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Research Snapshot:

Financial Knowledge Overconfidence and Emergency Fund Needs

S. T. Lee & S. D. Hanna

Research Summary

Have you ever worked with a client whose *belief* in their own financial knowledge vastly exceeded their *actual* financial knowledge? Lee and Hanna would describe that client as having "financial knowledge overconfidence," which measures the difference between subjective financial knowledge (what someone thinks they know) and objective financial knowledge (what they actually know, usually measured by a test or quiz).

Lee and Hanna were curious about the impact that overconfidence would have on the need for an emergency fund. Would an overconfident client think they need to save less for an emergency? You bet, according to the study's findings, which analyzed the correlation between financial knowledge overconfidence and perceived emergency fund needs.

The researchers found:

- **Overconfident individuals perceived they needed 24.1% less in an emergency fund, as compared to their appropriately confident peers.** These appropriately confident peers scored high in both objective and subjective measures of financial knowledge.
- **For a target emergency fund of three months, an overconfident individual may think they need a fund to cover only 2.35 months instead.**

The researchers also spent time describing the standard emergency fund benchmark: Save enough to cover three months of expenses, which dates back to the 1990s and was based on the typical period of unemployment (Johnson & Widdows, 1985). More recently, other researchers have suggested five or six months is a better benchmark, again based on the duration of unemployment (Rodriquez-Flores & DeVaney, 2007; Anong & DeVaney, 2010). For a target emergency fund of five months, an overconfident individual may think they need to only cover four months instead, based on Lee and Hanna's findings.

But those standard benchmarks fail to capture nuances your clients may be juggling, as highlighted by Lee and Hanna.

This is just a snapshot of a really excellent paper with a robust discussion of emergency funds. Read the full study to better understand the other literature in the field, the methodology, and the limitations of the study.

Lee, S. T. & Hanna, S. D. (2022). What, me worry? Financial knowledge overconfidence and the perception of emergency fund needs. *Journal of Financial Counseling and Planning*, 33(1), 1-42.

Study Details

Quantitative study: Survey

Using 2016 Survey of Consumer Finances dataset

5,423 respondents

Nationally representative sample

Bridge to Practice

As with all research, this isn't necessarily generalizable. There are limitations and more questions to answer. ***Nevertheless, there are interesting findings you can think about incorporating in your practice.***

Help overconfident clients learn.

We know from other research (lots of other research) that higher objective financial knowledge is positively correlated with higher rates of saving (Lusardi, 2007). So helping clients increase their *objective* financial knowledge is generally a good thing. Lee and Hanna found that it may be especially impactful for overconfident clients, especially as it relates to perceiving their emergency fund needs accurately.

Work to estimate true emergency fund needs.

Don't abandon the benchmarks for emergency fund needs, which can be wonderful starting points. But consider working with clients to dig into the nuances and details of their own situations to calculate a more unique (and accurate) emergency fund goal. Discuss lifestyle considerations (for example, multiple earners in a household or earning income from various sources); access to other resources (for example, social safety net resources like expanded unemployment, access to credit or home equity funds, the ability to borrow against retirement or even access to family or community support); and a client's risk tolerance (while adjusting for overconfidence!) to create a more personalized emergency fund goal.

Close the confidence gap.

If you have worked with overconfident clients, you know helping them close their confidence gap is not always easy. One way to close the gap is to help clients more realistically assess their own objective financial knowledge through personalized self-assessment tools (suggested by Kim, Lee, and Hanna in 2019). Consider, for example, inviting a client to answer a quiz-style question at the beginning of the relationship: What should you have in an emergency fund? The answer could then be personalized to re-set the confidence level. If a client says, "enough to cover three months," you could share that that number is based on the duration of unemployment in the 1990s, which may not be relevant to their own situation. Providing these "reset" moments (without alienating or condescending to the overconfident client) can help close their confidence gap and cement your value as an advisor.

Definitions

- **Objective financial knowledge:** Objective financial knowledge is measured by correctly responding to knowledge-based financial questions. There is no adjustment for perception. The answers are correct or incorrect.
- **Subjective financial knowledge: :** Subjective financial knowledge is based on one's *perception* of their own financial knowledge. It is often measured on a numeric scale (instead of by correctly answering questions).
- **Financial knowledge overconfidence:** Financial knowledge overconfidence exists when one's *subjective* financial knowledge exceeds their objective financial knowledge (sometimes by a large amount).
- **Emergency fund: :** An emergency fund is an amount of money an individual or household can use without penalty in the case of an emergency. It can be measured in quick assets (checking and savings accounts), intermediate assets (checking, savings, and long-term savings), or comprehensive assets (everything except retirement) (Johnson & Widdows, 1985).