CAP

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& Thoughts

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Shaping retirement savings programs and their use

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Behavioral Finance Research Digest for plan sponsors and their advisors. Brought to you by Dr. Shlomo Benartzi, Professor and co-chair of the Behavioral Decision Making Group
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Presented By
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Time (Mis)allocation and Retirement Savings

Executive Summary: Research shows recently-enrolled plan members often spend an hour or less deciding how much to save and how to invest their money. Thirty-eight percent of these members also agree they should spend more time planning for retirement. In fact, the vast majority spend at least as much time deciding where to go on their next vacation as they do making decisions about their financial futures. This article further describes these research results and potential action items for plan sponsors and their advisors.

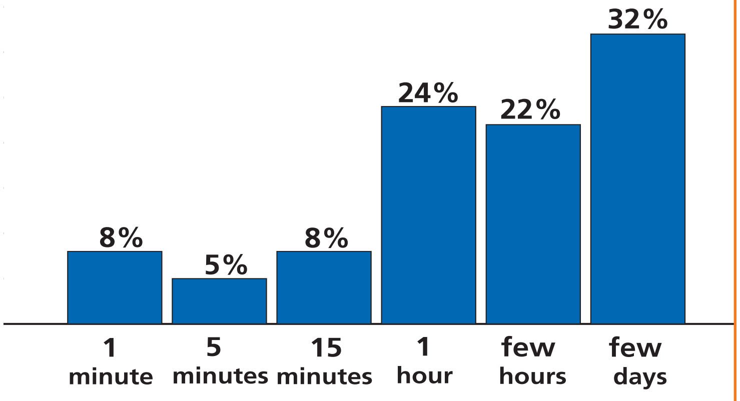
Many industry observers have repeatedly noted individuals do not spend enough time planning for retirement. In 1999, Richard Thaler of the University of Chicago and I documented that 58 percent of plan members spend less than an hour deciding how much to save and how to invest their savings.

However, more than 10 years have passed since our initial study, and it is possible that things have changed. More importantly, the concept of time allocation was not the primary focus of our original research, and we did not attempt to address whether individuals *should* spend more time planning for retirement. Therefore, I decided to revisit our original study to investigate how much time individuals spend planning for retirement, and whether the amount of time these individuals spend is sufficient.

In this update, the sample consisted of plan members served by T. Rowe Price. Figure 1 displays the amount of time newly-enrolled plan members spend deciding how much to save and how to invest their savings. I excluded members of auto-enrollment plans, since members of those plans have the option of simply sticking to the default saving rate and default investment fund – a decision that requires either very little or no time at all.

> Ninety percent of plan members spend at least as much time selecting a vacation destination as they do making their retirement plan elections.

Figure 1: Time Spent on Retirement Planning



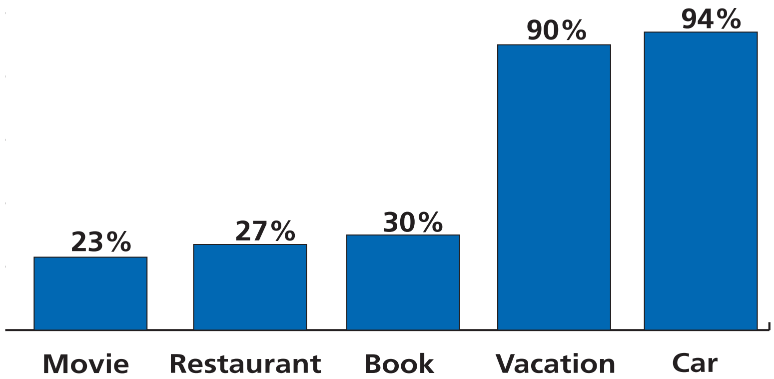
Unfortunately, about one-half of plan members (45 percent) still spend an hour or less making their saving and investment decisions. And, one in five members spends just 15 minutes or less reaching these conclusions. These results are troubling, since inertia suggests that most members will not revisit these rushed – and perhaps impulsive – choices.

Since economic theory does not specify how much time employees should spend planning for retirement, it is hard to tell whether an hour is too little, about right or even too much time. To try to answer this question, I adopted two alternative approaches.

My first approach compared the time people spend planning for retirement to the time they spend on other, perhaps less important, decisions. For example, if people spend less time selecting their saving rate and investment funds than they do deciding which movie to watch, they are likely spending too little time planning for retirement (or too much time picking a movie to watch). For comparison purposes, I asked plan members to indicate how much time they spend choosing (a) a movie to watch, (b) a restaurant to dine at, (c) a book to read, (d) a vacation destination, and (e) which car to buy.

The results are displayed in Figure 2. For example, 23 percent of members spend at least as much time picking a movie as they do on retirement planning. Similarly, 30 percent spend as much time selecting a book to read. Interestingly, 90 percent of people spend at least as much time planning a vacation as they do planning for retirement, and 94 percent spend as much time deciding which car to buy.

Figure 2: Same or Less Time Spent on Retirement Planning than ...



My second approach was to use people's own perceptions of the amount of time they should be spending on different decisions. In particular, I asked newly-enrolled plan members to indicate whether they spend "too little time," "about the right amount of time" or "too much time" making their retirement plan decisions. Partial results are displayed in Figure 3.

Figure 3: Too Little Time Spent Choosing a ...

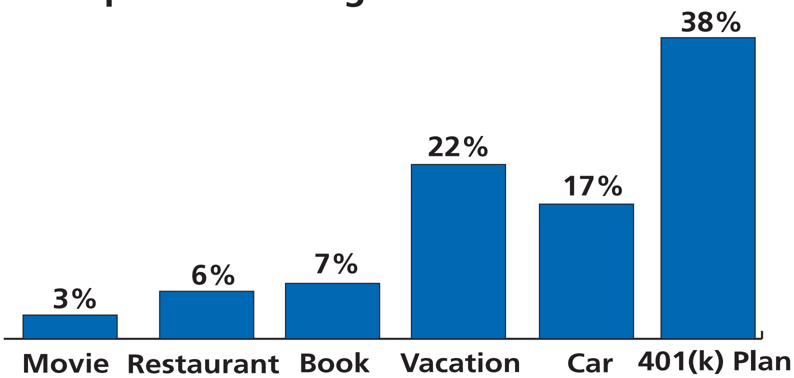


Figure 3 shows 38 percent of newly-enrolled members admit they spend too little time planning for retirement (which might begin to suggest a trend of people spending too little time on important decisions). Very few people feel they spend too little time choosing a movie or a restaurant, but 17 percent feel they spend too little time selecting a car and 38 percent feel they spend too little time making decisions regarding their retirement plan.

> Many plan members feel they spend too little time planning for retirement.

To summarize, the typical plan member spends too little time planning for retirement - but interestingly, most agree they should spend more time doing this. There are at least two courses of action plan sponsors and their advisors can adopt.

One is simply automating the plan, so employees who don't want to spend any time are guided in the right direction (i.e. the default saving rate and investment fund). Another course of action could be to emotionally engage employees in the plan by using visual images and by allowing individuals to link their retirement plan to specific goals.

Performance Chasing and Risk-Taking Behaviour

Executive Summary: Theory predicts that many retirees will consider a 'mixed' retirement income strategy - where a portion of income derives from a guaranteed annuity – appealing. However, data shows the vast majority of retirees either annuitize all of their retirement wealth or none of it. I describe several surveys illustrating how the framing and positioning of the alternatives can have a dramatic effect on retirees' decision whether to annuitize.

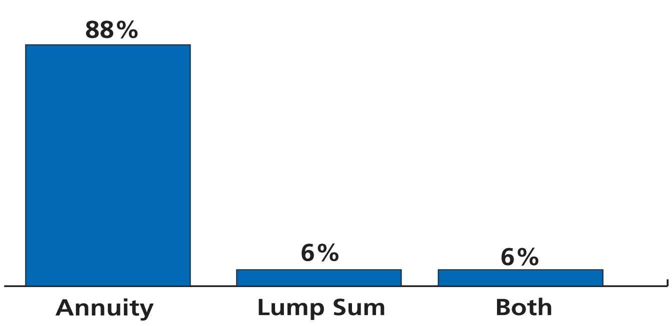
In an earlier issue of *CAP Trends & Thoughts*, I stated I believe that investors often suffer from a disorder that causes them to ***say*** they'll do one thing, but actually ***do*** another. While their stated risk preferences tend to be moderate or "normal," their portfolios often tend to be more extreme, containing either virtually no equities, or nearly 100 percent equities.

Recently, Alessandro Previtero of UCLA and I stumbled across a large pension plan that offered us the opportunity to study the behaviour of plan members as they prepare to retire. While the plan we investigated is a defined benefit plan rather than a defined contribution plan, the research proved insightful because the plan offers retirees a choice between a lump-sum, an annuity, and most importantly, a mix of the two alternatives. Furthermore, the plan has no default option, so employees must make a choice or their money stays in the plan.

Before I turn to the results, can you guess what percent of retirees chose the mixed strategy of withdrawing a portion of their retirement wealth as a lump-sum and the rest as an annuity?

To our surprise, just six percent of retirees chose a 'mixed' strategy. Eighty-eight percent chose the annuity and the remaining six percent opted for the lump-sum. We were a bit surprised, as intuitively, it feels 'right' to adopt the mixed strategy. Under a mixed strategy, the lump-sum can provide liquidity for out-of-pocket medical expenses (or other expenditures that are hard to predict), and the annuity can provide stability and guaranteed income for life.

Figure 4: Choice of Payout



Given these counterintuitive results, I suspected the payout choice of retirees was highly influenced by the framing of the decision. In particular, I suspected some frames would drive retirees to split their retirement wealth between the annuity and the lump-sum, whereas others would steer people toward picking just one of the two payout options.

To test my intuition, I designed a survey that varied the amount of mental effort required to pick the mixed strategy. To do this, I created three different versions of the survey. In the first version, plan members were asked to choose between these payout options:

__	Self-managing my account only
__	Self-managing part of my account and buying an annuity with the rest
__	Buying an annuity only

I predicted many plan members would choose the mixed strategy (i.e., self-managing part of the account and buying an annuity with the rest), because it would be as simple as checking the box. I never asked members for the exact split between the lump-sum distribution and the annuity. I refer to this version of the survey as the "low" mental effort condition.

In the second version, choosing the mixed strategy was made slightly more difficult, as the number of payout options increased. Plan members who received this version of the survey were asked if they would like to split their account evenly between the lump-sum and the annuity, or allocate more resources to the annuity than the lump-sum. I refer to this version as the "moderate" mental effort condition, and the specific choices I presented to members are displayed here:

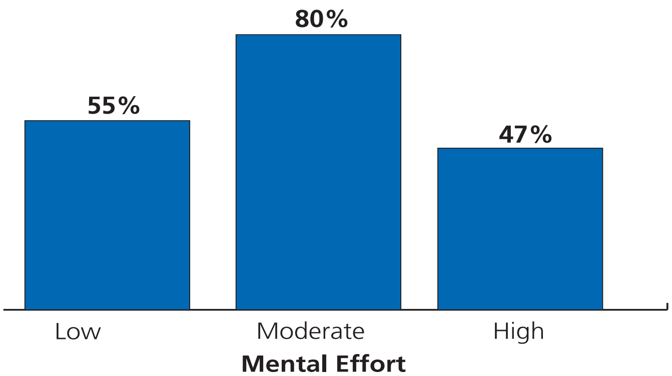
__	Self-managing my account only
__	Mostly self-managing my account
__	Self-managing part of my account and buying an annuity with the rest
__	Mostly buying an annuity
__	Buying an annuity only

In the third version, the "high" mental effort condition, members who selected the mixed strategy had to indicate the exact split of funds between the lump-sum and the annuity. Here, selecting the mixed strategy requires greater mental effort, so I predicted fewer members would do so.

The exact framing of the payout options is displayed here:

__	Self-managing my account only
__	Self-managing 90% of my account and buying an annuity with the remaining 10%
__	Self-managing 80% of my account and buying an annuity with the remaining 20%
__	Self-managing 70% of my account and buying an annuity with the remaining 30%
__	Self-managing 60% of my account and buying an annuity with the remaining 40%
__	Self-managing half the account and buying an annuity with the other half
__	Buying an annuity with 60% of my account and self-managing the remaining 40%
__	Buying an annuity with 70% of my account and self-managing the remaining 30%
__	Buying an annuity with 80% of my account and self-managing the remaining 20%
__	Buying an annuity with 90% of my account and self-managing the remaining 10%
__	Buying an annuity only

Figure 5: Plan Members Choosing the Mixed Strategy



The results highlight the dramatic effect of framing on plan member behaviour. The percentage of members who selected the mixed strategy varies from 47 percent to 80 percent, depending on the framing of the alternatives. However, the results are inconsistent with the 'mental effort' hypothesis, as I predicted the low mental effort condition would result in the greatest percentage of members selecting the mixed strategy. One possibility is that members misinterpreted "self-managing part of my account and buying an annuity with the rest" in the first version as an even split between these two income options, something they find unattractive. Further research is necessary to fully understand the results.

In addition to the above framing effects, I had a hunch the salience of the mixed strategy versus the "pure" strategies (strategies where 100% of the member's income derives from either the lump-sum or the annuity) could affect behaviour. Note that all three conditions described earlier make pure strategies salient by explicitly listing them as individual options. To test my hypothesis, I included a fourth condition as follows:

> Self-managing __% of my account and buying an annuity with the remaining __%

Note that plan members can still choose to self-manage their accounts exclusively (or buy an annuity exclusively), but the pure strategies are no longer made prominent. For example, those interested in buying an annuity have to indicate a zero

allocation to the lump-sum option and an allocation of 100 percent to the annuity. They can no longer just check the box like they were able to in previous versions.

Contrary to this hypothesis, as the salience of the pure strategies decreased, their popularity increased and the popularity of the mixed strategy decreased. Just 36 percent of the subjects chose the mixed strategy. I must admit further research is needed to fully understand the results.

> Depending on the framing of the alternatives, between 36 and 80 percent of plan members selected a 'mixed' retirement income strategy.

In summary, the framing and positioning of payout options could have a dramatic effect on member behaviour. The results raise some concerns about the design of retirement income solutions. Given that members are so sensitive to the framing and positioning of the choices, the solution members select could conceivably be influenced by something as inconsequential as the graphic designer who creates the election form. In related research, Thaler and I (2007) documented that graphic designers might accidentally affect the number of investment funds plan members select. To make things worse, research by Besedes et al (2009) indicates the elderly are more susceptible to suboptimal decisions and framing effects.

What can plan sponsors and their advisors do? It might be time to start contemplating the integration of retirement income solutions into defined contribution pension plans, hopefully with a sensible solution set as the default option. I realize that a number of obstacles – including legal ones – might slow the process, but the research warrants the need for careful consideration

I hope you enjoyed reading this edition of *CAP Trends & Thoughts*. If you have any comments, suggestions or feedback, feel free to send me an email at benartzi@ucla.edu.

Sincerely,

S. Benartzi

Shlomo Benartzi, Ph.D

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