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Behavioral Economics is Important to All of Us

An interview with Tom Toale

WHY IS BEHAVIORAL ECONOMICS IMPORTANT TO PROFESSIONALS INTERESTED IN RETIREMENT PLANS?

An understanding of behavioral economics will help practitioners be aware of the "*Predictably Irrational*" (to quote the title of a very good book on the topic) responses people tend to have to choices, and how those choices can be influenced. The fascinating thing is not just that humans are irrational but that their irrational responses can, to an extent, be predicted by the way in which those choices are presented. These choices include what and how much to spend or save, whether to have salad or pizza for lunch, and whether we watch NPR or Fox News. And changing the way those choices are presented can change their responses! This knowledge can help us influence clients, plan sponsors and colleagues, enabling them to make better (more rational) decisions.

WHAT IS MEANT BY FRAMING AND DECISION ARCHITECTURE?

Framing refers to how we present a choice to another, and how that presentation affects their choice. A relatively early study (Levin and Gaeth 1988) indicated that meat described as "80 percent lean" (a positive frame) was perceived more favorably than the same meat presented as "20 percent fat."

Decision (or choice) architecture is closely related and can refer to the manner in which, for example, "either/or" choices are presented. Default options are probably the most well-known examples; if the default choices on your new hire orientation package are "yes, participate in 401(k) plan," participation will be higher than would be the case for a "check yes or no" format. Designs like this are popularly known as nudges. Choice architecture can also refer to a conscious decision to limit choices. While more choices are (in traditional economics) always better, in many situations—e.g., investment options for 401(k) plans—an excess amount of choice can lead to paralysis or selection of the safe or familiar investment—a money market fund or corporate stock.

AS YOU LEARNED ABOUT BEHAVIORAL ECONOMICS OVER THE YEARS, DID ANYTHING SURPRISE YOU?

I have believed that behavioral economics had something to contribute to many fields since I was in grad school 30 years ago—when it was still somewhat of a heresy. But even I am surprised by the amount of change in behaviors that something as simple a change in a default election can elicit. Changing the default election for organ donation on a license application to yes or having a clerk ask if an applicant wishes to be a donor have significantly improved donor rolls. I am also surprised to see myself fall into traps—I'll drive a couple of extra miles to save 10 cents a gallon if gas is cheap, but not if it's $3.75 a gallon. Why? The savings in the latter case is not a "just noticeable difference," as discussed in the Weber-Fechner law. But it's still 10 cents—so I am clearly being irrational!

ARE YOU FAMILIAR WITH "THE BEHAVIORAL ECONOMICS GUIDE 2015"? HOW CAN ONE GET A COPY? ARE THERE ARE ANY ITEMS THAT MIGHT BE OF PARTICULAR INTEREST TO ACTUARIES?

I have reviewed it and it's very well done. Copies may be downloaded at *http://www.behavioraleconomics.com/.* The site has a wealth of interesting information. I found the listing of behavioral science concepts to be particularly helpful. There is still not a standard vocabulary of concepts—the "just noticeable difference" I referred to above, used by many practitioners, is treated as a subset of the "Mental Accounting" concept in the guide.

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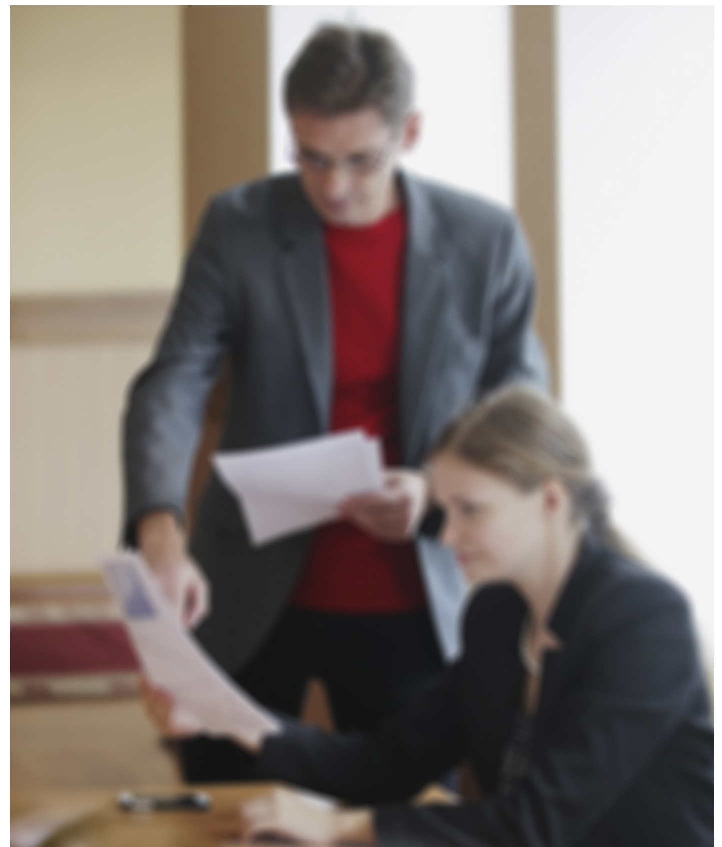

DOES "THE BEHAVIORAL ECONOMICS GUIDE 2015" INCLUDE A LIST OF DEFINITIONS OF TERMS? ARE THERE SOME THAT WE OFTEN DO NOT THINK ABOUT WHICH MIGHT BE OF INTEREST?

Precommitment is an interesting idea—that if we want to achieve a goal, precommitting to it publicly will help. The guide discusses the well-known Save More Tomorrow™ program in the 401(k) arena. Another example likely occurs when plan sponsors amend their defined benefit plan's investment policy to adapt a liability-driven investment policy when funding reaches a stated level—or when I promise my daughter I'll come to Chicago to see a show she's curating! Inertia helps here—the effort involved in formulating a new strategy, for example—as does the cost of moving from an accepted plan of action to a new one—not seeing the show would have highly adverse consequences. The guide points us to a website—stickK (*www.stickk.com*) —that uses "commitment contracts" to help people attain their goals.

Confirmation bias occurs when we seek out information to test our feeling or hypothesis—seeking information from a source that is likely to support our belief. Depending on our views on the Second Amendment, we may turn to Fox News or NPR for information—and be gratified to learn that our opinions are reasonable!

The IKEA effect, if only due to the name! While the endowment effect holds that simply owning something increases its value in our eyes (a predictably irrational belief), the IKEA effect holds that invested labor further increases our valuation of that thing. This may be a factor in why frozen defined benefit plan sponsors continue with risk-seeking investment portfolios when their plans become fully funded—most investment committees have invested a lot of time and energy in getting the most important decision—asset allocation—right, though I have not looked for academic validation for this belief yet.

WHAT CAN WE LEARN FROM BEHAVIORAL ECONOMICS ABOUT ANNUITY PURCHASING?

Let's focus on individuals considering purchasing a simple life contingent annuity—fixed payments for the lives of the primary annuitant and spouse. We'll limit ourselves to two issues:

Framing: Framed as an investment, an annuity may not always be a good deal—if you die right after purchasing it, the return will be zero. But if the annuity is framed as an income stream you cannot outlive, that objection may become less important. Jeff Brown and collaborators have done extensive work on this issue (see references).

Anchoring: If boomers like me get past this objection, we then notice that the amount we get in a monthly benefit is low—and we may then blame current interest rates. While this is of course correct, our experiences decades ago, when Treasury rates were in the teens, may—if we're not careful—provide an unrealistic "anchor" to our expectations for "normal" interest rates.

WHAT ABOUT SOCIAL SECURITY CLAIMING?

Clearly there are many people for whom claiming Social Security benefits at a relatively early age makes sense—job loss and ill health among them. However, for relatively healthy people who don't "need the money," the annual benefit increase granted for deferring claiming would seem an overwhelming reason to delay. Very often, this does not happen.

Framing is a factor here, as well. A breakeven analysis is frequently used to help individuals make their decision. This is framed as "if you live past 84, delaying benefits is a good idea, but if you don't think you will, then claim them ASAP." Given this framing—"if you don't think you'll live past 84, claim now"—and a profound misunderstanding of longevity, from a traditional economic perspective, most people opt to take Social Security too soon.

WHAT ARE SOME OF YOUR FAVORITE BOOKS ON THESE ISSUES?

The ones that got me interested in these issues are *Advances in Behavioral Finance*, edited by Richard Thaler, and the less intimidating *The Winner's Curse*, which he wrote. More recent books I've enjoyed include *Thinking Fast and Slow* by Daniel Kahneman, *Nudge* by Thaler and Cass Sunstein and *Predictably Irrational* by Daniel Ariely—the historical import of the title alone still impresses me. It was the realization that not only are individual decisions sometimes irrational (as early behavioral economists such as laureate Herbert Simon correctly asserted in discussing "bounded rationality"), but that traditional economists were content a simple error term handled the issue. The concept that those decisions were *predictably* irrational—that with insight into issues like framing, behavioral economists could predict those irrational responses—was I think the insight which validated this as a legitimate field of study.

The Society of Actuaries also has sponsored two research projects on behavioral finance matters affecting retirement related decisions; this information is available here.

HAS BEHAVIORAL FINANCE INFLUENCED RETIREMENT PLAN STRUCTURE AND HOW?

It has had a significant effect on defined contribution plans. The idea that "too much" choice both reduces participation and hinders effective investment selection has caused service providers and sponsors to focus on offering a limited number of diversified investments. Save More Tomorrow™ (SMarT), a concept designed by Thaler and Shlomo Benartzi, addresses several behavioral economics heuristics in an attempt to increase participation and savings rates.

It is also having an effect on the management of defined benefit plans. One is in the area of "mental accounting." Plan sponsors—and until recently

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analysts and rating agencies—have been more tolerant of pension debt (underfunding) than they have been of publicly floated debt (it's even been referred to as "soft debt"). This tolerance is evaporating as rating agencies and management become more cognizant that pension underfunding is a real risk. This has led sponsors to float public debt to fully fund—and in some cases terminate—their defined benefit plans.

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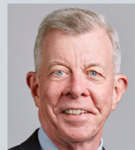

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