Behavioral Finance, the Market Crisis and Retirement Savings

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Thank you Chairman Miller and members of the House Committee on Education and Labor for the opportunity to share with you my views on behavioral finance, the market crisis and retirement savings.

My name is Shlomo Benartzi. I am a Professor and co-chair of the Behavioral Decision Making Group at the Anderson School of Management at UCLA. I am also co-founder of the Behavioral Finance Forum (BeFi). I have spent the last 15 years researching participant behavior in 401(k) plans, with a particular focus on using behavioral economics to increase retirement savings and retirement security. Some of you might be familiar with the automatic savings increase program Richard Thaler of the University of Chicago and I designed about a decade ago, which we dubbed Save More Tomorrow (or SMarT).

Let me begin my testimony by outlining the behavioral principles that guide retirement savers and how these behavioral tendencies could undermine the retirement security of 401(k) participants in the current environment. To keep this report brief, let me focus on just three behavioral principles that could weaken retirement security.

1. **Buy High, Sell Low**: Individuals have a tendency to buy at the peak, and then panic when markets drop and sell at the bottom. We saw this happen with the Internet bubble when individuals bought a lot of technology stocks at the end of 1999 and the beginning of 2000 right before the market cracked. We also saw individuals pulling money out of the stock market in 2002 right before the market started to go up. There is a real concern that individuals will repeat the same mistake during this market crisis and sell at the bottom and perhaps even stop contributing to their retirement plan.

2. **Myopic Loss Aversion**: The term “myopic loss aversion” refers to the tendency of individuals to focus on short-term losses, even if they have 20 or 30 years until retirement. The myopic focus on short-term losses could result in individuals chasing safety and placing all their retirement savings in cash. And, we know that a portfolio invested 100 percent in cash is unlikely to provide the long-term growth that many individuals need to fund their retirement. The unusual market volatility we have experienced over the past few weeks and months could magnify the degree of myopia and loss aversion individuals display.

3. **Excessive extrapolation**: Individual investors tend to place too much weight on past performance. For example, many buy stock funds after they see a few years of positive returns. Similarly, the propensity of employees to invest in company stock is highly correlated with the past performance of company stock. I suspect that a lot of employees who were chasing performance and invested heavily in company stock a couple of years ago have recently suffered major losses. This probably includes many employees of financial institutions who invested in company stock and lost their savings and jobs at the same time. Interestingly, preliminary data on recent activity in 401(k) plans indicates that the average participant moved money into company stock in September and early October, probably misjudging the risk of company stock.
The three behavioral principles outlined above highlight the risk of individuals mismanaging their retirement savings, especially in the current economic environment. And, I do believe some retirement savers will panic and bail out of the stock market at the wrong time. I also believe, however, that inertia is extremely powerful and a lot of individuals are likely to procrastinate and never take any action. In the current environment, sticking to one’s long-term plans and avoiding impulsive actions might actually be the best decision, even if it is caused by inertia and procrastination.

Having highlighted “behavioral obstacles” that tend to undermine the retirement security of many people, the real question is what can be done to help employees better plan for retirement? I believe Congress has already made significant contributions to the retirement security of Americans with the Pension Protection Act. In particular, automatic enrollment and automatic increases made saving for retirement a lot easier for many Americans. Similarly, clarifying what constitutes a Qualified Default Investment Alternative made plan sponsors more comfortable choosing balanced portfolios on behalf of their plan participants, rather than playing it safe with the most conservative option. However, our system should be improved to help individuals better plan for retirement. Below I list three key areas that I believe could be improved.

1. **Participant Information:**

   a. **Highlight Long-Term Performance on First Page of Statements:** Defined contribution plans are required to provide quarterly statements. Unfortunately, a lot of plan providers interpret that requirement as having to highlight the most recent quarter’s performance on the first page of the statement. Since individuals are already obsessed with short-term performance, why not use the quarterly statements as an opportunity to promote long-term thinking? In particular, I propose that the statements display longer-term results on the first page, then provide the recent quarter numbers on the second (or last) page. While this might be permissible under the current law, an endorsement of the idea might be all that is needed to get plan providers to design more sensible participant communications.

   b. **Provide Retirement Income Projections on Statements:** I argue that most individuals are ill-equipped to analyze rates of return. The goal of a retirement plan is to provide retirement income, so why not translate account balances, deferral rates and investment elections into projected retirement income? Such projections would not be exact, but they would certainly be more informative for the average plan participant. And, they would dampen the effects of volatile financial markets, as they would incorporate both existing balances and future contributions. For example, someone who just experienced a 40 percent decline in his/her account balance might notice just a 10 percent decline in his projected retirement income once future contributions are taken into account. Again, an
endorsement might be all that is needed to get plan providers to add income projections to quarterly statements.

2. **Company Stock:**

   a. **Stop the Preferential Treatment of Company Stock:** Company stock enjoys special treatment under ERISA, exempting it from the diversification requirement. It is the only investment option offered to plan participants that is undiversified. I believe, however, that all investments offered to plan participants should be well-diversified, that is, comply with ERISA’s diversification requirement. I would like to clarify that I am not proposing to disallow company stock in defined contribution plans. I am just proposing that company stock pass the same fiduciary standards other investments must pass. Of course, if company stock is inherently undiversified and will fail basic fiduciary standards, then plan sponsors will voluntarily stop offering it. I view that as a good thing. We saw thousands of Enron employees lose their jobs and retirement savings simultaneously, and I predict the current crisis will result in many more employees losing their retirement savings due to concentrated positions in company stock.

   b. **Endorse Gradual Diversification Programs:** Many plan sponsors are concerned about the financial security of employees investing in company stock. However, they do not know what to do about it. If they tell employees to diversify and sell the stock, then employees might wrongly believe that the company is in trouble. And, if they offer employees the option to gradually trim down their company stock exposure, they could possibly be liable for selling the stock at the wrong time. Professor Richard Thaler and I promote the idea of offering employees the option to gradually sell their stock holdings, perhaps keeping a modest amount of say five percent of their savings in company stock. We dubbed our proposed program, “Sell More Tomorrow.” Endorsing some type of a gradual diversification program could make plan sponsors more comfortable addressing the company stock problem before it is too late.

3. **Retirement Income Solutions:**

   a. **Define “Qualified Retirement Income Solutions”:** The Pension Protection Act has shed light on best practices for the accumulation stage. In particular, it endorsed automatically enrolling employees into retirement savings plans and automatically escalating their deferral rates over time. We are already seeing that the mere endorsement of these best practices by Congress resulted in many plan sponsors adopting the proposed changes.
Unfortunately, the Pension Protection Act did not spell out best practices for the decumulation phase. In particular, it did not provide any guidance on what would constitute appropriate retirement income solutions for employees getting ready to retire. As a result, the vast majority of plan sponsors are totally confused about: (a) whether or not making retirement income solutions available to retiring employees is part of their duties and responsibilities, and (b) what type of retirement income solutions would be prudent to offer. Given that, it is not surprising that most plan sponsors do not offer any retirement income solution through the plan. Retirees are given a lump sum of cash and sent out into their golden years searching for a solution on their own. As we all know, most individuals are ill-equipped to handle such a complicated financial decision.

I encourage regulators and legislators to shed light on best practices for the decumulation stage. Again, I believe an endorsement would encourage the industry – both plan sponsors and providers – to create and offer competitive retirement income solutions.

The current financial crisis also highlights the need to rethink the type of retirement income solutions that would be prudent. For example, is an immediate annuity that pays monthly income for life prudent, given that insurance companies have recently failed to properly manage risks? I do not necessarily have the answers, but I do know that without guidance from regulators and legislators, plan sponsors will not offer any retirement income solutions. And, I do know that retiring employees are ill-equipped to set a sensible drawdown program on their own, especially in the current volatile environment.

b. **Evaluate Longevity Bonds:** Both defined benefit and defined contribution plans face longevity risk, that is, the risk that people will live much longer than was anticipated, leading to the possibility that plan assets will run out. Note that insurance companies do not presently have the financial instruments available to them to manage systematic increases in longevity where most people end up living longer than reserved for. Systematic longevity risk is simply too large for insurance companies to handle. Furthermore, it is not diversifiable internationally, as medical advances in say the US will end up increasing longevity in all countries sooner or later.

The government could help facilitate the creation of a market for hedging systematic longevity risk by issuing longevity bonds. These are bonds that pay more if people live longer and vice versa, and are similar in concept to TIPS (which allow the private sector hedge another systematic risk, namely inflation risk). Not only would longevity bonds enable retirement plans to better manage longevity risk, they would, more importantly, enable insurance companies to better price and guarantee lifetime income streams. This is because longevity
bonds would help to establish the market price of longevity risk, in the same way that TIPS help to establish the inflation risk premium. I must admit I am not an expert on launching new markets, but there are experts who have studied these issues extensively. I think establishing a committee to evaluate the merits of longevity bonds is appropriate. Professors David Blake and Robert Shiller would be superb candidates to serve on such a committee.

In summary, improving participant information, addressing the company stock problem and incorporating retirement income solutions into defined contribution plans could enhance the retirement security of millions of people. And, some of the changes I propose could also address behavioral obstacles such as myopic loss aversion and excessive extrapolation.

Keeping in mind the regulatory burden employers already face by offering a retirement plan, my proposals focus on endorsing better practices without necessarily forcing or requiring plan sponsors and plan providers to implement new or expensive options. To the extent that the proposed changes make sense, I believe mere endorsement by regulators and legislators might be sufficient to make a difference.

Again, thank you Chairman Miller and members of the committee for the opportunity to share my views.