Humans Are Not Necessarily Rational Thinkers, Especially In Retirement - Part 1

Factoring in human behaviour when building retirement income strategies

Investing in retirement is different. To best understand how and why clients make decisions about their finances, and in particular, their retirement, advisers must consider the behavioural factors behind those decisions before even starting to address the more technical and product-specific dimensions of retirement.

Behavioural finance looks at how people make financial decisions and the psychological factors that can influence their choices. As individuals take more responsibility for their retirement savings, the human (and emotional) element becomes a critical determinative factor in whether they make good or bad choices with their money. For retirees, their decisions can mean the difference between living in financial security and running out of money. For an adviser, factoring in the behavioural aspects at play when guiding a client through a decision-making process can help shape the provision of specialist advice.

A detailed study conducted and compiled by Professor Shlomo Benartzi of UCLA and sponsored by Allianz of America[1] noted that there are ten behavioural insights, to be taken into account when creating and evaluating a retirement income strategy.
"Behavioural finance looks at how people make financial decisions and the psychological factors that can influence their choices.**"**
These insight theories, whilst fascinating and complex, have identified a checklist[2] of 10 questions as part of the study.

Throughout four articles, we take a closer look at the drivers of human behaviour, as outlined in the checklist. Advisers can evaluate how taking into account these behavioural factors can assist in overcoming common bias and cognitive behaviours to enable the delivery of holistic advice and sound client outcomes.

Here are the first three:
Behavioural Insight – #1 Framing

Simply speaking, framing looks at the way humans interpret information based on how it is presented, instead of relying on the individual facts. In retirement, as individuals move away from wealth accumulation, there is a need to help them focus on income generation, over seeking investment returns. If we consider framing in an advice scenario, asking a retiree to decipher what percentage return, they require from their investments to cover their annual expenses isn't as relatable as asking them how much income they need to manage their bills.

In framing, context is king and how an adviser frames the conversation will have maximum impact in delivering the desired mindset and outcome.

Checklist question: Is the retirement income strategy framed in terms of the monthly income a retiree will receive?[2]
Behavioural Insight – #2 Vividness

If you ask yourself what life will be like in 20 years, it's particularly hard to envisage. Surely that's a problem for 'future you'. But that's precisely the state of mind a retiree needs to enter when making their financial choices to set up their financial future. In work undertaken by Professor Daniel G. Goldstein of Yahoo Research and London Business School[3], individuals were asked to immerse themselves in virtual reality to look into an age-morphed mirror. Individuals were then asked to allocate money towards their hypothetical retirement account. Those that saw their 'future selves' were over two times as likely to provide money to the retirement pot, compared to those that saw their own, current reflection.

That may be quite an extreme example of bringing vividness to life, but in practice, conversations supported by tools, scenario-based case studies, or real-life comparisons can assist in allowing retirees to imagine how their present financial assumptions may affect their future wealth and lifestyle satisfaction.

Checklist question: Are the implications of today's financial decisions vividly presented so clients see how their life will be affected?[2]
Behavioural Insight – #3 Hyper Loss Aversion

"Losses loom larger than gains" (Kahneman & Tversky, 1979)[4].

Hyper loss aversion looks at the propensity for people to become more sensitive to financial losses as they age. Retirees fear a loss five times as much as they value a gain. The average person (someone in accumulation phase) fears a loss only twice as much as they value a gain.

Our decision-making faculties can be vastly skewed when we consider the risk of losing money, to say a sudden market downturn or negative returns. Loss aversion has implications on how retirees make decisions, and fear can manifest in suboptimal investment choices. Allowing a sense of control and flexibility shouldn't be underestimated when dealing with loss aversion in retirement portfolio construction. Incorporating products that provide income with a greater degree of certainty in outcome is critical in providing retirees with a sense of control over their destiny. It is also crucial that solutions specifically address loss aversion- particularly for those that are hyper-sensitive - while addressing retirement specific risks, such as sequencing risk.

Checklist question: Is the strategy appropriate for retirees who are hyper-sensitive to losses?[2]
Behavioural finance has the potential to reshape the financial lives of retirees and can help add a human dimension to the design of a client's retirement income strategy. By considering these checklist questions as we share them, we hope you will be better able to evaluate a retirement strategy, before it's put in front of a client.

Reference list:

[1] Source: Behavioural Finance and the Post-Retirement Crisis. Prepared by Sholomo Benartzi, UCLA. Sponsored and submitted by Allianz of America, 29 April 2010.

[2] Source: Behavioural Finance and the Post-Retirement Crisis. Prepared by Sholomo Benartzi, UCLA. Sponsored and submitted by Allianz of America, 29 April 2010; A Behavioural Financial Checklist for Retirement Income Strategies, Summary and Checklist, p17.

[3] Source: Behavioural Finance and the Post-Retirement Crisis. Prepared by Sholomo Benartzi, UCLA. Sponsored and submitted by Allianz of America, 29 April 2010; Vividness, chapter 3, p7.

[4] Source: Behavioural Finance and the Post-Retirement Crisis. Prepared by Sholomo Benartzi, UCLA. Sponsored and submitted by Allianz of America, 29 April 2010; Hyper Loss Aversion, chapter 4, p8.