Helping Investors Get Out of Their Own Way

by Dr. Vicki Bogan

One of the first things you learn as a finance professor is that students learn financial concepts in different ways. Some prefer graphics and visual explanations. Others want a technical description. While still others benefit from an explanation of the intuition behind a particular concept.

This is also true for the investors you work with every day, except in your case, there are some major behavioral factors that affect the learning process. Research has shown, repeatedly, that when it comes to financial and retirement planning, people seem to have trouble getting out of their own way. It is as if they are hard-wired to behave in ways that are not in their best interest. Let me explain and then offer a few ways you can help to rewire them.

It used to be simple for people to plan for retirement: join a company, stay with the organization for 40 or so years, retire and collect the pension the company planned, funded and managed. What made that system good for investors is that they were not allowed to take any actions that did not serve their best long-term interests (except perhaps leave the company before being fully vested in the pension plan). It was a system that kept many built-in biases at bay.

The world in which we live today is one where households must now actively manage their retirement portfolios. So how is that working out? Apparently, not very well. Thirty-nine percent of U.S. households do not have *any* savings for retirement.[1] This figure is shocking given the well-publicized inadequacies of the U.S. Social Security System in meeting a household’s full retirement needs.

At issue are the behavioral factors: people lack financial literacy (“it’s too complicated”); they let their mental state and emotions overtake logic (“it’s too scary”); and they stick with the status quo (“yeah, whatever”). In Behavioral Economics, the status quo bias is actually known as the “Yeah, Whatever” heuristic.

The lack of financial literacy is pervasive. When people learn that I am a finance professor, they often say “I really could use your help.” They know that they do not know all they should. Since many people have difficulty understanding the financial products being sold — not to mention the way financial markets work in general — they do not invest money for retirement.

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[1]The 2012 Consumer Financial Literacy Survey – Harris Interactive, Inc. Public Relations Research

Just as you probably take into consideration an investor's physical health in preparing a financial plan for them, you need to assess their mental health, too. Investment decisions made by someone with fluctuating mental states – depression or anxiety, for example — could not be in their best interest. In a paper I wrote with Angela Fertig called *"Mental Health and Retirement Savings: Confounding Issues with Compounding Interest"*, we show that mental health issues, like depression and anxiety, exacerbate problems that households already have saving and managing their retirement portfolios. We find that depression and anxiety in the household can significantly decrease the probability of households holding a retirement savings account and decrease the share of financial assets devoted to retirement accounts. Additionally, conditions like depression and anxiety can cause increased withdrawals from retirement savings accounts.

The solution? Start by understanding the relationship your client has with money. Is money a source of stress in the household? How often do they deal with money issues? What prompts them to spend money? Assessing their starting point can help you help them navigate any emotional factors at play.

Inertia, or the status quo bias, is another big influence on retirement savings behavior. It is far easier for someone to do nothing than to take action. Multiple academic studies have found that when it comes to actively managing their retirement plan, not doing anything year after year is the default. One study found that more than half of a plan's participants made exactly no changes in the way their contributions were being allocated over their entire careers.[2]

Financial advisors can help investors overcome inertia by creating commitment plans that get them started and then makes it difficult for them to make decisions that are not in their best interest. Setting up automatic retirement plan contribution increases to be "opt out" instead of "opt in" is one such step. Another might be to set up automatic investment deposits. These commitment devices are ways to implement what Richard Thaler (author of *Nudge*) calls "libertarian paternalism," because you, as the advisor, are providing them with guidance in their best interests, and yet they still have free choice.

The role you play in helping clients get out of their own way is significant. It is critical that you let your clients know that your goal is to serve their best interest when it comes to retirement planning, and that they may be hard-wired to do things that are not in their

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[2] Thaler, Richard, & Sunstein, Cass. (2008). Nudge: Improving Decisions about Health, Wealth, and Happiness. Yale University Press: New York.

best interest. You will have to meet people where they are –their literacy levels, mental state and bias towards inaction – mixing the art and science of financial planning to help them get, and stay, out of their own way.

Key takeaways:

1. Clients often cannot help getting in their own way. They are not doing it intentionally; it is hard-wired behavior.
2. “Inertia” may be a client’s worst enemy. Change, especially when it comes to money, is very difficult. Commitment devices may help.
3. Making sure that your client understands that everything you do is in the best interest of their happiness — not just their money — can make a big difference.