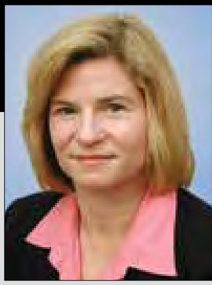

RETIREMENT

By Alison F. Salka
*Corporate Vice President, Retirement Research, LIMRA*

# Mitigating Behavioral Risk

People face many risks with respect to their retirement planning, and the industry has spent a considerable amount of time trying to quantify and explain them to consumers. Most of us are familiar with the perils of longevity, inflation, and investment risk. Much has been done to raise awareness and design solutions that address these risks. But there is another risk that is not as well recognized and is particularly difficult to plan for: behavioral risk. This risk relates to how people make financial decisions and the biases that can handicap their decision-making.

Behavioral finance is a field of research that combines psychology and economics to try to understand how and why people make decisions that are not always economically "rational." It looks at our natural biases — including the tendencies toward inertia in decision-making, discounting the future, and the aversion to loss — all in an effort to see how they affect our financial decisions. It is important to consider these propensities when designing and marketing retirement income products to ensure they are as effective as possible.

Behavioral finance has already provided insights that changed the way many people currently save for retirement. For example, by recognizing an individual's tendency toward inertia in retirement planning, researchers identified an opportunity: retirement plan automation. Automatically enrolling employees in a retirement plan and automatically increasing their savings rate annually make inertia work for people instead of *against* them. They only need to take action if they want to opt out and stop saving. The fact that very few people actually do opt out makes a tangible difference in the retirement outcome of millions of retirement plan participants.

Much behavioral research has focused on understanding how people can save adequately and invest appropriately for retirement. While decisions made during the accumulation phase are certainly critical, they are no less crucial than the decisions that occur at and after retirement — including defining a retirement income strategy. Decisions made at this stage are particularly important; if people make bad economic decisions, they have less time and ability to make up any financial losses. This may, in part, explain why retirees are particularly loss averse. Carriers and producers can better meet the needs of this group by recognizing that their loss aversion has an emotional component, as well as a financial one.

Most people are loss averse. Kahneman and Tversky (1979) were the first to point out that losses hurt us more than gains please us. Emotionally, it's estimated that the pain of a loss has twice the impact as a win; it takes a $1,000 win to have the same emotional resonance as a $500 loss. This propensity influences many investment decisions. Sensitivity to loss often leads people to opt for a smaller certain gain over a potentially higher gain. This helps explain why, at a time of market volatility when the potential for extreme gains *and* losses is higher, people who adjust their portfolio tend to seek safety in fixed income investments. Investors will "sell low," but then likely "buy high" later on.

More recent research has found that loss aversion is even stronger among retirees. In fact, they seem to weigh losses about *10 times* more heavily than gains. This "hyper loss aversion" seems to apply beyond economic loss as well. According to Eric Johnson of Columbia University, perception of loss of control over assets can be another facet of loss aversion. It was initially assumed that loss aversion would, in fact, predispose retirees to prefer products that provide guaranteed income. Interestingly, Johnson's research found the opposite. Retirees averse to loss did not favor products with additional protection and guarantees.

This may seem irrational or counterintuitive, but this type of irrationality is endemic to human nature. Johnson's research suggests that there is an emotional component to loss aversion; in this case, it takes the form

CONTINUES ON PAGE 70

## RETIREMENT COMMENTARY

CONTINUED FROM PAGE 59

of the loss of control. Product manufacturers and distributors need to take these inconsistencies into account when explaining and marketing guaranteed products. This is where framing, or how the issue is presented, can be helpful. If retirees see guaranteed products in terms of gains and control (the gain of certainty and control over income), then it may help overcome some of their discomfort.

Framing also affects the perceived attractiveness of income solutions. Consider that most people seem comfortable with the idea that they can live on 70 or 80 percent of their pre-retirement income. People seem a lot less comfortable, however, when asked about their planned spending reduction of 20 or 30 percent. Framing can also affect income choices. While LIMRA found that using the term "annuity" to describe an annuity (versus calling it a "financial product") doesn't seem to affect their appeal, *how* it is described *does* matter. Annuities are perceived as more attractive when they are viewed from a "consumption" frame; more people viewed an annuity favorably when it was presented as a specific monthly paycheck for life. When it was presented as an investment paying a certain return for life, it was less popular. Clearly, context matters here.

Consumers can be irrational. This means that they do not always act in ways that are consistent with their self-interest, which poses a risk to their retirement security. However, people tend to be irrational in some common, predictable ways. This "predictable irrationality" lets us better identify where people go wrong and help steer them toward better retirement decisions. Mitigating "behavioral risk" is every bit as important as mitigating the other types of retirement risk. Those who can successfully address it, along with the traditional retirement risks, will have stronger, more productive relationships with their customers.