Humans Are Not Necessarily Rational Thinkers, Especially In Retirement – Part 2

Factoring in human behaviour when building retirement income strategies.

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.

Based on a detailed study conducted and compiled by Professor Shlomo Benartzi of UCLA, and sponsored by Allianz of America[1], our four part series - *Humans are not necessarily rational thinkers, especially in retirement* - looks at 10 behavioural insights that should be taken into account when creating and evaluating a retirement income strategy. In part one, we reviewed the psychological factors associated with *Framing, Vividness and Hyper Loss Aversion* and how they influence a retiree's judgement or choices.

In this article, we continue to look at the drivers of human behaviour by exploring *Cognitive Impairment* and *Tangible Mental Accounts* as they relate to investment decision making in retirement. The checklist within is designed to assist advisers in identifying these behaviours, and will provide a practical framework of questions to explore with clients to help overcome these common bias and cognitive behaviours.
Behavioural Insight - #4 Cognitive Impairment

While old age may bring the benefits of experience and wisdom, it also impacts the quality of cognitive function and subsequent decision making. A study of older adults, conducted by Prof. David Laibson of Harvard University, saw a decline in 'analytical cognitive functioning' – the ability to learn, think, reason, remember and problem solve. In addition, the study showed a marked decline in financial literacy, including mathematical skills and the ability to understand charts, graphs and tables[3]. This finding is quite alarming when you consider many people only start making key retirement decisions when they're nearing retirement in their early to mid-60s. Understanding and assessing advice; how your investments have performed; and the potential impact of things like sequencing risk on retirement income streams is challenging enough as it is. Add in the additional complexity of the 'new compliance regime' and the associated paperwork, and we have a problem.

So how can advisers help clients make good decisions about drawing and protecting their income in retirement? Consider encouraging older clients to: lock in their retirement strategy as soon as possible; protect against draining investment assets too quickly; and/or ensuring provision of a regular income stream. Either way solutions that help people make early key decisions about retirement are critical.

Checklist questions: Can retirement income decisions be made before the onset of cognitive impairment? Are the number and complexity of choices manageable for older individuals?[2]
Behavioural Insight - #5 Tangible Mental Accounts

The fear of running out of money and/or making investment losses are genuine concerns for retirees dependant on existing assets for a regular income stream.

Advisers can help by working with retirees to identifying specific needs or goals and separating them into 'buckets' for easy reference. This can help retirees to mentally account for and control their spending, and investment strategies can be developed accordingly. For instance a bucket that pays for essentials, such as utilities, council rates, medicines and groceries, can be invested conservatively whilst a bucket that pays for the 'nice to haves', e.g. holidays, or luxury items can be invested more aggressively to provide growth.[4]

Going one step further and labelling these 'buckets' can also make them much more tangible, providing relevance and emotional engagement, as well as a basis for ongoing conversations around controlling spending, meeting needs and realising goals.

Checklist question: Do your clients' retirement income strategies offer flexibility for multiple accounts to facilitate different goals, such as paying the rent or spending money on holidays?[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 Finance Checklist for Retirement Income Strategies, 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; Cognitive Impairment, chapter 5, p9.

[4]Source: Behavioural Finance and the Post-Retirement Crisis. Prepared by Sholomo Benartzi, UCLA. Sponsored and submitted by Allianz of America, 29 April 2010; Tangible Mental Accounts, chapter 6, p10.

needs. Past performance is not a reliable indicator of future performance. No person should rely on the content of this material or act on the basis of anything stated herein. Allianz Retire+ and its related entities, agents or employees do not accept any liability for any loss arising whether directly or indirectly from any use of this material.