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

JUST.

THINK

A FRESH PERSPECTIVE

THE PAST CAN FUTURE PROOF YOUR ADVICE PROCESS

Understanding the innate primal responses that drive our behaviour can significantly improve decision-making. That's why it's important to integrate behavioural economics into your advice process. Behavioural economics reveals how the past can influence decisions we make about our future.

Recent research suggests that more than 1 in 3 advisory firms have already introduced behavioural economics into their advice process. And many more are thinking about it. This is unsurprising really. Our new Bias Insight and Action tool suggests that in a typical retirement process there are around 50 touchpoints where behavioural biases could prevent the right outcome.

For example, holistic retirement planning will include non-pension assets. One such asset is equity in the home. There are two behaviours that could influence how clients assess this. Firstly, 'mental accounting'. Often people allocate money for specific purposes. They may have a holiday fund and rainy day savings for emergencies. Their property might be mentally ring-fenced for inheritance or some other purpose.

That means people may not volunteer the equity in their home as a possible source of retirement income if you ask an open question. The solution could be to prompt from a list of potential assets. This way you're less likely to miss anything.

The second behaviour in this context is 'framing'. How a choice is presented can affect the decision consumers will make. A 2017 research study found that when over 55s were asked if they would like to continue to live in their current home as they grow older 61% 'strongly agreed'. When the same question was asked, but the word 'property' substituted for 'home' the number dropped to 48%. This is not about leading people, but understanding that how something is 'framed' can influence the response.

What's more, the same behaviour can play out in different ways across the advice process. For example, 'framing' can also occur in the context of annuities. The FCA revealed in its 2014 report 'Does the framing of retirement income options matter', that when annuities are 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% chose the annuity.

A further example of 'framing' could impact drawdown clients. Research shows that people are highly likely to choose the middle option if offered three choices. So offering funds with 0%, 40%, 80% equity content or 40%, 70%, 100% can lead to quite different results. Of course, an adviser will have identified the risk appetite of a client and their capacity for loss, which should lead to a personal recommendation, but it is another example of how one behaviour can manifest itself in a number of ways.

In fact, there are several behaviours that recur throughout a typical retirement advice process. Take 'hyperbolic discounting'. This is the tendency to put a greater value on money today over money tomorrow. It can lead to clients choosing a single life annuity, without escalation, to maximise their income today.

It may tempt them to take more income than perhaps they ought to under drawdown. It can also explain why many people in the US and Australia are running out of money during retirement.

It's surprising just how many behaviours can influence a typical retirement process. Some like 'framing' and 'hyperbolic discounting' are relatively well-known, but there are a number of lesser known behaviours that can play out. For example, 'disposition effect' is a behaviour to be aware of. It's the tendency to sell 'winning' investments too early and hold on to 'losers' too long. There's a logic to this. Once you sell a poorly performing fund the loss is realised, but up to that point there is still the prospect that the fund could make a recovery. Equally, selling a fund that has been profitable is attractive because there's always the possibility that the gain could be lost if the fund starts to perform poorly.

A US study showed that this bias can harm returns. The study found that the average return of 'winning' stocks that were sold was 3.4% higher in the following year than the average return of 'losing' stocks they held on to. And taken to its logical conclusion the client would end up with a portfolio of poorly performing funds (having sold funds whenever they perform well).

Another lesser-known behaviour that can hamper sound decision-making is 'projection bias', described as 'failing to observe that future preferences could differ from today'. In short, we struggle to recognise that our life will be different in the future. For example, if you've ever shopped for food when you're really hungry, you'll almost always buy much more than you need. Even looking over a short space of time, we can't easily appreciate that our hunger will pass and we'll feel less hungry once it does.

Planning for retirement means looking into the future to consider how life will change. For example, on average, a 65 year old can look forward to around 10 years of good health during retirement (women fare a little better than this) and about the same time as their physical health is deteriorating, cognitive ability starts to decline. By 85, two thirds of people have a disability or longstanding illness. These changes can affect someone's ability to make sound decisions in the future and will also impact on their spending requirements. It's critical advisers make their clients aware that life will be different and emphasise the need for regular reviews.

These are just a few behaviours that, if left unchecked, could undermine the advice process. Our new Bias Insight and Action tool plots where biases and behaviours are most likely to occur in a typical retirement advice process. It also identifies actions you can take to mitigate negative influences. If you haven't introduced behavioural economics into your advice process our new tool can give you a head start.

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.

Financial Adviser SERVICE AWARDS 2018