The road to retirement success:

Strategies to decode human nature and improve employee savings

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A WHITE PAPER

INTRODUCTION

As human beings, we like to think of ourselves as rational creatures. For many years, economic principles and financial advice were based on this idea. But it turns out that we're more complicated creatures than early economists realized. Over the past few decades, behavioral science research has revealed that financial decision-making can't simply be explained as a series of rational choices. Cognitive biases, emotions and long-standing habits often outweigh reason and, at worst, can wreak havoc on financial plans — particularly those that rely on long-term thinking related to future events such as retirement.

Fortunately, insights from behavioral finance can help us turn the quirks of the human brain to our advantage. A growing body of knowledge — based in part on psychological and behavioral economics research from the Stanford Center on Longevity — is helping people acknowledge and overcome these tendencies. This white paper will draw on that knowledge to help financial professionals and employers understand some of the common biases workers bring to investing and saving. Most important, it will provide a framework to help counteract these bad habits and encourage people to make more sound long-term investment decisions.

Behavioral stumbling blocks and how to overcome them

The behavioral bias: Emotional distortion

Financial information can impede saving and investing by exacerbating emotions. Behavioral research finds that people react to specific events or new information based on the positive or negative feelings they evoke.[1] As a result, overly negative messaging or scare tactics can backfire. Rather than inspiring urgent action, they instead leave people overwhelmed with feelings of guilt and fear.

The behavioral solution: Motivate with positivity

Framing possible outcomes in a positive light can go a long way toward encouraging good decision-making. When it comes to workplace savings plan features, consider a plan provider that offers a digital participant experience that focuses on encouraging positive choices rather than emphasizes the risks of not saving enough. Consider including personal success stories on materials that promote the workplace savings plan and are used at sign-up events. Above all, plan sponsors, plan providers and plan features can act as coaches and cheerleaders in efforts to bolster employee confidence in their ability to change their saving habits. The more employees believe they can change, the more they will.

The behavioral bias: Loss aversion

Behavioral finance research shows that people feel the pain of loss much more acutely than they enjoy the benefits of gains.[1] For example, imagine a situation in which you ask two groups of people to make a $100 bet. You tell members of the first group they have a 75% chance of winning $50 and members of the second group they have a 25% chance of losing $50. The odds are identical, yet people are much more likely to turn down the second bet because you framed the situation for them in terms of their potential loss. Fearing loss can lead investors to follow a too-conservative investment strategy, making it less likely that their savings will grow enough to sustain their standard of living.

The behavioral solution: Accentuate the positive

When designing your messaging, take particular care in how you frame potential losses. Emphasizing choices in terms of potential losses, rather than potential gains, can spook investors into making overly conservative choices. At the same time, loss aversion can be used to steer plan participants away from potentially harmful choices. For example, framing saving for retirement as a way to avoid the potential for diminished financial security can be a very effective way to get your point across.

The behavioral bias: Anchoring

At 7%, survey participants' median deferral rate[2] is far below the 10 to 15% of income that experts believe is required to accumulate an adequate retirement nest egg.[3] One reason for such a low rate of saving can be explained by a behavioral finance concept known as anchoring. Anchoring means that once a particular figure is fixed in a person's mind, it's difficult to get them to adjust that figure higher or lower — even if the initial number isn't ideal for them. So if a saver is used to deferring at 5 or 6%, they may come to accept it as normal and be reluctant to increase their deferral rate.

The behavioral solution: Move the match

Fortunately, employers can use anchoring to their advantage. Employer match rates serve as a type of anchoring for employees. Recent research from the Empower Institute shows that among employees who know their plan's matching formula, 73% set their contribution rates to maximize the match.[2] Increasing the contribution rate at which employees receive the maximum match has the potential to anchor them to a new, higher savings rate.

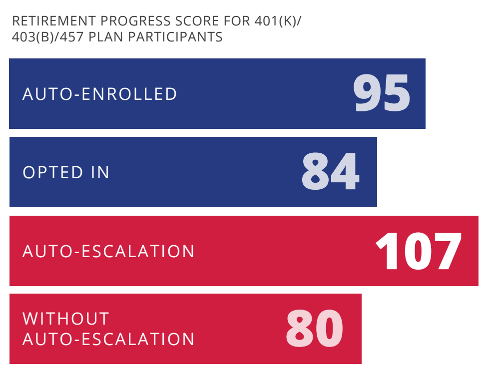
The behavioral bias: Inertia

People's bias toward inertia can make it challenging to motivate employees to take action. Put simply, people tend to be averse to making changes, even if they know the changes are in their best interest. Why do employees fail to enroll in a workplace retirement plan? Why might a person not increase their deferral rate, even after a raise? You can place at least part of the blame on inertia.

The behavioral solution: Use automatic features

Automatic features such as auto-enrollment and auto-escalation can help overcome the tendency toward inertia. Workers who don't defer could be nudged into action through auto-enrollment, and workers who defer at low rates could be nudged to save more through auto-escalation. Both types of auto features lead to higher expected income replacement in retirement. Employees in plans with auto-enrollment are on track to replace 95% of their income in retirement compared to 84% for employees whose plans don't have the feature.[1] Similarly, employees in plans with auto-escalation are on track to replace 107% of their income in retirement compared to 80% for those without.[2]

AUTO-ENROLLMENT AND AUTO-ESCALATION[2]



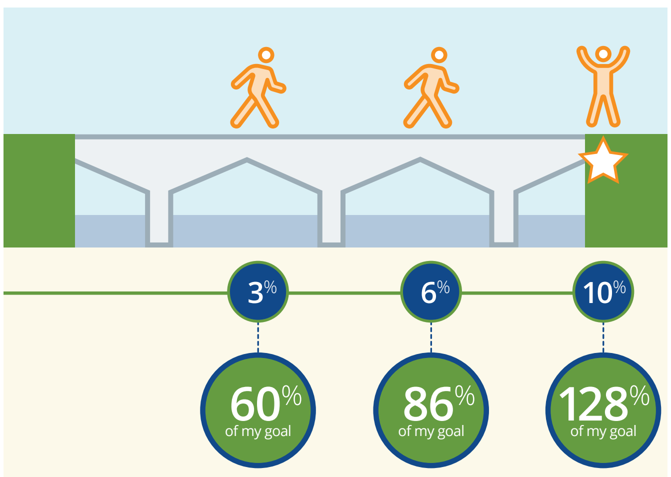
Empower Institute, "Scoring the Progress of Retirement Savers," May 2018.

The behavioral bias: Seeking confirmation

People tend to seek out and favor information that supports their beliefs and filter out contradictory facts.[1] In a retirement savings context, that means once people believe setting aside 5 or 6% of income for retirement is the "right" amount, they tend to ignore messaging that tells them otherwise.

The behavioral solution: Tell a story

While confirmation bias leads us to tune out numbers that don't align with what we already believe, it's harder to ignore a good story. The human brain has a pro-narrative bias — another behavioral tendency you can use to your advantage. Rather than repeating, for example, that survey respondents that defer 3% of their paycheck to their workplace plan are on track to replace 60% of their income in retirement while those that defer 10% or more are on track to replace over 100% of their income in retirement, include statistics in the context of stories. Infographics can be useful (see below).



The behavioral bias: Temporal discounting

Amassing adequate retirement savings isn't just about setting aside more money; it's also about spending more wisely in the present moment. That's not always easy to do. Employees with discretionary income often have little idea how much they actually spend, or how some of their spending could be diverted to saving with little overall effect on their current lifestyle. In part, that's because of an obstacle known in behavioral finance as *temporal discounting*. Put simply, we have a tendency to overvalue the present and place lower value on future benefits.

The behavioral solution: Reframe the story

One way to combat temporal bias is to reframe saving as future consumption — that is, today's savings are actually just money that the saver will spend tomorrow. The money isn't lost, and the enjoyment of spending it isn't gone; they simply are deferred for later. Workplace plan providers can help by illustrating how today's savings can translate into future monthly income.

Experience shows that asking employees to commit to future incremental savings increases helps them resist the temptation to choose current spending over future financial security. Encourage this behavior by emphasizing how much they will enjoy their future financial freedom when they stop working if they make some minor spending adjustments today. Using a story can help make the point:

> ***Deciding to pass up a $4-a-day gourmet coffee treat, for example, can result in savings of more than $1,000 a year. If that money were invested over 25 years and earned even a modest rate of return, it could provide an additional nest egg of about $35,000.****

* FOR ILLUSTRATIVE PURPOSES ONLY. This hypothetical illustration is not intended as a projection or prediction of future investment results, nor is it intended as financial planning or investment advice. It assumes an X% annual rate of return and reinvestment of earnings with no withdrawals. Rates of return may vary. The illustration does not reflect any associated charges, expenses or fees. The tax-deferred accumulation shown would be reduced if these fees were deducted.

The behavioral bias: Habituation

Behavioral finance researchers have proven through experimentation what many long have known from experience: People tune out messages they hear repeatedly. As a result of this tendency, which is known as habituation, savers can become immune to continual messaging that attempts to goad them into action.[1]

The behavioral solution: Change things up

Keep employees moving forward by finding new and interesting ways to call attention to long-standing messages. One way to do this is to choose a plan provider with a digital employee experience that helps motivate saving. Novel and personalized presentations can effectively enhance the digital employee experience. Another way to catch attention is to add new voices or new sources of information. Take advantage of new ways of spreading the message, too, maybe through a podcast or short video series. Arguments carry new weight when they come from a different expert, even if new messages are consistent with what was said in the past.

In addition to recasting messages to draw attention, keep up the rewards for positive behavior, so savers are less tempted to backslide. Consider adding positive reinforcements leading up to annual enrollment as well as throughout the year. A digital employee experience can show an employee if they are on track to replace their current income in retirement and highlight the impact of the next dollar they save.

A FRAMEWORK FOR CHANGING BEHAVIORS

Academic work in behavioral finance and real-world experience have led to the development of a model that guides better savings and investing choices.[1] The model, called MORE, can be used to better understand employees, interact and educate them more effectively, and engage with them through plan design to encourage better outcomes.

Pioneered in the institutional market, MORE is based on the principle of "guiding design," or the idea that the presentation of investment choices can be structured to guide people to do what's in their best interests. You can use this framework as a plan to put behavioral research insights into action.

The MORE design identifies four steps in the change process:

STAGE 1 MOTIVATE	**Make employees aware of the need for change and motivate them to take action.**
STAGE 2 OPTIMIZE	**Assist and encourage employees to gather facts, learn strategies, study options, and help build their capability to make and adopt a decision.**
STAGE 3 REALIZE	**Support employees in making and implementing a decision.**
STAGE 4 EVALUATE	**Help monitor progress and make adjustments if necessary.**

CONCLUSION

Bombarding employees with more information and rational explanations won't always lead to the desired outcome: savings behaviors that form the basis of a comfortable retirement. Savers' reactions to market fluctuations and countless other economic, social and political phenomena may often cause the best-intentioned guidance to fall on deaf ears. Fortunately, through the findings of behavioral finance, we now know more about the real-world dynamics that drive decision-making and behavioral change. By understanding the change process, employers can help promote better long-term outcomes by tackling behavioral obstacles head on. Once you understand behavioral finance, you're better equipped to make choices about plan providers, messaging, design and communication that use these common biases and cognitive distortions to your employees' advantage.

Action steps

To combat anchoring and confirmation bias, choose automatic features, such as auto-escalation, to help nudge employees to save more.

To reframe retirement saving decisions, carefully compare plan providers' digital employee experiences.

Ask plan providers how else they help support employee decision-making.

Footnote

1 Steve Vernon and Elizabeth Borges, Stanford Center on Longevity, "The MORE Design," July 2017.

2 Empower Institute survey results are from a National Survey of 4,038 working adults (full-time, part-time, never retired) ages 18 to 65, conducted in conjunction with NMG Consulting. Respondents answered an online survey between December 18, 2017, and January 21, 2018.

3 Darla Mercado, InvestmentNews, “Retirement readiness: 15% salary deferrals are the new 10% for 401(k)s,” January 2015.

The Empower Institute is brought to you by Empower Retirement and critically examines investment theories, retirement strategies and assumptions. It suggests theories and changes for achieving better outcomes for employers, institutions, financial advisors and individual investors.

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