These Biases are Bad News for Retirement Savings

We hate to break it to you, but you may have a savings bias or two that works against you.

The fact is the human brain is not necessarily set up in a way that makes it easy to plan a secure retirement. Cognitive biases — faulty ways of thinking --are unfortunately hardwired into your brain. Behavioral finance and behavioral economics are the study of these phenomena, and understanding these natural tendencies can increase your wealth and happiness.

Here are a few of the important biases that affect how you form your retirement plans and savings habits – along with strategies to free yourself from them:

Present Bias

This bias is the tendency we have to value the moments that are closer to the present than those farther in the future. As a result, we put less value on future rewards, which makes it hard to incur a small cost today (such as saving money from your paycheck) in exchange for a larger reward in the future (like a retirement nest egg that takes advantage of compound interest).

EXAMPLE

It is a well-documented phenomenon that you are more likely to spend money this month on something that gives you pleasure now rather than save that money for your future self. Present bias is one of the BIG reasons that saving for retirement is so difficult for so many people.

HOW TO OVERCOME PRESENT BIAS

One way to break the hold of this bias is to imagine (or even view, if you have the software) a picture of what you might look like as an old person — even a really old person. Research indicates that if you can truly visualize yourself in the future, then you are more likely to save money, eat better, exercise and generally plan to take care of your future self.

Ambiguity Effect

We naturally avoid information that we think will be too overwhelming. (As a consequence, one study found that financial education has almost no effect on people's savings.) This feeds into the tendency to avoid decisions or options where unknown information makes it hard to predict an outcome.

EXAMPLE

When planning your retirement, you would like to "know" how long you will live, future inflation rates, investment returns and other factors that are actually unknowable. Not being able to "know" this information can make planning feel ambiguous and impossible and many, many people just avoid it altogether. You might also fall victim to the ambiguity effect with investments; you might opt for bonds where the returns are considered safer than stocks, which are more volatile but are likely to have higher returns.

HOW TO OVERCOME THE AMBIGUITY EFFECT

One way to use behavioral finance to overcome the ambiguity effect for retirement planning is to assign optimistic and pessimistic assumptions, based on historic norms, for the unknowables. Using best and worst case scenarios makes it a little easier to get your hands around the unknowables. For retirement investments, you might want to tailor your asset allocation strategy to your "needs" and "wants" — investing money for needs in conservative vehicles and for wants more aggressively.

The Bandwagon Effect

The bandwagon effect is a behavioral observation that you are inclined to do things because many other people – particularly your friends and family – do them. This can be a big problem when it comes to financial matters because we see people's spending, but not their savings, which means that we do not take advantage of mirroring the good saving habits of others.

EXAMPLE

Research shows that people who have friends who exercise and eat well are healthier themselves. The same is actually true of retirement planning. People who have friends who are knowledgeable and proactive with their finances are more likely to be financially stable themselves. Unfortunately, the reverse is also true. That matters because the vast majority of people in the United States have an extremely low financial IQ. In fact, according to a report from Charles Schwab, only a quarter of people have a written retirement plan! The reality is that the bandwagon effect is probably working against you.

HOW TO OVERCOME THE BANDWAGON EFFECT

Have you considered starting, or joining, a "retirement club?" A retirement club is similar to a book club, but you discuss retirement topics instead of novels. It can provide a friendly forum for learning about financial topics. Best of all, if both you and your friends are engaged in retirement planning, then you are using the bandwagon effect to your advantage and stand a better chance of being financially successful.

Loss Bias

Research indicates that people are far more stressed by the prospect of losing money than they are excited by the chance of gaining money. Put another way, the fear of losing money is greater than the benefit of gains – what is termed "Loss Aversion." In fact, some studies have suggested that losses are twice as powerful, psychologically, as gains. This can make investment management particularly tricky. You need to be able to take appropriate risk and sustain the potentially temporary losses if you want to ultimately achieve positive rates of return.

HOW TO OVERCOME LOSS BIAS

Creating and maintaining an Investment Policy Statement can help you proactively make a plan for responding to different economic scenarios, which in turn can help you overcome the negative bias of loss aversion.

What Exactly is an Investment Policy Statement (IPS)?

This is a statement that defines general investment goals and objectives. It describes the strategies that will be used to meet these objectives and contains specific information on subjects such as asset allocation, risk tolerance, and liquidity requirements.

An IPS is a document that is meant to define:

- Your goals for your investments
- Strategies for achieving those objectives
- A framework for making intelligent changes to your investments
- Options for what to do if things don't go as expected

By creating this tool, you have a good chance of maintaining your perspective during rough financial waters. After all, you are reminding yourself where you are headed over the longer term, and you can have confidence in the course that you have set!