumers with characteristics of vulnerability are more likely to lack the ability to assign probabilities to future returns, and among those who are able to assign such probabilities, to be less financially sophisticated, suggesting that a disproportionate number in this group may struggle to make good savings decisions.

But, as we've tried to emphasise, it's important to remember that having a characteristic of vulnerability doesn't, by itself, mean that a consumer will have additional or different needs or will experience harm. And this work confirms that a substantial number of consumers with characteristics of vulnerability do indeed display considerable financial sophistication. This suggests an approach that tries to identify those specifically with low sophistication might be more valuable than focusing exclusively on other characteristics of vulnerability. This holds true especially for those population subgroups that do have investible assets in the first place.

Expectations about future asset returns among those who answer probabilistic questions seem broadly sensible. In line with previous returns, individuals think that low returns on savings accounts are highly likely; that housing and stock market returns may go up or down; and that there is a higher probability of positive local housing returns than of positive stock market returns. Those with low or moderate financial sophistication tend to have subjective expectations about asset returns that are more extreme.

An interesting avenue for future research would be to study the link between subjective financial market expectations and savings choices. If such a link is found – as it has been in other countries – then helping consumers understand how different ways of saving work has the potential to improve savings choices, particularly among the vulnerable, who are more likely to have low financial sophistication.

However, our next piece of work explores a different issue: can we explain how expectations are formed? Specifically, we are investigating whether variation in local conditions is related to the way people form expectations about stock market and housing market returns. This will help us understand whether negative experiences make people more reluctant to save in particular ways, which may be detrimental to future outcomes.

