How Financial Risk and Financial Planning are Perceived in Latin Countries

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Today's climate is dominated by the figure of the cross-border investor. As a result, there are large capital flows across international borders, which contribute to a rapid evolution of the financial markets. This, in turn, makes the job of portfolio managers, and especially that of financial advisers rather difficult, because they have to know how to communicate the concept of risk to the investor in an effective manner. In other words they must make them understand what the underlying risks are, which no doubt are greater today than in the past.

The perception of risk in countries that have not had a great tradition in investments in stocks is somewhat different to countries where investing in stocks is considered the principal "safe haven". The term financial planning for us Latinos (meaning anyone speaking Spanish, French, Italian or Portuguese, both in Europe and Latin America) has a slightly different meaning compared to the common usage of the term in Anglo-Saxon countries.

The so called "more creative" and "less organized" cultures have always been rather reluctant to draw up scenarios about their future financial flows. Perhaps it is due to the dominant fatalistic culture or because it is thought to be bad luck, but there is a physiological resistance to make up a detailed financial plan that goes all the way to the end of one's expected life span.

It seems to be difficult, not only to think about death, but also about planning. To identify goals, and determine the ways to reach them, implies the possibility of frustration perhaps by not reaching those goals, or making a mistake at the time of choosing the road to take.

In this way of thinking, it is worth it to avoid any thought about the future: it will happen, and you cannot do anything to avoid it, or to create a better situation when it happens.

The standard assumption that investors should be rewarded for risk-taking is not well understood, the same goes for the perception of systemic risk and specific risk.

It is interesting to note how, as of Dec. 1999, capital invested in mutual funds in Italy was distributed as follows:

- Cash and Near Cash 0.2%
- Italian Government Bonds (short and long term) 32%
- Stocks of Italian companies 9.7%
- Convertible Bonds 0.1%
- Non Government Bonds 2.1%
- Stocks of Foreign Companies 28.1%
- Foreign Bonds 21.4%
- Other assets 6.4%

Total: 536,000 billion Euro.

This distribution represents a break with tradition, when foreign bonds and stocks were an insignificant percentage of total assets. In the '80's the share invested in stocks by Italian families, as a percentage of total assets, was only 7%. In 1999, this number spiked up to 37.8%. There has been truly a cultural revolution in investing. One should note that in Italy, up to the beginning of the 90's, the annual yield on bonds was in the double digits, so nobody bothered sailing in uncharted waters. This fact has created a population of investors who prospered by buying government bonds, thus diverting large amounts of capital away from the stock market.

It is true that, in the past, the Italian stock market, aside from a handful of companies, has never provided enticing returns, in fact it has sorely disappointed those few investors who strayed from the main path, bringing consistent losses. The Italian stock market has suffered because of the unchallenged dominance of certain family-owned groups, which in fact have always looked only after their private interests. It has only been in the past decade that real public companies have appeared on the Milan Stock Exchange, starting when Mediobanca lost its leadership.

Given that almost all Italian savings were channeled in to domestic government bonds (BOT, BTP, CCT) Europeans nicknamed Italian investors "bot people". Today's rates are at about 3.5%, also thanks to the introduction of the Euro. Given the good performance of the stock market in recent years, risk has become a daily topic and now it is seen in a different light.

There is however a lot of confusion about the relationship between risk and return, because of an increasingly pervasive "lottery ticket" mentality that is taking hold, also due to the astronomical P/E ratios of the stocks belonging to the so called "new economy." The great proliferation of financial consultants has generated a certain sense of disorientation among investors, which have often fell pray to professionals, or alleged professionals, who have not always offered their best advice. This not completely above-board behavior was displayed also by certain very aggressive financial institutions, which were better at selling than at asset management, and "sold" unreasonable promises based on past results. Given this environment, what chance do investors have to understand the risks related to investing in stocks?

From the time of the migration of the so-called "bot people" towards the stock market in 1995 there have been no major disasters, aside from some complaints about companies whose stock has under-performed compared to the benchmarks.

In general, Italian investors hold all their assets in a single financial institution. Furthermore, the mutual funds they own belong all to the same family of funds, thus taking-on an unnecessary form of risk since, as a consequence, it becomes impossible to diversify in different asset management styles.

This peculiar behavior has its historical roots in the rivalry between different regional banks. In the past, and even today, it is not unusual for 60-70% of the capital of a family to be invested in the stock of a single company – thus violating the rules of diversification – for no other reason than this sense of partisanship of belonging to a particular bank faction. Any further comment on this phenomenon is superfluous.

In Argentina, as of December 1999 the money invested offshore totaled 90 billion USD, 40% of which was in US federal bonds, 5% in money markets, 20% fixed-term bank deposits, 15% in offshore real estate and the rest in stocks. Regarding the money domestically invested in Argentina, 40% is in retirement plans and insurance, 10% domestic stocks, 10% private mortgages, 25% bank deposits, and 15% government bonds.

Devaluation, high interest rates, turmoil.... This has been the typical environment for many years in countries like Brazil or Argentina. People grew used to knowing that the circumstances of the day could dramatically change the following night. This means that the possibility of loss is very high.... But gains, when they occur, are very high too.

In Argentina the USD-based mortgage interest rate ranges from 14% to 24%. Interest rates for consumers with credit cards go from 24% in dollars to 40% in pesos. The reason of the spread between interest rates in dollars and in pesos is the so-called "Argentine risk". It means that, although there is a Convertibility Law, that says for example, that 1 dollar is equal to 1 peso, the phantom of devaluation has never been forgotten, especially in a country where hyperinflation happened only ten years ago.

So, people who have to get a loan sometimes prefer a higher interest rate in pesos, just to avoid the risk of a devaluation. What they do not know, is that, if a devaluation was to happen in the short run, nobody would lend money in pesos. So, while the Devaluation Phantom is a good banking excuse to have hyper-high interest, this is really lending money to Argentine people without good advice.
At the same time, when a person wants to invest his money in the bank, he will never receive more than a 10% annual interest rate. It means that there is a great spread between interest paid and interest received. To avoid this, a lot of people are used to investing in some dangerous alternatives.

There is a common place for those investments: the short run. Argentine investors are compelled to find opportunities for today that perhaps will be useless in the future. It is not common yet, the planning mindset. Everyone looks for profits today and a very small percentage of the population plan for retirement and other goals in the long run.

It is an educational and awareness issue: how will people be convinced that the best for them is to forget great income today, invest carefully to protect their assets, and be sure that their assets will arrive safe to the moment they will need them? This is the immense work that financial planners must do: teach people about planning and the possibility of taking control of their own future.

As mentioned previously, today the mindset is changing in favor of global planning. The real problem starts once the client has set the objectives they want to reach, it is necessary to define the level of risk that they are willing to bear. The masses want low standard deviation coupled with high returns. Often, to calm investors down planners have to resort to using a psychological approach, discussing the client's current wealth and distinguishing between those who are already wealthy and those who are still in the accumulating phase. An approach is to suggest that wealthy individuals worry more about capital preservation and will accept only moderate amounts of risk. Some of the more adventurous investors have opened an on-line trading position by using a small portion of their assets, in order to give free rein to their gambling compulsions.

Things are gradually changing. In Italy, with the second highest savings rate in the world after Japan and the third largest government bond market, a bit of financial sophistication is finally starting to take hold. Even though it is difficult for investors to fully perceive how much potential their portfolio really has, in spite of their naivete they understand that diversification is a worthwhile goal and that the objective cannot be to reach the absolute highest potential return possible.

The relationship between risk and return is partly subjective and partly objective: the evaluation that everyone makes about their risk aversion is subjective (basically how much risk can one accept and still sleep well at night); the performance of the stock market is instead objective and unfortunately not predictable. The financial planning process consists precisely in finding a rational compromise.

For a financial planner unfortunately it is not always easy to understand the objectives that an investor wants to reach, because Latinos tend to be rather fickle in their choices.