What Victorian households can teach us about financial decision-making

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In today's financialised societies, households are heavily exposed to financial risk. Many researchers are exploring how such households make financial decisions and manage financial risk in practice. There are also substantial efforts being made by government, regulators, charities and financial players to increase the financial literacy of households to help them make better financial decisions.

In our research, we explore the financial decisions made by a sample of late Victorian investors and attempt to draw some lessons from a period which, in its global outlook and investment opportunities, is similar to today.

We show that investors diversified their portfolios both internationally and across sectors, well before the benefits of diversification were modelled by Markowitz in the form of modern portfolio theory (MPT), which recommends that portfolio weights be chosen according to the returns and risks of individual securities but also according to the correlations between the various security returns.

But during the period that we study, contemporary investment publications also promoted the benefits of diversification in terms of enhanced yield without increased risk. They showed this by using historical data to quantify the greater returns achievable.

So, nineteenth century UK investors were also aware of the benefits of spreading risk across different types of securities as recommended by MPT. The most common advice, though, was not to calculate mathematical correlation matrices, as does MPT. Rather, the advice was to invest equal amounts in a range of securities, the so-called 1/N or naïve diversification approach.

Our study breaks new ground in our understanding of what Victorian investors did in practice with their portfolios. Up

to now, researchers have merely acknowledged that such diversification took place, or have used market prices to argue that Victorian investors *ought* to have diversified and quantified what such investors would have gained in return terms, had they had perfect foresight.

In contrast, we look in detail at a sample of 508 investor portfolios at death, using carefully analysed probate data, for the period 1870 to 1902. The results of our analysis of these investor portfolios allow us to draw a number of conclusions.

For example, the probate records of our sample show an almost equal number of women and men held financial portfolios at death, highlighting the importance of women investors in this period. Also, we find that, for these estates at death that included financial securities, investments represented on average a substantial 60% of gross assets, the remainder being property, life assurance, loans and cash.

The average number of financial securities held in a sample portfolio was 4.6, with a median of only two. Surprisingly, though, this level of diversification is not dissimilar to that of portfolio holdings from US samples in the 1970s and 1990s, one hundred years later, and decades after MPT was formalised in the 1950s and 1960s.

In our sample, the level of diversification was linked to wealth, with the top quartile in gross wealth terms holding an average of 11 securities in their portfolios, with men holding more diversified portfolios than women.

But overall, investors did not hold securities in equal weights, as generally recommended in the investment literature of the period. They did not manage financial risk via naïve diversification. Nor did they evenly spread their risks across sectors and countries.

For example, investors living outside London, as well as less wealthy investors, preferred the securities of domestic companies other than railways. This indicates a preference for local investment, which offers an alternative route to risk reduction, that of trust in local enterprise. This is in line with recent economic history research on trust.

We also find that wealthier investors, who held more securities, were more willing to hold international and government securities than the less wealthy. In contrast, a surprising 35% of our sample of investors held only non-railway corporate securities in their portfolios.

Lessons for today's decision makers

In conclusion, individual investors in our late nineteenth century sample *did* diversify, but not as much as recommended by the contemporary investment literature. Instead, we find that they relied more closely on local trust networks for their financial decision-making.

This does not mean that investors failed to see the benefits of international, sectoral or naïve diversification. Rather – and this is a key lesson for today's decision makers – non-wealthy households who hold the majority of their wealth in non-tradable form and who are unable to easily hedge financial risk, are reluctant, as were their forebears, to embrace relatively sophisticated financial approaches to investment.

They prefer, instead, to rely on trust, whether of the companies in which they invest or of their financial intermediaries.

Notes:

- *This blog post is based on the author's research Diversification in the UK during the first globalisation era: evidence from individual investor portfolios, presented in the 2017 Conference of the Economic History Society.*

- *The post gives the views of its author, not the position of LSE Business Review, the London School of Economics and Political Science.*
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