Leeds University Business School

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Behavioural Finance and Retirement Decision Making

ACA, London, 6th Feb 2015

Overview

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- From rational economics to behavioural economics
- Individuals
- Trustees
- Regulators
- Advisors
- The brave new world of UK pensions…

Rationality and Retirement Savings

“People seek to maximise their well-being not at a single point in time, but over time. Someone who saves does so not because extra consumption today has no value, but because he values extra consumption in the future more highly than extra consumption today.”

Barr and Diamond (2006)

What is this statement saying people do?

What are the Criteria for Rationality

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1. Completeness – all actions can be ranked
2. Transitivity – (ApB) (BpC) therefore (ApC)
3. Independence of Irrelevant Alternatives – (ApB) (A, B, X) (ApB)

This allows us to arrive at Von Neumann and Morgenstern Utility (1944)

'…a complete set of rules of behaviour [for] all conceivable [contingencies]'

Rationality is connected with decisions and actions and not beliefs and attitudes

Individuals attempt to maximise their expected utility …how can this be the case in pensions in an inherently uncertain World…

Fama and Shiller get the Nobel Prize?

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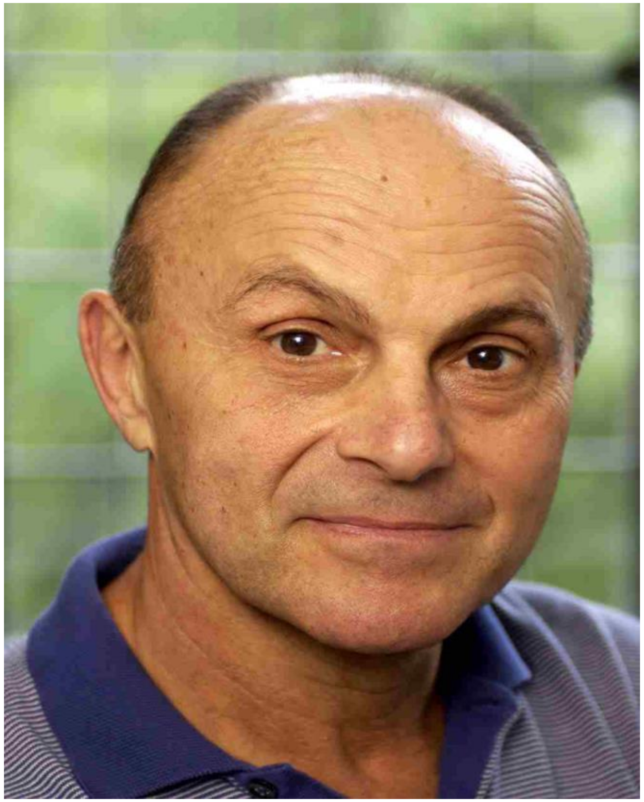

So what is Behavioural Finance?

Well, there is a 4th criteria for rationality

– attitudes and beliefs should not be incompatible with empirical observation

If this is not the case we get to ‘irrationality’ – the world of anomalies in academic finance…

So what is behavioural finance concerned with?

- The real world with all its complexities – rational is easy irrational is hard

Some Relevant Behavioural Traits

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Prospect Theory

The value function is defined over gains and losses relative to some reference point. Anchoring - Transactions are often evaluated one at a time, rather than in conjunction with everything else.

Both the gain and loss functions display diminishing sensitivity. That is, the gain function is concave and the loss function is convex.

Loss aversion. Losing £100 hurts more than gaining £100 yields pleasure

Some Relevant Behavioural Traits

<u>Extrapolating small samples to large samples</u>

Linda is a bank teller is much more likely than Linda is a bank teller and a bank robber

- Representativeness

I have won on the last 5 races I bet on, ergo I must win on this race

- Gamblers Fallacy

Some Relevant Behavioural Traits

Mental Accounting

Framing – the description of an event

Win £75 or win £25 and £50?

Sales in shops – big discounts seem more attractive

Hedonic Editing – the internal process by which a decision is reached

Why does £5 off something costing £15 seem better than something for £120 that was £125?

Some Relevant Behavioural Traits

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<u>Budgeting and Fungibility</u>

Big baths Vs tins

Substitutability

Regular income Vs petty cash - Starbucks

<u>Choice Bracketing Dynamics</u>

Memberships of health clubs

Credit cards increase spending – salience of costs is lower

Individuals

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Individuals are prone to all of the above characteristics – but not systematically

Gender and risk taking in the DC world – default funds

Understanding costs – 2015 pensions become bank accounts

Understanding the best deal – not everyone is honest – misselling

Lamborghini’s for all – problems of framing and discounting

Mental accounting around life expectancy

Interia

Trust…

Individuals

People do not save enough – Save More Tomorrow – better outcomes via behavioural finance?

The Nudge - Richard H Thaler, Cass R Sunstein

Now been criticised based on civil liberties in the US?

Trustees

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Investment decision making

- Risk aversion
- Discounting
- Information processing/framing

Myners (2001) – Pensions Act (2004)

One particular asset class interests me – UK infrastructure

Herding in pension funds is significant – regulations/de-risking

In so many respects, investment decision making is a gamble. But it is hoped it is a structured gamble, framed by habits, rules, and norms that allow trustees scope for both decision making and protection in case things go wrong.

Clark (1998)

Regulators

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In the real world we use heuristics

We are happy with good outcomes as optimal outcomes are too hard and costly

Regulation does not satisfice in this way

Regulation is for optimal and leads to bad outcomes – 40/80 – 35/80 or DC?

Equitable Life has an awful lot to answer for…

Inconsistency in policy – NEST Vs the pension as a bank account

Advisors

Advisors have to work in this World…

https://www.youtube.com/watch?v=2tfB-SSYL1A

Advisors

Focus on remuneration

Emotional awareness

Emotional intelligence

Political compass – authoritarian experts

What is the optimal outcome anyway?

The Brave New World…

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State endorsed pensions liberation…people are not good with restraint

https://www.youtube.com/watch?v=QX_oy9614HQ

The Brave New World…

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Retirement savings products are going to have to be smarter?

Do we need collectivism in pensions and retirement savings?

As we move towards individualism how can we operate and get to good outcomes in an irrational world?

If outcomes are bad this ultimately falls back on the state

At the other end – games are afoot – transfers to DC – no mandatory retirement – death duties on pension transfers abolished…

More changes to come – leaves the industry open to unscrupulous players in the short-run