Retirement Today

an educational series for retirement plan investors

Behavioral Finance and Retirement

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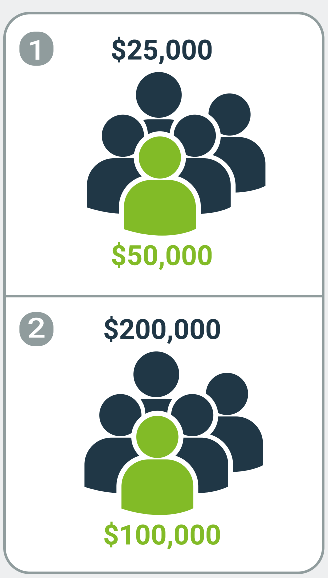
Making more than the Joneses

Money and irrational behavior seem to go hand in hand. In one study, researchers from the Harvard School of Public Health asked students and faculty which they preferred (among other things):

- Earning $50,000 a year when everyone else around them makes $25,000.
- Earning $100,000 a year when everyone else around them makes $200,000.

The researchers stipulated that prices and therefore, purchasing power would remain the same in each case. So, a higher salary could mean being able to own a nicer home or buy a nicer car, for example.

Making more than the Joneses



Over 50% chose the first option, leaving $50,000 on the table to avoid earning less than others.[2]

What drives investment decisions?

This is one of the basic questions behavioral finance tackles. Individuals enrolled in employer-sponsored retirement plans have more responsibility and decisions to make than ever when managing their retirement savings. Investors may benefit from assessing how their basic human nature—emotion, biases and personality traits can affect their decision-making process.

As studies on investor behavior reveal, an investor's natural instincts can betray him or her, resulting in irrational behavior. Consider the following concepts that are fundamental to the field of behavioral finance.

Loss Aversion. Investors are much more strongly motivated by fear of loss than by the prospect of gain. In studies performed by Amos Tversky and Daniel Kahneman (widely considered the father of behavioral finance), losses are more powerful psychologically, than gains.[1] Loss aversion helps to explain how many investors are influenced disproportionately by events. For example, many retirement investors liquidated all or part of their accounts during the 2008-2009 bear market only to miss out on the major recovery that followed.

Biases Abound. Individual biases clouding rational investment decisions may include overconfidence, selective reasoning, emotional reactions to events and the hindsight that unpredictable events were predictable and obvious. Additionally, many investors retain a short-term focus based on recent experience, despite having decades-long investment time horizons. Investors may suffer regret when their investments fall short of expectations, causing them to assume too much risk to "catch up" in accumulating enough retirement savings. That is, of course, if one can overcome the tendency to delay participation in a retirement plan in the first place.

Do these biases sound familiar? How does one overcome his or her emotions, biases and innately human, irrational behaviors that can sabotage good investing habits?

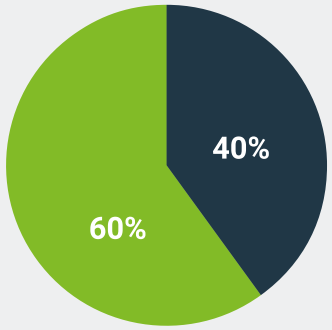
Being a disciplined investor despite being human.

Auto-Enrollment to the Rescue. Auto-enrollment helps investors defeat the beast within and overcome the inclination to put off tomorrow's decisions today through employer plans that automatically enroll employees. During the 2020 retirement plan year, 62% of employer 401(k) plans featured auto-enrollment, according to the nonprofit trade association Plan Sponsor Council of America.[3] The following year, the council noted that total plan participation had risen from 88.5% of eligible employees in 2020 to 89.2% in 2021, and that plan sponsors continued auto-enrolling participants at a rate high enough to obtain the full employer match for their contributions.[4]

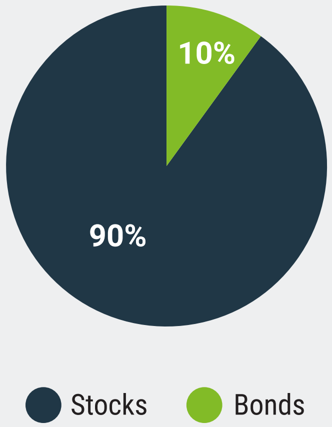
Think Long Term. Maintaining a long-term perspective when investing for retirement may help investors avoid panic-based decisions or decisions influenced by regrets. And, staying invested for the long term potentially helps investors avoid missing the best days in periods of market volatility while providing the opportunity to participate in the power of compounding through reinvestment.

Keep it Real. 401(k) pioneer Shlomo Benartzi has emphasized the importance of taking individual preferences and needs into account when investors think about their retirement savings.[5] Research published in the *AMA Journal of Marketing* revealed that using age-progression software to drive home the connection between the present and the future self doubled the amount of money study participants indicated they would allocate to retirement savings.[6] Utilizing aged images or not, investors benefit from setting realistic retirement goals, considering the lifestyle they wish to lead and calculating the amount of savings it will require.

The loss-aversion effect



When shown a distribution of one-year returns, investors allocated 40% to stocks.[7]



When shown a distribution of 30-year returns, investors allocated 90% to stocks.[7]

Investors are very sensitive to potential losses. When they consider what they might lose in a single year, they lower their commitment to equities. When their allocation is considered in the context of long-term returns, which tend to be more favorable, investors are more willing to invest aggressively.

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