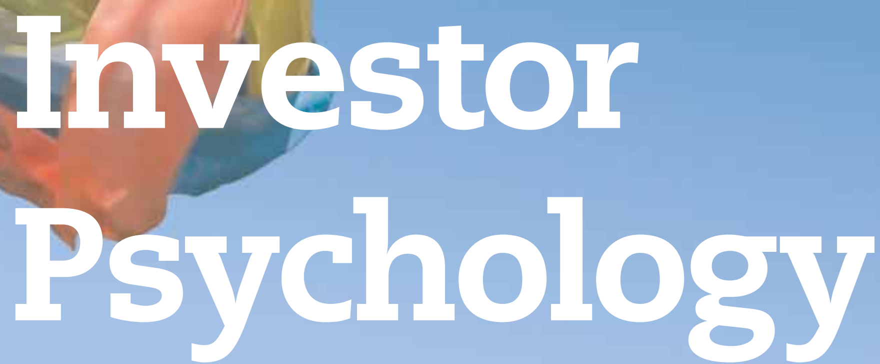

Investor Psychology

Part 2: Future of DC Investment Strategy

June 2010

STANDARD LIFE

Introduction

Despite, or perhaps as a consequence of, the increasing sophistication of DC pension scheme investment models, the majority of DC members either ignore or fear the issue of pension investment.

In this paper we will explore several of the key issues around engagement from the perspective of the emerging and influential discipline of behavioural finance. The issues examined will include whether excessive choice creates inertia; whether we can assess the tipping point at which pension contributions stop being a drain on income and become an attractive investment; and whether we can isolate the factors that lead to this lack of engagement.

Having dealt with the symptoms of disengagement the paper will then focus on establishing how far it is possible to identify opportunities for enhancing the impact of communication and active participation.

As more than two-thirds of all DC scheme members are invested in the default fund, according to the Pensions Regulator, the paper will examine whether this suggests that members are too passive, too financially illiterate, or too confused. If so, it is necessary to anticipate future best practice in default fund provision in order to take account of such influential factors.

The rationality myth: How scheme members are supposed to behave

Much of current pensions communication and engagement is predicated on notions that do not stand up to much scrutiny and indeed are actually counterproductive.

There is widespread acceptance of the precepts of classical economics. Individuals are considered to be clear in their objectives, rational in their decision-making processes and pre-disposed to consider all the information made available. A vast amount of today's financial service communication assumes that individual investors and pension fund members are able to take a dispassionate, long-term view of their personal circumstances and behave accordingly.

In the real world, however, the situation is different. Recent major advances in the field of behavioural finance and economics suggest strongly that investors are guided by emotions rather than rational judgement. They focus on aspirations and not products and on desires rather than realistic expectations. How else do we explain the huge amounts spent on national lottery tickets where the odds against winning are some 14 million to one?

As leading behavioural economist, Daniel Goldstein puts it; employees making retirement investment decisions are unlikely to have clear or informed preferences about the dizzying number of possibilities before them. Since well-defined preferences are necessary to guide the reasoned selection of investments, it is not clear how employees choose products.

This has profound implications in terms of persuading and influencing the decision-making processes of DC pension scheme members in terms of optimising contribution levels, choosing between default fund and active participation as well as in terms of fund selection and asset allocation.

It therefore seems that a new dynamic is required to optimise the communication, engagement, participation and management of Defined Contribution Pension Schemes.

Voodoo finance: How we actually behave

Despite the preference among players in the DC pension sector to treat members as rational actors with consistent investment objectives, the evidence reveals repeated patterns of irrationality, inconsistency, and incompetence in the ways members make decisions and choices. As decision-makers, scheme members are capable of logical thought but this is tempered by emotional response and the influence of past experience.

Significantly in this regard, a 2005 study by researchers from the universities of Carnegie Mellon, Stanford, Iowa, found that people with an impaired ability to experience emotions made better investment decisions in a simple investment game.

Much of the problem of engagement stems from the fact that the concept of retirement is too abstract for many people who prefer to forego future wealth in favour of current consumption.

Interestingly though, these same people are capable of saving and investing in order to achieve long-term tangible goals such as a dream property. It is also the case that most members insure their houses against future risk.

Indeed, the latest National Savings and Investment (NS&I) study into savings habits examined the emotional triggers for savings behaviour. Surprisingly, for most women (67%) holidays and other short-term outgoings inspired them most to save, with planning for the future only a secondary thought. In contrast, most men (60%) think about longer term events, such as saving for their wedding, starting a family or buying a house.

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Psychological blocks: Key emotional barriers to optimal decision-making

In order to optimise the retirement outcomes for DC scheme members it is vital to understand the classic emotional responses and behaviours that prevent members achieving the most beneficial outcomes in terms of accumulation and retirement. All received wisdom about member participation in group DC pension funds is being turned on its head.

Where once choice, diversity and flexible retirement options were seen to be benefits, it is clear that they lead instead to fear, inertia and disengagement. Members faced with options tend not to make good choices. This is a consequence of many emotional responses.

Common emotional and behavioural drivers include:

Prospect theory

Originated in 1979, this ground-breaking theory proved that individuals are much more distressed by prospective losses than they are made happy by equivalent gains.

Short-term loss aversion

Members are far more focused on the immediate returns and short-term cash balances than on the more important long-term gains.

Regret avoidance

People tend to feel sorrow and grief after having made an error in judgement. This can lead to a disincentive to make choices in the first place.

Procrastination and inertia

While most people know they should contribute to their workplace DC pension scheme, many feel they are incapable of resolving to do so. Procrastination generally arises from three psychological causes: fear, disorganisation, or perfectionism.

Information overload

Beyond a certain point, greater choice has a dramatically negative impact on decision-making in the context of the pension scheme. Faced with excessive choice of investment funds in their pension plan, people may be overwhelmed, ill-equipped and make no choice at all, which could have detrimental effects for retirement planning. This compels people to opt for the default.

Rules of Thumb

Many scheme members rely on arbitrary rules of thumb, known as heuristics, to short-circuit the decision-making process. Many of these rules are hard-wired into individual's mindsets even though they may be plain wrong, out-of-date or irrelevant.

Home Bias

Investors tend to prefer the familiar to the exotic or remote on the mistaken assumption that they have a greater knowledge of these territories or sectors. This can lead to failure to diversify the asset allocation in their fund choice and lead to over-representation in certain classes such as UK equities.

Herd Behaviour and Group Think

People are influenced by what others in their peer group are doing and by fashionable investments. Emulation rather than analysis takes over. This behaviour is the classic cause of investment bubbles.

Diversification Bias

Where there is a high ratio of, say, equity funds relative to bond funds, scheme members tend to have a higher than average allocation to equities. There is also a so-called 1/n heuristic, which compels members to split their contributions equally among the funds on offer, regardless of the underlying composition of the funds.

It is vital to understand the classic emotional responses and behaviours that prevent members achieving the most beneficial outcomes

Emotion in action: the Swedish experience

In 2000, the Swedish government changed the country's national pension system so that all citizens in paid employment were given the opportunity to allocate part of their pension savings into equity funds and other securities. A major academic study analysed the behaviours governing the resulting investment decisions and came to some instructive conclusions.

When Swedish DC scheme members were given the choice between a recommended fund and a choice of up to 785 other funds, they tended to display an exaggerated preference for the 'default' option with 98 per cent of new entrants making this choice.

This reflected the fact that they anticipated having more regret if they made an active choice.

Of those who made an active decision, the analysis revealed that members tended to opt for variety, leading to investment in more funds than was desirable. This was compounded by the choice of funds, which revealed a susceptibility to home bias and investing very little in foreign assets.

Again this was reflected in the choice of percentage investment in each fund, which showed that the Swedes obeyed the '1/n' heuristic and spread their contributions evenly across all the investment instruments offered.

Another major study conducted by behavioural finance experts Benartzi and Thaler (Naïve Diversification Strategies in Retirement Savings Plans) revealed that asset allocation decisions by pension scheme members could be greatly influenced and manipulated by psychological considerations.

Participants who were given the choice of an equity fund and a bond fund chose an average equity allocation of 54%; those offered an equity fund, a balanced fund and a bond fund, chose an average equity allocation of 73%; those offered a balanced fund and a bond fund, chose an average equity allocation of 35%.

The Solution: Action points

The introduction of NEST (National Employment Saving Trust), from 2012 will remedy the pension investment gap for the estimated seven million people, according to the Department for Work and Pensions, who are not saving enough for retirement. NEST will also benefit as many as 10 million low or moderate earners who are not members of an employer pension scheme.

Make savings simple

It is instructive to ask why ISA has achieved a greater engagement in savers' minds than pension. ISAs and pensions both have a place, so it is not a question of one replacing the other. However, there are lessons to be drawn from the success of the ISA brand in promoting longer-term saving. A lifetime savings approach encompassing elements of both ISA and pension within a 'lifetime saving fund' may achieve the greatest appeal. Employers may wish to develop their employee wealth schemes to take account of this.

Communicate the reasons for choosing certain investment options

This might involve the inclusion of a breakdown of the types of members for whom certain options may be most appropriate. Members can then decide which choices best fit their requirements and adjust their fund selection accordingly.

Focus communication on beneficial outcomes rather than product offerings

Framing the concepts in the appropriate terms that are appealing to the target audience can play a vital role in getting buy-in. Asking members whether they would like a secure retirement is an abstract notion. But couching the communication in terms of whether they would like to play golf three times a week and holiday abroad four times a year after leaving work is a more tangible, concrete aspiration.

Rather than focusing on 'matched employer contribution' and 'tax efficiency' it may be better to promise 'free money' or 'effective pay rise' and put an actual figure on it to take it out of the realms of the abstract. What may emerge is a focus on tangible benefits rather than abstract features and discussion of long-term savings and investment decisions in terms that individuals relate to. Ultimately communication and engagement strategies may move to describing retirement income as 'retirement salary' and framing the discussion in terms of tangibles such as the kind of home, car or holidays they could afford.

Optimise asset allocation

Seek a proper balance in the number and type of funds on offer: Provide a limited but diverse and clearly categorized range of funds to avoid confusion, anxiety and disengagement among members. An initial limited range of funds supplemented with a more extensive selection of advanced funds has been demonstrably effective in encouraging choice.

Use the right language

Research indicates that the way investment propositions are presented can affect individual's attitudes to them. Individuals take a more positive view of investment products with names that reflect return, such as high growth fund, rather than those that merely describe the assets contained. Simplifying the name of the fund can have a significant, positive impact on fund choice.

Embrace inertia to your advantage

Making better use of opt-out rather than opt-in mechanisms at all stages of the process has been shown to be effective. Automatic contribution increases on an annual basis will leave members better provided for without obliging them to return constantly to their investment decisions.

Improve the default fund structure

There is a danger of generating apathy through auto-enrolment. Experience shows that many plan members will use a default option, and often stay there even if encouraged to make a change. As far as possible, it makes sense to focus on default options that include diversification, a balance between different types of investment funds, and some adjustment for changing time horizons.

Sensitise members to perceptions of long-term pain

Disrupt members' tendency to discount future pain by getting them to empathise with their older, potentially impoverished, selves. This will make members more likely to forego current consumption to avoid distress in retirement.

Alleviate antipathy towards short-term financial pain

Communications should find ways of translating current saving into simple-to-grasp equations. For example, by saving the equivalent of the cost of one latte coffee or pint of beer a day, members could build up a substantial retirement fund.

Limit the number and nature of choices

The fund range should be sufficiently diverse and presented in a systematic way so that plan members can easily differentiate between them. Too much choice is likely to confuse. Too few choices could result in suboptimal allocation of funds, as members adopt a "1/n" heuristic approach, allocating their assets in equal proportions to the number of funds (n) available to them.

Summary

The best default option is one that meets the needs and attitude to risk of its members. There is a range of strategies and approaches that employers can deploy in their DC plans to assist their employees to make better pension plan investment decisions. Plan design elements such as an employer matching, auto-enrolment, automatic contribution increases, the provision of a target date or lifecycle funds and a limited but diverse fund selection can contribute to members making beneficial decisions.

Regular and simple communication about pension plan investing is proven to enhance positive feelings in individual members about their participation and decisions. It allows them to better understand the available options and make the appropriate investment decisions for retirement.

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