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A FRESH PERSPECTIVE

WHY THE PAST IS A RELIABLE GUIDE TO THE FUTURE

'People spend their money like drunken sailors... as if they will die in a few years'.

The author of this quote, Harvard Psychologist, Steven Pinker, attributes this to primal forces - our evolutionary ancestors may have regularly feared for their life. But why should such unpredictability shape how we live today?

Behaviours like this have profound implications for financial services. Appeals to rational argument: For example, the case for saving for the future - fall largely on deaf ears. Our 'live for today' mentality is the driver behind auto enrolment and 'save more tomorrow' schemes to steer people towards better decisions.

Behavioural economics attempts to define how these influences play out in the way we make decisions about money. Nowhere is this more important than during retirement. As we age, cognitive ability declines and we often become more risk averse.

Here are some examples of how different behaviours and biases can influence decisions.

Herding

We're inclined to follow the lead of others. This herd-like behaviour may account for the rapid rise of drawdown following the infamous statement by the then Chancellor, George Osborne, that 'no one need ever buy an annuity again'. This, together with a hostile media, will have coloured the judgement of many people towards annuities. It's little wonder that drawdown, which accounted for only 5% of sales in 2013, now dominates the market. It's an oversimplification to attribute the rise of drawdown solely to herding - the reasons are more nuanced than this, but it's likely to have played a significant part.

Loss aversion

We fear loss more than we value gain. Our evolutionary ancestors may have enjoyed having too much to eat, but not having enough could be fatal. And our aversion to loss increases during retirement. A US study found that the very act of retiring makes people more risk averse. The loss of a regular salary and the uncertainty of knowing how long retirement funds have to last underpin their fear of loss. A separate US study found that people who annuitise have lower levels of depression. The stress of not knowing whether you'll run out of money, or that a market crash could cause significant loss, is unsettling.

Framing

How a choice is presented can affect the decision that's made. One of the obvious examples in the retirement market is the positioning of annuities. FCA research revealed that when presented as a form of insurance, 66% of consumers preferred an annuity to a savings account. When presented as an investment product only 17% chose the annuity. Framing can take many forms. For example, when asked to choose between three funds with different allocations, most people will choose the middle option. So offering 3 funds with equity content of 0%, 40%, 80% or offering three funds with 40%, 70%, 100% equity content will lead to quite different outcomes.

Paradox of choice

Too much choice can cause people to procrastinate and become inert. This is the subject of the memorable jam experiment, which discovered that consumers were 10 times more likely to purchase jams on display in a supermarket when the number of jams available was reduced from 24 to 6. A more relevant example might be the use of default funds. Countries offering limited investment choice have much higher levels of people making active investment decisions. In contrast, countries offering a wide choice of investment funds have fewer people making active choices and more people ending up with the default option. In the UK, Hewitt, Bacon and Woodrow estimate that more than 80% of members in DC plans accept the default fund choice.

Hyperbolic discounting

This is the 'drunken sailor' scenario Steven Pinker referred to at the start of this article. Because life was more precarious at the beginning of our evolution, we tend to value jam today over jam tomorrow (on the basis that tomorrow may never arrive). This behaviour fuels the 'dash for cash' we have witnessed since the new pension freedoms. Although many people are behaving responsibly, around half a million people have cashed in their pension pot since the new pension freedoms were introduced and around half of these have already spent the money (though some have used the money to repay debt). Another example might be the very low numbers of people buying inflation linked annuities. Studies repeatedly reveal how inflation is one of the major concerns people have as they enter retirement, yet when faced with a lower starting income most would rather have the money upfront. There have been concerns raised about the pricing of inflation linked annuities in recent years, but in practice there has never been a halcyon period looking back where these products were popular.

Availability bias

This is about making a judgement based on how easily an example comes to mind. For example, researchers found that people are more likely to overestimate the chances of a car crash if they've seen a car crash recently. Similarly, investors are more likely to fear the stock market when there has been a crash recently (though this is often the best time to invest). George Osborne's comment that 'no one need ever buy an annuity again' might easily be recalled as a reason to dismiss annuities without going through a rational appraisal of their strengths and weaknesses.

These are just some of the key behaviours and biases. Advisers who are aware of these influences can use these insights to counteract negative behaviours that could lead to sub optimal outcomes for clients. Most clients probably have little understanding of the full range of issues and risks they face in retirement. This makes it more likely that they will rely on mental shortcuts, possibly making irrational judgements. Given the general decline in cognitive abilities as people age, it's imperative that advisers, focused on the retirement market, are aware of the importance of behavioural economics.

FOR MORE INFORMATION

Call: **0345 302 2287**
Lines are open Monday to Friday, 8.30am to 5.30pm

Email: **support@wearejust.co.uk**

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