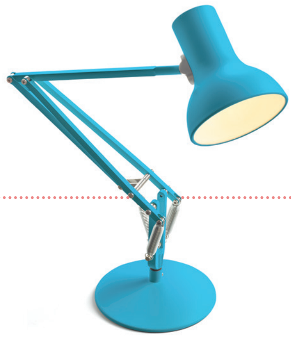
JUST.

THE PERIL OF TOO MANY OPTIONS



This article on behavioural economics and the advice process focuses on stage three, exploring how a variety of biases can undermine a rational assessment of retirement options.

The choices facing clients at retirement have increased since the introduction of pensions freedoms. What's more, the popularity of drawdown can lead to greater complexity and more exposure to a wider wider range of risks. This makes it more challenging for advisers who have responsibility for helping their clients to successfully navigate their way through the maze of decisions, choices and risks that they face.

Check retirement income will exceed expenditure

A starting point at this stage of the process may be to confirm whether or not estimated income is likely to be greater than planned expenditure. If it isn't, the client is faced with a number of options. There may be discretionary spend that can be reduced, or the client might consider deferring retirement (or continuing to work in some capacity). Alternatively, they could leverage other assets like the equity in their home.

In this context, beware of a behaviour called **'framing'**. How you frame something can influence whether the response is positive or negative.

Bewildered by choice?

Assuming income does exceed expenditure, the conversation can move onto the suitability of different options. One of the key behaviours to be aware of is **'paradox of choice'**. Too much choice can confound people. In an episode of The Simpsons, Marge visits a new supermarket, Monstromart, whose advertising slogan is 'where shopping is a baffling ordeal'. Of course, as an adviser you'll steer clients through the options facing them, but it's worth being aware of this behaviour.

Fast track to wrong conclusion?

As you discuss different options there are multiple behaviours that can come into play. For example, any discussion of a guaranteed income for life (GIfL), provided by an annuity, should consider **'framing'** and **'availability bias'**. An understanding of each can help position GIfL objectively.

We've already defined framing but, in the context of annuities, FCA research revealed that when presented as a form of insurance, 66% of consumers preferred an annuity to a savings account, but when presented as an investment product only 17% choose the annuity.

Be on your guard for availability bias; the inclination to leap to judgements on the back of easily recalled examples or instances.

The hostile media and George Osborne's pejorative comment that 'no one need ever buy an annuity again' may spring to mind and colour perceptions of GIfL, yet in many instances it may be the right solution.

Drawdown also exposed to biases

Any consideration of drawdown introduces a further range of behaviours to consider:

- **'Familiarisation bias'** can lead to a preference for UK shares and funds underpinned by an erroneous belief that they are somehow less risky.
- **'Overconfidence'** is a largely innate trait, which most of us possess to varying degrees. It can lead to a belief in one's ability to pick winning funds or investments.
- **'Disposition effect'** is the tendency to sell winners and hold on to losers too long. There is a logic to this. If you haven't sold a loss making investment there is always the prospect that it could recover. Similarly selling a profitable stock realises a profit (over time the investment could turn loss making). However, as a strategy, this process rarely pays off.

'Hyperbolic discounting' can influence people to take too much income in the early years from their drawdown fund. And there is evidence that this is happening elsewhere in the world. Nearly 40% of Australians run out of money by age 75 and pension savings in the US lasting typically just 17 years.

Other behaviours can inhibit effective decision making and can prevent people acting in their best interests. '**Status quo bias'** is described as 'a preference for the current state of affairs'. In other words, doing nothing. Of course, doing nothing may make sense. For example, if there are penalties or GARs to be considered, but often it's simply inertia. Similarly, **'reciprocity'** can lead people to stay with the existing provider out of a sense of loyalty. And **'regret aversion'** can cause people to procrastinate, because once they commit to a course of action, it's not uncommon to immediately experience feelings of discomfort and regret.

Consideration, flexibility and regular reviews

One solution to overcome these biases is to give people plenty of time to decide. Research shows that people will choose a default option 82% of the time if they are asked to decide immediately, but only 56% of the time after a delay. Reminding clients that they have a cooling off period can help too. And it may be worthwhile emphasising what parts of a strategy can be changed or reversed. All these actions can help combat any reluctance to take decisions.

The client should also be made aware that regular reviews throughout retirement will provide an opportunity to consider any changes or adjustments that might be required. Either because the client's circumstances have changed or to react to any extraneous influences that could impact on the client's retirement plans.

The final article in our series looks at the last stage of the process 'Recommendations and implementation'. We'll explore how hard it is to imagine our life in the future and why we're prone to significantly overstate the risks of stock market investing.

Read these articles to discover how behavioural economics and biases impact other stages in the retirement advice process:

Stage 1 INTEGRATING BEHAVIOURAL ECONOMICS INTO YOUR INITIAL CLIENT DISCUSSIONS

Stage 2 OVERCOMING NEGATIVE INFLUENCES IN OBJECTIVE SETTING

Stage 4 BIASES TO BE AWARE OF WHEN PRESENTING RECOMMENDATIONS

Visit justadviser.com for insight and ideas on how to work with biases to create better retirement outcomes.

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