FRANKLIN TEMPLETON INVESTMENTS

Topic Paper

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Behavioural Finance and Building Better Retirement Plans

KEY TAKEAWAYS

DC Plans Are Growing: Canada is joining other developed economies in shifting away from defined benefit retirement savings plan in favour of defined contribution workplace retirement savings plans.

Employee Responsibility Expands: A key feature of DC plans is that investment decisions are largely or entirely left up to the employee. This can be a challenge for many people.

The Influence of Behavioural Bias: A variety of personal behavioural biases, often undetected, can have a negative impact on the choices employees make about their retirement savings investments.

Plan Design Solutions: Plan sponsors can build features in to their workplace savings plan design to help counter behavioural biases and keep plan members on track to reach their long-term goals.

Behavioural Bias and DC Plans

Plan member directed Defined Contribution (DC) & Group RSP plans are gaining traction across the Canadian pension landscape. DC plans are now widely used in the United States, Australia and the UK. A key feature of these plans is member responsibility for making investment choices but this can be a challenge because there is still a lack of well informed decision making by plan members about their investment options

This tendency, which can include simple inertia, or avoidance of decision making, can be understood within the context of behavioural finance. In contrast to the longstanding economic theory that individuals make rational financial decisions, behavioural finance argues that choices can be significantly influenced by social, emotional, and even cognitive factors that can lead to biased or irrational investment decisions.

This topic paper is designed to assist plan sponsors in understanding how concepts from behavioural finance can provide important insights for designing a plan with the goal of improving plan member retirement outcomes. Here are four of the most common behavioural biases plan members may exhibit – often unknowingly – when considering their retirement savings plan investment options.

Availability Bias

There have been just three shark attacks in Canada in the past 127 years, and just one in the past 93 years. The odds of being attacked by a shark in the United States are 1 in 11.5 million – you are more likely to hit by a deer. The odds are so low that the vast majority of people swim in the ocean with no concerns. But what if you watch a shark documentary just before heading to the beach? The odds of being attacked don’t change, but swimming in the ocean may suddenly become less appealing.

This is an example of availability bias, which occurs when our thinking is influenced by what is personally most relevant, recent or dramatic. For example, the 2008 financial crisis continues to linger in the minds of many investors but focusing on past losses can limit future potential. A long-term retirement savings investment plan should not be derailed by short-term events and good DC plan design should actively facilitate that goal.

Home Country Bias

This is when irrational loyalty rooted in emotions can block out sensible planning. Here’s a familiar example: Olympic hockey. Fan passions run high when we’re cheering for Team Canada and any weaknesses in the line-up are brushed aside. But what if you were given the job of assembling the best hockey team in the world?

Given that talented players come from many different countries, the chances are high that you would pick some who are not Canadian. Similarly, it makes sense when investing to look beyond our borders for diversified growth opportunities around the world. But many investors instinctively avoid doing so and as a result do not participate in the 97% of global markets outside of Canada. DC plan investment menus should always offer carefully chosen options for global exposure in either standalone, asset allocation or managed solution formats.

Herding

Herding happens when people prefer doing what everyone else does. Conforming is easier than going against the flow but herd mentality can create unforeseen risk in investing.

A famous example is from the 1600s when the tulip was introduced to Holland. The Dutch went crazy for the flower and were soon investing in them and trading contracts for tulip bulbs. Prices soared. Tulip mania swept the country and at one point a single tulip bulb sold for the equivalent of 10 times a skilled craftsman's annual income.

Inevitably, buyers eventually stopped buying. Panic selling ensued. At the height of any investing bubble it all seems logical because everyone is doing the same thing. Yet it is only when a market collapses that investors see how wildly irrational it was. So when virtually everyone buys the same thing, the price can inflate based on nothing but demand, leading to growing risk of a sudden fall in value. Target date funds can be a sensible DC solution for protecting plan members – and their savings – from irrational investment fads.

Loss Aversion

A good example of this behavioural bias is a water hazard on a golf course. A player may be able to easily chip their ball 50 yards down an unobstructed fairway, but hitting that ball the same short distance over a pond can quickly become a daunting challenge. And because knocking the ball into the water can feel like a disaster, most golfers will look for a safer option – even at the cost of adding strokes to their round.

Similarly, when an investment falls short of expectations or experiences some short term volatility, a plan member may look for what they perceive as a safe choice for avoiding risk completely. This can also mean limiting their ability to attain long-term retirement savings goals by allowing fear to unduly influence their investment decisions.

Conclusion

Availability bias, home country bias, herding and loss aversion can all influence how plan members manage their group retirement savings investments. While it is impossible to eliminate all behavioural biases there are steps employers can take in plan design to help members stay focused on their long-term goals:

- **Default choices** – using managed solutions like asset allocation funds or target date funds take the investment allocation and rebalancing decisions out of the hands of the plan member by providing access to professionally managed diversified portfolios.
- **Mandatory participation/automatic enrollment** – allows members to be invested in their workplace savings plans without having to make a decision.
- **Auto escalation –** allows plan members to increase their savings allocation without having to make the decision.
- **Enhanced active choice** – EAC encourages behavioural changes by stating the potential benefits or costs for specific options. *Ask for our EAC topic paper.
- **Simplified investment menu design** – reduces information overload and "decision paralysis". *Ask for our Plan Design topic paper.

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