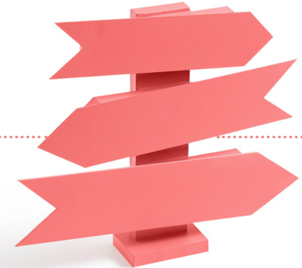
For financial advisers only. Not approved for use with customers.

JUST.

OVERCOMING NEGATIVE INFLUENCES IN OBJECTIVE SETTING



This article in our series on behavioural economics explores how biases can hinder decision-making when meeting a client to agree objectives.

The start point is a financial audit, which should include a review of the client's existing assets, an assessment of their debts and liabilities, and an understanding of how and when they plan to retire. It also includes their goals and objectives.

Breaking down money silos

In defining the client's assets one behaviour to bear in mind is 'mental accounting'. We're inclined to view money in silos based on either its source or what we plan to use it for. People often ring fence money mentally for specific purposes like a holiday fund or rainy day pot. This means they may not volunteer assets that could be used to boost their retirement income (because they're earmarked already).

An example may be equity in the home. They might see this as a legacy to be shared among their children. To make sure assets and their purpose aren't missed, use a prompted list rather than ask an open question.

Another important element during this stage of our retirement advice process is an assessment of risk. A different aspect of 'mental accounting' may come into play at this point. The previous example considered the intended use of assets, but people also separate money based on its source. Put simply, we may squander a lottery win because it's perceived to be 'easy money'. In contrast, we're likely to be more circumspect with pension savings that have taken years to build up. The effort to create a sizeable pension pot is likely to make us more risk averse.

Increased 'loss aversion' in retirement?

An 'attitude to risk' assessment should flush out this issue, but it is worth being aware of the subconscious influences that determine our attitude to risk. 'Loss aversion' is a behavioural influence that also shapes our attitude to risk. We instinctively fear loss more than we value gain. The origin of this behaviour is primal. Our ancestors may have enjoyed periods where they had more food than they needed, but not having enough food was potentially fatal. This gives rise to an asymmetric view of loss.

Prospect theory suggests that most people won't gamble a pound to win a pound. The upside needs to be around £2 before people consider putting their pound at risk. And there's evidence that the act of retirement can intensify our fear of loss. The absence of a regular salary and the uncertainty of not knowing how long savings need to last can be unsettling.

Bread today not jam tomorrow

The next area to explore is the client's income needs and this introduces a number of potentially damaging behaviours. In particular, 'hyperbolic discounting'. Hyperbolic discounting is the 'preference for a smaller reward sooner rather than a larger reward later'. This live for today attitude again links back to our ancestors and a time when the prospect of living from one day to the next was less certain than it is today (for those of us fortunate enough to live in developed economies).

Dangers of thinking short-term

This behaviour can manifest itself in many ways during a conversation about income needs. It can lead clients to take too much income or unnecessary lump sums from drawdown.

Nearly 40% of Australians have exhausted their pension pot by age 75 and pension savings in the US typically last just 17 years.

It can also tempt people to take more than the 25% tax-free limit as a lump sum. Around 500,000 people have cashed in their pension pot since the new freedoms were introduced and roughly half have spent the money (though some have used it to pay off debt).

And it can lead to people choosing single life guaranteed income for life (GIfL), provided by an annuity, without death benefits or escalation to boost their initial income. Clients often find the temptation to maximise their income today irresistible, so it falls to the adviser to temper this instinct and inject a note of realism.

Remind clients how long retirement can last these days and the insidious impact of inflation. Where necessary, invoke their sense of responsibility to take care of partners and loved ones in the event of their death.

The importance of a reality check

Another behaviour which acts as a prop to hyperbolic discounting is ‘optimism bias’. Hyperbolic discounting explains why people may be tempted to take too much income or ignore inflation, ‘optimism bias’ may convince them that their actions are justified. We’re naturally wired to look at life optimistically, but this can have a dangerous impact on retirement planning.

Clients may believe investment returns will be higher than average or that inflation will be benign. Maybe they’re underestimating how long retirement will last. This kind of optimism is largely misplaced in retirement planning unless the client has significant assets and can take remedial action if their optimism is unfounded.

This part of the advice process can highlight several behavioural biases that should be addressed. Understanding how these can influence and impact a client’s objectives can help you steer your clients in the right direction.

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

Stage 1 OVERCOMING NEGATIVE INFLUENCES IN OBJECTIVE SETTING
Stage 3 THE PERIL OF TOO MANY OPTIONS
Stage 4 BEHAVIOURS REVISITED

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

FOR MORE INFORMATION

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

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

Or visit our website for further information: **justadviser.com**

Please contact us if you would like this document in an alternative format.

Just is a trading name of Just Retirement Limited. Registered Office: Vale House, Roebuck Close, Bancroft Road, Reigate, Surrey RH2 7RU. Registered in England and Wales Number 05017193. Just Retirement Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Please note your call may be monitored and recorded and call charges may apply.