RISA®

Retirement Income Beliefs

And How They Impact Investment Behavior and Retirement Outcomes

Introduction

Whether or not you're fully aware of them, you hold certain beliefs about your retirement income strategies and possibilities. We all do. These psychological constructs influence our financial behavior—sometimes sensibly, more often irrationally. But how exactly these variables affect retirement income planning is another matter. It's an area of study that has been lagging. Until now.

Without a better understanding, we are doomed to repeat foolish errors. So, to mitigate adverse outcomes, better identify retirement income behavioral tendencies, and promote more successful retirement results, it's critical to examine the dynamics of these traits and the interplay among them.

Identifying behavioral tendencies

How do we do this? First, we review several recognized tendencies that impact financial behavior. We look at "mental shortcuts" that lead us to what are often ill-considered decisions. They may help us adapt to the stresses of everyday life, but they can be counterproductive when it comes to financial decision-making.

Among these tendencies, the fear of loss can drive us to making rash decisions. For many people, it's an even stronger impulse than the desire to realize gains. Known as "loss aversion," it's a surprisingly compelling force that permeates much of our personal finances. It presumes that losing money will be more impactful on our well-being than realizing returns. This, in turn, tends to make us look backward more than forward and can lead to short-sightedness. It's a pattern that's associated with "hindsight bias," a psychological phenomenon that causes us to overestimate our ability to predict events, and "recency bias," which refers to overestimating the probability of certain outcomes based on recent memory.

Other terms in behavioral economics related to these kinds of mental shortcuts are "survivorship bias," which is overestimating the strength of financial instruments based on their past performance; "affinity bias," or the tendency to make irrational choices based solely on a belief that a product or service reflects your personal values; "gambler's fallacy," the illusion that random events happened for a reason rather than pure chance; and the "endowment effect," which is an emotional bias that makes you value an owned object or asset more highly than its actual market value.

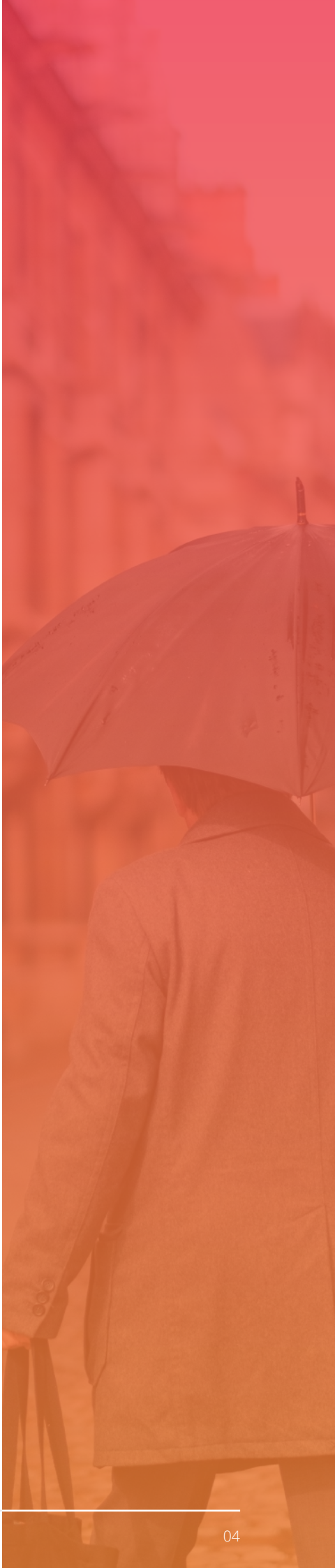
Beyond biases

Another common problem is inertia—i.e., not moving forward or following through on financial plans in a timely manner, thus jeopardizing outcomes. It's a kind of indifference, or a tendency to maintain the status quo. Inaction can be an even stronger impediment to financial decision-making than fear of loss. To push past it, you need to have clear and worthwhile options, and the motivation to choose among them.

Financial literacy, sometimes called numeracy, can help or hinder your progress. It means you're able to comprehend concepts such as probabilities, risks, and other mathematical processes. But it's also been associated with an inability to understand the impact of portfolio volatility. Low proficiency, or a general avoidance of mathematical concepts, can undermine your financial choices. If so, you're not alone. Only 57% of Americans scored a passing grade in a standard financial literacy test.

Yet this is an important consideration when developing a retirement income plan. Even if you possess some numeracy, you may be harboring a sort of false confidence. This is called the Dunning–Kruger effect—a hypothetical bias that leads you to overestimate your abilities. The idea is that low ability people don't always recognize their own incompetence. The gap between what you know what you think you know, between perceived and actual financial literacy, can lead to weaker financial decision-making. Naturally, such discrepancies are paramount when investigating financial behavior.

Self-efficacy encompasses the conviction of how well one can successfully execute a specific course of action. And it influences our financial behaviors. It differs from a general feeling of self-confidence. You may be good at saving money but not a very smart investor; just because you're adept at one doesn't mean you're skilled at the other. Measuring your degree of retirement income self-efficacy is another important construct to realizing successful retirement outcomes.



While many studies show the benefits of having a financial professional, there remains a negative view of their usefulness among the investing public. This skepticism leads to their underutilization. Contributing to these misgivings can be a lack of fee transparency among some practitioners.

Still, your belief in the value of financial advisors, or the lack thereof, can be directly related to your perception of their cost-effectiveness. So, assessing your feelings about the cost-effectiveness of financial advisors is key to understanding whether or not you're likely to use one. Matching your approach to financial professionals with your particular needs can positively influence your retirement outcome. What follows are summary findings from our research paper, Retirement Income Beliefs and Financial Advice Seeking Behaviors.

Analyzing these factors

	Retirement Income Self-Efficacy	Financial Biases	Numeracy	Numeracy Self-Awareness	Advisor Usefulness	Inertia	Portfolio Loss Aversion
Retirement Income Self-Efficacy							
Financial Biases	−						
Numeracy	+	−					
Numeracy Self-Awareness		+	−				
Advisor Usefulness	−	+	−				
Inertia	−	+			+		
Portfolio Loss Aversion	+	−	+		−	−	

We've analyzed how these factors are related to one another and to particular retirement outcomes and solutions. High self-efficacy, for example, is often associated with high numeracy. Low self-efficacy correlates with low numeracy—so much so, in fact, that low self-efficacy folks may be most likely to realize they need an advisor. But high self-efficacy scores are also related to the ability to take on more investment risk and lower levels of financial biases and inertia.

High numeracy can result in a greater willingness to take on investment risk, since you have confidence in your understanding of how risk works, and less of a desire to seek professional advice. On the other hand, those who score low in numeracy are likely to overestimate their abilities—the Dunning-Kruger effect. There's a negative relationship between your level of actual numeracy and your perceived numeracy, such that we found the worse people performed on numeracy, the better they thought they'd performed. Needless to say, this is a huge danger!

Financial bias scores tend to be the inverse of self-efficacy scores. Those with a high level of financial bias tend to have a high degree of inertia, a low degree of numeracy, and a lack of this self-awareness. However, they may have enough insight to realize they could use professional financial advice; their traits are positively correlated with a sense of advisor usefulness.

Three key retirement income concerns

Relating these observations to retirement income concerns is another matter. Those with a high degree of financial bias and trust in financial advisors but a low score in self-efficacy are likely to be concerned about what's called "longevity risk." Longevity risk is the fear of outliving your money, not being able to generate sufficient income to last through your retirement years. This is a very common fear.

Another oft reported concern is liquidity: Do you have sufficient access to ready cash when you might need it for unexpected emergency expenses? This worry is common among those who have strong financial biases, a high degree of inertia, and a strong sense of advisor usefulness. It is, however, negatively associated with retirement income self-efficacy. If you have solid feelings of self-efficacy, you're less likely to worry about liquidity.

A third retirement income concern is being able to meet your lifestyle objectives, your desired standard of living for enjoying your retirement. This often involves having enough money for discretionary spending. To maintain or even improve your lifestyle, you may need to maximize your spending power. (The alternative is to live more conservatively.) The desire to achieve lifestyle goals can run high, especially among those with a strong sense of self-efficacy, numeracy, and loss tolerance.

Three key retirement income concerns

	Retirement Income Self-Efficacy	Financial Biases	Numeracy	Numeracy Self-Awareness	Advisor Usefulness	Inertia	Portfolio Loss Aversion
• Longevity Concern	−	+			+	+	
• Liquidity Concern	−	+		−	+	+	−
• Lifestyle Concern	+		+				+

Most people have a measure of all these retirement income concerns. What differs is how much, or which fears represent more of a priority than others. Generally, increased financial biases, lower numeracy scores, and lower levels of retirement income self-efficacy are associated with a greater concern for achieving essential spending needs and accommodating unexpected emergencies during retirement. In contrast, achieving more discretionary spending goals signals a shift beyond the threshold of longevity and liquidity concerns.

While achieving essential spending needs is a requirement for any successful retirement income plan, people with a high level of lifestyle concerns are not overly nervous about their ability to fulfill their longevity needs. Such folks typically desire spending increases to achieve more of their retirement lifestyle objectives. That can be a problem. It generally requires greater exposure to market volatility, which increases risk. These personalities tend to have greater levels of self-efficacy, numeracy, and loss aversion tolerance.

RISA® Interpretation

	Retirement Income Self-Efficacy	Financial Biases	Numeracy	Numeracy Self-Awareness	Advisor Usefulness	Inertia	Portfolio Loss Aversion
• Dividend Agnostic	+	−	+	−	−		+
• Non-Forecasting vs Forecasting	+	−	+	−	−		+

To see how these beliefs also affect investment behaviors, we looked at two additional factors: "dividend agnosticism" and "forecasting versus non-forecasting investment strategies."

Dividend agnostic people don't care much about the dividends their investments throw off. Conversely, those with a low score in this regard are very much focused on dividends. Most retirees in our study were somewhat agnostic about dividend producing stocks for retirement income. Dividend-paying stocks, of course, produce income for shareholders, but from an economic perspective it is irrelevant. With dividend payouts, the capital just moves from one theoretical pocket to the other. Nevertheless, many retirees favor a dividend matching approach to retirement income. The industry facilitates this with “investing for yield” products aimed primarily at retirees.

Looping this back to the earlier factors, we find that dividend agnosticism is positively correlated with retirement income self-efficacy, numeracy, and loss aversion tolerance. Those with a higher understanding of numerical concepts tend to believe there is no true economic benefit to focusing a retirement income plan on dividend producing stocks. But the more you favor dividends, the higher your score for having financial biases and the lower your measure of numeracy self-awareness. Thus, investors most susceptible to financial biases and lacking numeracy self-awareness may be emphasizing the benefits of dividend stocks for retirement income while minimizing the risk of focusing on a concentrated selection of stocks.

Dividend agnosticism and forecasting vs. non-forecasting

We also created a Forecasting versus Non-Forecasting scale, to single out favored investment approaches. A forecasting approach usually anticipates either general market or individual stock movement, or both. This is frequently referred to as an active investing approach. A non-forecasting approach accepts market prices as a best estimate and is usually identified as a passive investing approach. Most participants exhibited a non-forecasting approach to their investment strategies.

Non-forecasting is positively associated with retirement income self-efficacy, numeracy, and loss aversion tolerance. Though these folks may have the ability and self-confidence to attempt to identify market mispricings, they may also recognize the inherent difficulties in this, and the potential for unplanned, undesirable, and accidental outcomes. They generally prefer to capture broad-based market returns over individual stock movements. A strong forecasting approach, however, is positively related to financial biases and low numeracy. People in this camp tend to be more vulnerable to financial biases and often to repeated exposure to unpredictable market volatility. Coupled with a lack of numeracy self-awareness and lower self-efficacy, these folks are more likely to seek professional financial guidance for help.

Nest egg satisfaction and retirement strategy anxiousness

	Retirement Income Self-Efficacy	Financial Biases	Numeracy	Numeracy Self Awareness	Advisor Usefulness	Inertia	Portfolio Loss Aversion	Age	Gender	Marital Status	Net Worth
• Nest Egg Satisfaction	+										+
• Retirement Strategy Anxiousness	−	+				+		−			

We were then able to connect these factors to two measures of retirement outlook: nest egg satisfaction and retirement income strategy anxiousness. We found that those who reported a high degree of nest egg satisfaction—they felt their retirements were on track with their expectations—tended to have strong feelings of retirement income self-efficacy. In fact, self-efficacy proved more influential to nest egg satisfaction than other variables, including age, gender, marital status, and net worth. Higher levels of net worth was the only other significant variable in this group.

Conversely, those who had a high degree of anxiety—i.e., low levels of comfort with their retirement income strategy—tended to have lower feelings of self-efficacy. Self-efficacy had the largest influence on retirement anxiety. Albeit to a lesser degree, those with high anxiousness also tended to (a) be more susceptible to solving problems quickly, in a way that seems good enough for the moment; (b) have difficulty executing financial tasks on schedule; or (c) be not yet near or into retirement.

Our results also show that even when accounting for various demographic variables, these psychological constructs exert a significant influence on retirement outlook. Again, self-efficacy was the only variable significantly related to both nest egg satisfaction and retirement anxiousness.

Conclusions

Assessing specific retirement income psychologies and financial behaviors provides key insights into how people who are preparing for or are already in retirement are likely to handle retirement decision-making. Our scales for self-efficacy, financial biases, numeracy, self-awareness, inertia, and perception of advisor usefulness can be associated not only with one another but also with important retirement income fears such as longevity, lifestyle, and liquidity—and to investment behaviors such as an affinity for dividend-paying stocks and investment management styles (i.e., active versus passive approach). Many of these factors were further associated with nest egg satisfaction and retirement income anxiety. Therefore, these new scales demonstrate a validity that represents an important step toward better assessing retiree attitudes and behavior.

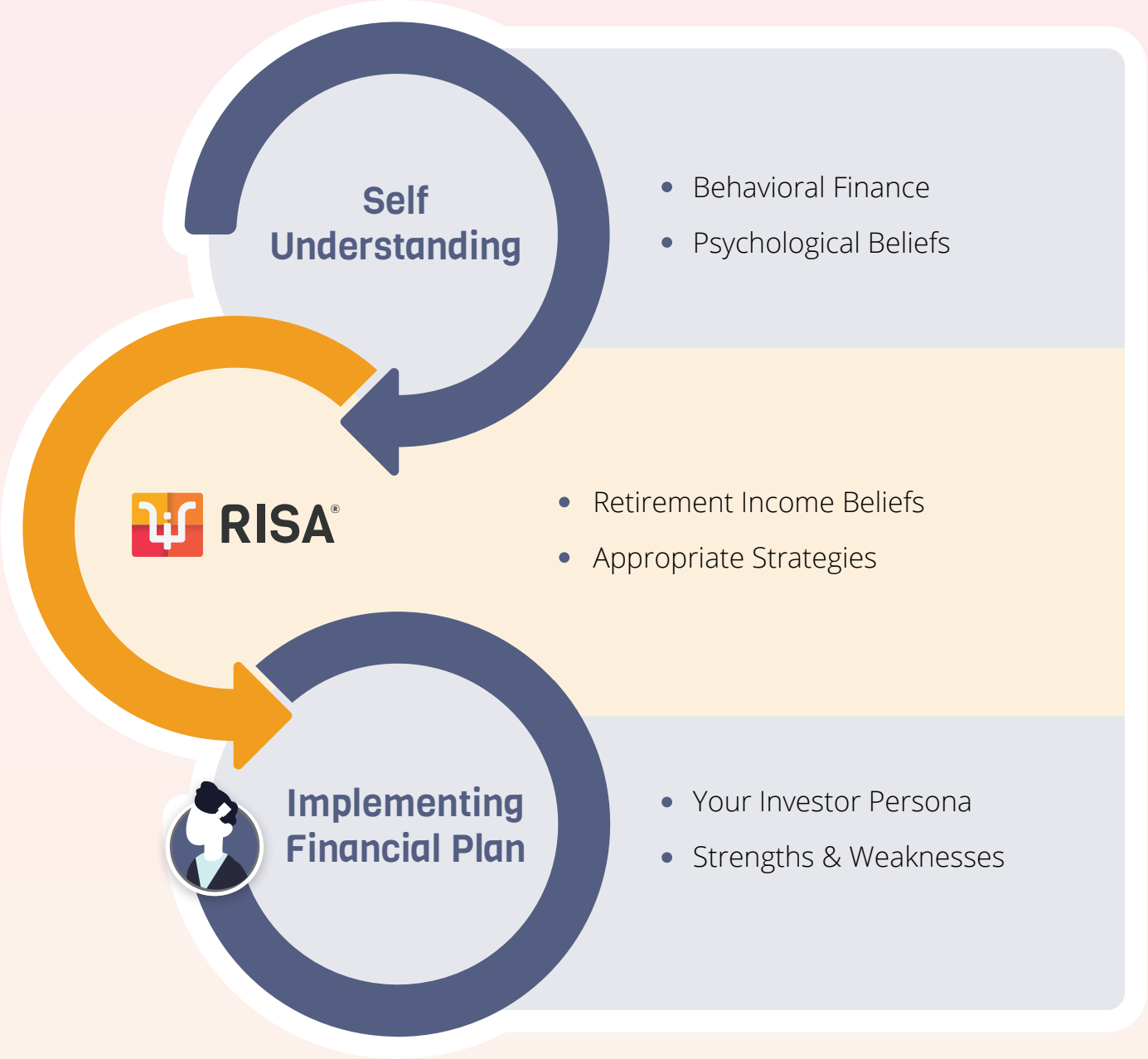
Next steps

Given these psychological constructs and interconnected dynamics, knowing where you stand can help you figure out the right retirement income strategy for your unique personality. These psychological factors are important because they help you identify your potential strengths and weaknesses as you implement your retirement income strategy. The right strategy is one that you feel comfortable with, that works with your preferences and gives you a feeling of "buy in" satisfaction. As such, it's also one that's most likely to succeed because you're most likely to stick with it.

We've developed a way to help you find out where you stand on these measures and interpret the results to help determine the best way forward in your retirement planning. It's part of our Retirement Income Style Awareness® (RISA®) tool. RISA® is primarily designed to assess your preferred retirement income approach, based on your personal style, but it's also a great way to measure where you fit on these financial personality scales. Taking the RISA® questionnaire is a stress-free way to empower you to successfully implement a comfortable, well-fitting retirement income plan.

Further, you can use your scores to create your own investment persona, which in turn will help you identify your preferred financial implementation method. This is via our unique Financial Implementation Matrix™.

To discover your RISA® profile and how various investor personas and implementation strategies can be individualized for greater efficacy, take our RISA® assessment tool.



Want to learn more?

Visit our website:

www.risaprofile.com