# Ten Ways Behavioral Finance Can Boost Retirement Security

Have you ever questioned why your pension and benefits communication program isn't more effective in helping workers make better choices? What can you do differently to encourage workers to take the steps required to improve their retirement security?

A relatively new area of study, behavioral finance, examines how emotional, social and cognitive factors influence our decision making. It tells us that retirement plan design and communication are too often based on assumptions about people that are wrong. People don't always approach retirement decisions (in fact, all sorts of decisions) in a rational way that is in their best interests.

The insights of behavioral finance have the potential to help employers, plan sponsors and plan administrators make changes that can yield a substantial difference in the actions of employees and plan participants. Here are ten tips based on the principles of behavioral finance for helping workers achieve a secure retirement.

1 **Stress what could be gained or lost.** A chief tenet of behavioral finance is that people are loss-averse. People are highly motivated to avoid what they consider a loss. In fact, losing hurts worse than winning feels good. To spur people to take action regarding their retirement benefit, frame messages so individuals will clearly understand how they might "gain" by taking action or "lose" if they don't take action. For example:

a. *Planning for retirement is how dreams become a reality.* (Gain frame)

b. *Would you like a 5% pay increase? Take advantage of your retirement plan match.* (Gain frame)

c. *Stop missing out on your retirement plan match.* (Loss frame)

d. *Would you rather pay yourself or the goverment? Increase your retirement savings and cut your taxes.* (Loss frame)

Items b and c show how the same point can be made using either a gain or loss frame. Some people may be motivated by one type of frame and not another. Consider using them in different messages, but don't use them in the same message.

2 **Point out what others are doing right.** When making choices, people tend to do what they think most other people are doing because they believe there is less chance they will make a wrong choice. They are also influenced by what they think is expected or socially acceptable. Using these *social norms* can help drive people to take specific action. Consider these two messages to convince workers to save for their retirement:

a. 80% of ABC employees contributed to their retirement plan last year.

b. Nine out of every ten new hires say "yes" to saving 15% of their pay for their retirement.

The more similar the people described in a message are to those being targeted (e.g., people in the same building or organization), the more likely they are to copy the behavior desired.

3 **Use testimonials versus eye-popping statistics.** Rarely does a day pass when there isn't a news story backed up by statistics warning there is a retirement crisis ahead. Consider this headline:

**Experts warn 1 in 3 could face poverty in retirement.**

Those among us who are more analytical may feel that using numbers will motivate people to start saving for retirement. In reality, few people are motivated to act when they are given statistics that reflect our collective situation. People are much more likely to be motivated by a testimonial concerning an individual's circumstances that taps their emotions. Still not convinced? Think about people who are afraid of flying. For many, one horrific airline crash has trumped all the statistics that show flying is safer than driving a car. If you just can't resist including a few statistics in a communication piece, relegate the numbers to footnotes.

**4** **Encourage individuals to picture their retirement.** People have a tendency to focus on the short term versus the long term. Given a choice, they usually select a smaller payoff now versus a bigger payoff later. They are more likely to buy something for today or set aside money for a vacation in a few months than save for retirement. The short-term purchases are more tangible. One way to help counter what behavioral finance refers to as *hyperbolic discounting* is to encourage workers to envision their future retirement—where they want to live, what they want to do, etc. Having a personal retirement picture helps people avoid temptations to spend today, which can derail their retirement.

**5** **Leverage competition.** Some people are motivated by competition. Competition with oneself and others can also be used to promote retirement savings. Try challenging individuals to defer at least 10% of their annual salary for retirement. Or have groups of workers compete to see who can save the largest portion of their income on average. Offer prizes like gift cards, a free lunch or vacation days to the winner(s). Alternatively, give each worker one chance at a prize for each percent they defer.

**6** **Use opt-out versus opt-in features.** People who don't enroll in their retirement plan are making a choice. They are choosing to do nothing. Failing to do something *(inertia)* and putting off doing it *(procrastination)* are also the reasons many people fail to increase the amount they are saving and do not rebalance the investments in their portfolios. Autoenrollment and autoescalation features in a defined contribution (DC) retirement plan combined with the use of a target-date fund default option have proven to be highly successful strategies for countering these behaviors.

**7** **Limit investment choices.** People find it easier to make decisions when they have a small menu of choices. The unintended consequence of a large number of choices is *choice avoidance*—another way to describe participant inertia and procrastination. A consensus is growing among experts that the appropriate number of funds in the investment menu for a DC plan is between five and ten. Be aware that in a naïve effort to diversify, some participants split their contributions evenly among investment offerings. If a plan offers more aggressive funds than conservative funds, these participants will invest more heavily in the aggressive vehicles than in those that are more conservative (and vice versa).

**8** **Structure the menu of investment choice.** When people are provided a list of choices, they tend to choose the first choice they are given. If the list is very long, another behavior kicks in—choosing the last items because these are the items that stick in their minds. Consider the implications of these behaviors when a list of investment choices is ordered from least to most risky. Participants may choose the option at the top of the list, which may be too conservative for their needs. At the other extreme, a very long list might result in the selection of inappropriately aggressive investments. Similar problems can occur when investments are listed alphabetically. An optimal investment menu might have at the top a "basket of funds" like a balanced or target-date fund that is appropriate for a majority of workers.

**9** **Use a stretch match.** People tend to follow an employer's message, even if it isn't in their best interest to do so. As an example, consider employers that autoenroll employees into a company retirement savings plan offering a 100% match on amounts up to 3% of an employee's pay. Those who stick with their employer's "endorsement" will have a total savings equal to 6% of their pay—an amount unlikely to achieve their retirement goals. Take advantage of the *endorsement* effect by using a stretch match. Offer 50% on amounts up to 6%, which yields total savings of 9%. Alternatively, offer a 50% match on amounts up to 10% to encourage a total savings of 15%. Both of these stretch matches are good starting points until a worker looks more closely into his or her retirement needs with a financial calculator or advisor.

**10** **Provide access to a financial advisor.** Thanks to inertia and procrastination, many people also don't take the time to assess how much they will need to achieve a secure retirement. A lack of knowledge and the complexity of the retirement planning process are viewed as the roots of these behaviors. Providing access to and encouraging the use of financial advice helps workers make smarter decisions that keep them moving in the right direction toward their retirement objectives. DC plan participants who have received advice from an independent professional save more, have more diversified portfolios and stay on course even when they feel vulnerable in market downturns. To encourage the use of a financial advisor, some sponsors arrange for a free or low-cost advisor to come to the workplace and allow individuals to meet with this professional during paid work hours.

**Looking for more information on how you can help workers achieve a secure retirement?**
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