Going against our nature

Behavioural finance has found how saving for the long term runs contrary to people's natural instincts. Laura Blows explores how the industry can implement some simple techniques and technologies to overcome this

Having extradited themselves from the food chain, humans are instead determined to be their own worst enemy. Whether it's climbing rock faces or simply choosing to have that third pint, people make decisions that they know are not in their best interests or can even put themselves at risk. But while these are deliberate choices, the subconscious mind can be no friend either.

This is particularly true when it comes to planning for the future.

According to Columbia Threadneedle's *Mind the gap* report, people, when thinking about their future selves, "use the same part of the brain as when thinking about strangers – so the savings decision effectively becomes a choice between spending today and saving for a stranger to spend our money in the future".

Cognitive challenges

This is especially true amongst young adults – millennials – as Standard Life Wealth senior investment manager Tammy Hall notes, even for the eldest millennials, retirement is still 30 years away. She attributes their lack of pensions engagement to "the immediacy effect, which is the brain's built-in mechanism that makes people prefer an instant reward over attaining something of potentially more value in the future".

As well as being impatient, people tend to naturally be both lazy and fearful – and according to Aries director Ian Neale, irrational.

He acknowledges that there is far too much for individuals to take into account when attempting to plan for retirement, of which a great deal cannot be known with any certainty.

"Apart from that, people do not behave rationally," Neale adds. "We lack willpower, display inertia and procrastination, make decisions 'anchored' strongly to where we started, rely too much on past performance and tend to see patterns in a small series of random numbers. We are overconfident in investing, too quick to lock in gains, while unwilling to cut our losses."

According to Fidelity's *Behavioural Economics and Retirement* paper, "it is a well understood phenomenon that people often make decisions, or more accurately make no affirmative decisions, on the basis of least effort".

It also notes people's tendency towards 'loss aversion', "which means encouraging people to pay more *[into a pension]* from their existing pay is difficult".

People also tend to anchor the amount they pay into a pension to the minimum amount they can, in the mistaken belief that this is the 'correct' amount recommended to provide an adequate sum in retirement and has been 'taken care of' on their behalf, Columbia Threadneedle notes.

The way messages are presented can also make all the difference. Research from State Street Global Advisers and The People's Pension into gender, age and pension savings found that 'negative' messages – such as 'ignoring your pension planning' – were ineffective at spurring people into action, compared to positive messages, like 'how to improve your retirement'.

As saving for retirement involves action, long-term planning, the risk that investments may fall and the fear that the eventual pension pot size may still not be enough, along with receiving warnings about said risks – all things behavioural finance has shown people shy away from – the pensions industry has a significant challenge on its hands.

However, efforts are already being made to work with this knowledge of human behaviour.

Using behavioural finance knowledge

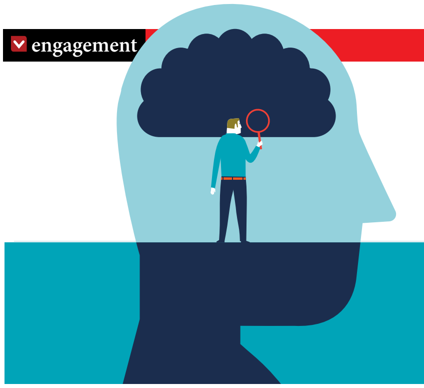
The biggest success story in the UK of the use of behavioural finance must be auto-enrolment. Harnessing the power of inertia by requiring people to actively opt out of retirement saving, instead of having to opt in, has seen participation rates into workplace pension schemes increase from 55 per cent of eligible employees to 78 per cent; an additional nine million savers.

Default funds are another example of accepting human nature, that people are unlikely to actively engage with investment fund choices, and so instead making the decision for them by automatically placing people into a fund that should generally suit their needs. As SEI managing director for defined contribution for the EMEA region Steve Charlton says: "Default funds provide a means to overcome the indecision created by choice."

Looking away from the UK, Shlomo Benartzi and Richard Thaler's 2004 'Save More Tomorrow' theory proved very successful with 401(k) retirement plans in the USA. Save More Tomorrow required employees for a mid-sized company to agree to pay 3 per cent of future pay increases into their retirement funds. According to Benartzi, over a four-year period this led to a quadrupling of retirement contributions.

"The pain is deferred, and it involves money the employee never actually has in their hands anyway," Neale explains.

Thaler also recently received the Nobel Economics Prize in December 2017 for his findings on how to gently 'nudge' people into making better decisions instead of using outright coercion.



Summary

- There are cognitive barriers to long-term saving – such as people's innate inertia, loss aversion and desire for immediate rewards.
- People's inertia has been harnessed effectively with retirement saving through the use of auto-enrolment and default funds.
- To get people to actually engage with pensions, simple, timely, positive and personalised messages are required.
- Technology is expected to further facilitate understanding of financial behaviours and increase engagement.

However, Columbia Threadneedle warns that the use of nudges are effective in influencing isolated behaviours, but not for helping people make informed choices. As an example, "the misplaced assumption among many auto-enrolees who believe that making the minimum contribution and passively opting for the default fund within auto-enrolment will provide them with a good financial outcome at and in retirement means that individual outcomes are not being optimised, even if a more socially desirable outcome has been achieved".

Engagement

So to move away from using inertia, and to try to actually increase engagement, Columbia Threadneedle recommends the 'EAST' framework – making pension saving easy, attractive, social and timely.

The company suggests a number of ways to do this, such as making benefits arising in the distant future seem more tangible, using novel incentives (such as giving away lottery tickets) to make saving more attractive, using gamification for enjoyment and providing positive peer comparisons to drive better behaviours.

For Neale, keeping it easy is vital. Neale gives the following example: "Research on the design of an online financial adviser found that if decisions were reduced to binary choices, instead of five options, contribution rates went up significantly. People may feel overwhelmed by too much choice and abdicate from making a decision, which helps to explain the common predilection for default investment funds."

The Pensions Policy Institute (PPI)'s research on member engagement has focused on the importance of timely reminders about pension saving during 'teachable moments' – a time when the intervention is relevant to people's current circumstance, relates specifically to their goals and allows them to respond with simple, practical actions.

According to the PPI, teachable moments vary between people by age and circumstances, but generally occur during key transitions, such as moving house, starting a new job, getting married or having children.

Along with making communications timely, tailoring it to the individual can ensure the message is noticed and action taken.

Technology

Mercer has demonstrated this with the personalised video statements it has sent out to some of its clients' scheme members. The company found that over 65 per cent of people watched their own personalised video and of those, 51 per cent acted to improve their retirement.

It is not just Mercer that has noticed the benefits of using technology for personalisation. The DWP-led upcoming pensions dashboard, which will enable savers to see the values of all their pension pots in one place, is expected to increase individual engagement with retirement saving.

BlackRock's latest *Investor Pulse* survey backs this up, as the company's head of defined contribution investments UK Claire Felgate explains: "Encouragingly, the emergence of technology solutions is beginning to drive greater engagement and understanding, with people taking control of their finances through the use of online tools and mobile phone applications.

"One in 10 people in the UK say having an online tool has been most useful in helping monitor financial plans for retirement, while six in 10 people who have monitored their retirement plans online have done something as a result, with a quarter deciding to spend less and 17 per cent increasing their pension contributions. These new technologies are a crucial enabler in helping change behaviour and help people save for their long-term financial futures."

Looking beyond the widely-available technology of today, SEI expects artificial intelligence to bring more tailored research and understanding of individuals' actions.

"It is clear that innovations in technology and specifically artificial intelligence are likely to provide further tools to assist with the challenges faced in encouraging members to save for retirement," Charlton says.

"The current tools use behavioural techniques based on predicting behaviour across a large population. What we need to be able to do, in the future, is to be able to use artificial intelligence to learn and understand individual behaviours. This would allow us to understand how smaller groups or individuals make decisions and then to tailor the communications and scheme design to enhance member engagement and contributions."

We may be our own worst enemies when it comes to long-term saving, but the increasing amount of research into why we do what we do, coupled with the advantages technology brings, will become our best friends in overcoming our natures.

Written by Laura Blows