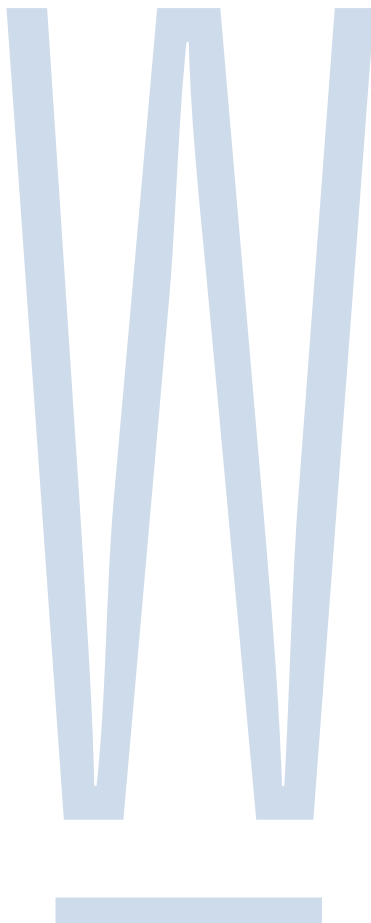
FEATURE

If at First You Don't Succeed, Try Science

BY ROBERT L. FRICK AND CATHY SMITH

A big impetus for founding the Center for Behavioral Finance was to help accelerate the transfer of academic knowledge to improve financial decision-making for individuals and their advisors. Here's a look inside the Center.



ITH THE BEST OF INTENTIONS, EXCELSIOR AMALGAMATED CORP. SET OUT TO IMPROVE ITS LACKLUSTER RETIREMENT SAVINGS PLAN. The head of HR did a little research and discovered some interesting strategies. One big company with a high match rate had high participation, for example. And some industry studies showed that showering employees with investment advice and adding a fancy retirement calculator to the company intranet also paid off. Plus, those who used the calculator actually cost the company less in health care costs.

So the company cafeteria was booked for the "Excelsior 401(k)!" rally. T-shirts were printed. Cake was ordered. In ink and icing, the Excelsior 401(k)! goals were touted: 6% average annual savings, and 70% enrollment.

A year later, the CEO of our fictional company found his T-shirt at the bottom of a drawer, and called the HR chief for an update on the Excelsior 401(k)! program. "Well, boss," he was told, "the plan is about where it was a year ago, but we've discovered some new ideas. Shall I book the cafeteria and order T-shirts and cake?"

We think that this time around the T-shirts should say, "If at first you don't succeed, try science," and any new ideas should be grounded in psychology and behavioral science, not gut feelings and gimmicks.

That's the approach found to be most effective by the Allianz Global Investors Center for Behavioral Finance: Identify the best academic research and transform it into practical tools for advisors and plan sponsors to use to improve outcomes for their clients and employees. Call it "Behavioral Finance 2.0," the term used by the Center's chief behavioral economist, Prof. Shlomo Benartzi of UCLA. Behavioral Finance 2.0 is about taking behavioral finance beyond the mere observation of human behavior, and turning behavioral challenges into behavioral solutions. So rather than just mimicking another company's match plan, as Excelsior did, advisors and plan sponsors can improve their plan by taking a scientific, measurable approach to improving plans.

When scientific methods aren't used, knowing what really lies behind improvements or changes is hard. Consider a study outside the realm of finance that seemed to show that children who slept with the lights on were more likely to develop myopia. Further research showed that myopic parents tended to leave the lights on in their kids' rooms. Since children inherit myopia from their parents, it turned out that it was genetics, not the lights, that made the kids nearsighted. This is a classic example of how correlation can be mistaken for causation. And this problem is at the root of many misguided prescriptions to improve retirement plans.

Now consider the examples in our Excelsior parable. Is it the calculator that makes the difference, or is it that those who use it are already motivated, and so are likely to increase savings anyway? And is a high match responsible for higher participation, or are other factors at play, such as the high-match company has a highly educated, well-paid workforce?

Leaving Guesswork Behind

When behavioral finance is applied to improve defined contribution plans, it's not just plan sponsors and participants who benefit. Plan advisors and record keepers who understand behavioral finance benefit too, because they go from guesswork to predictable outcomes and measurable improvements, which is good

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for business too. "By using automatic plan design features which are grounded in behavioral finance, employees are put on track to retirement readiness," says Daniel Haverkos of AFS 401(k) Retirement Services in Bethesda, MD, an advisor who has received training in behavioral finance from Allianz Global Investors. "That goal improves DC plans overall, and lets advisors like us, and the record keepers we work with, achieve predictable retirement plan success for our clients."

Consider two research-based DC plan innovations: auto enrollment and higher initial default savings rates (6% vs. 3% of pay). Auto enrollment takes inertia, one of our biggest behavioral challenges, and turns it on its head to create a solution. Let's look first at the power of inertia to save lives and then apply it to saving for retirement. In a 2003 study ("Do Defaults Save Lives?", *Science* 302 (Nov. 21, 2003)), Eric Johnson and Dan Goldstein compared organ donation programs in 11 countries. Some of these countries required citizens to consent to donate, or opt in to the program, and others presumed consent, so everyone was placed in the program unless they opted out. Two of the countries, Germany and Austria, were particularly interesting. Although these countries have similar cultures and a common border, they have slightly different organ donation programs that yield vastly different results. Austria's opt-out system means 99% of people donate their organs, versus just 12% in Germany, which requires people to opt-in. In the realm of DC plans, when opting out is set as the default option using auto-enrollment, studies have shown that plan sponsors can expect participation rates to rise by 20 percentage points or more and 90% participation is standard.

Now consider the impact if Excelsior had auto-enrolled its employees at a 6% savings rate instead of the 3% rate that is commonly used. Many plan sponsors do not choose a higher initial default savings rate because they are concerned it will cause participants to opt out. That may seem to make sense on the face of it, but research by John Beshears, David Laibson and Brigitte Madrian at Harvard and James Choi at Yale proves otherwise. Employees, they find, are not deterred by a higher default rate. According to their study published in 2009 (John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian. 2009, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," in Jeffrey Brown et al., eds., *Social Security Policy in a Changing Environment*. Chicago: University of Chicago Press), participation rates and opt-out rates are virtually the same whether the initial default is set at 3% or 6% of pay. This effectively harnesses the power of inertia to double savings rates. On the other hand, setting the initial default too low can seriously undermine employees' retirement readiness by discouraging those who might have saved more from doing so. According to the Employee Benefit Research Institute, the most common initial default savings rate is still 3% of pay, not 6%.

Making Behavioral Finance Easy to Use

The two science-based examples described above have major implications for financial advisors, plans sponsors and participants. But research like this doesn't always make its way out of the ivory tower. A big impetus for founding the Center for Behavioral Finance in 2010 and for hiring Benartzi as the chief behavioral economist was to help accelerate the transfer of academic knowledge to improve financial decision-making for individuals and their advisors. We wanted to make the science accessible and easy to use.

This first major project the Center undertook was its system for bringing behavioral-science-based solutions to retirement plans. The centerpiece of that system is *Save More Tomorrow: Practical Behavioral Solutions to Improve 401(k) Plans,* written by Benartzi with Roger Lewin. The title was inspired by a highly successful savings escalation program, "Save More Tomorrow," developed in the 1990s by Benartzi and his colleague, Richard Thaler of the University of Chicago. While the book stands on its own as a source of behavioral strategies to build better DC plans, it's also the text book for the Center's PlanSuccess System and accompanying Certified Behavioral Finance Analyst (CBFA) training program. The Center has certified about 100 CBFAs to perform "behavioral audits" of their clients' and prospects' DC plans using its proprietary online audit tool.

Advisors use the audit tool to gauge plan participation, savings rates and investment menu health, and to make recommendations for improvements based in behavioral science. Advisors can also use the audit tool to measure the impact of these behavioral prescriptions over time. To complement this program, and to help address growing demand from advisors beyond CBFAs, the Center also developed a Save More Tomorrow seminar, which is currently being rolled out to a broader range of advisors and record keepers.

Training in the science behind behavioral finance is crucial for those interested in improving DC plans, says Benartzi. Advisors with a deep understanding of why these strategies work, as opposed to "hobbyists" who throw around behavioral finance phrases, can better influence plan sponsors to make needed plan improvements. And they can measure progress and confidently link that progress to science, he says. Such proven results are how record keepers and advisors should be evaluated in the long run. "We believe using behavioral economics is the right thing to do, but we also believe it's the only sustainable business model that will work."

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Real World Results

So how much success are the concepts from Save More Tomorrow having being adopted in the real world?

Let's start with the original Save More Tomorrow program. That success was documented in a recent *Science* magazine article. (Shlomo Bernartzi and Richard Thaler, "Behavioral Economics and the Retirement Savings Crisis," *Science* 339 (March 2013).) The program and others like it have helped over 4 million Americans double their retirement savings to the tune of more than $7 billion a year. Save More Tomorrow was not only the first example of behavioral finance at work, but it continues to be one of the most powerful.

And what about the broader range of strategies presented in the book? First of all, advisors tell us that employers are becoming much more receptive, which is likely in part due to success stories like the one just mentioned. "Five years ago behavioral finance was a much harder discussion," says Paula Hendrickson, a CBFA and the director of retirement consulting services for First Western, based in Denver. But these days, many plan sponsors have at least a general understanding of behavioral finance and are eager to discuss ways to improve plans beyond "fees, fiduciaries and funds," she says. Behavioral finance dovetails with the message she's been preaching for years, which is first "you must get people in the plan and saving enough."

Now consider the case of a major law firm in the Washington, DC area. Jerry Whitmire, an advisor with Morgan Stanley Wealth Management in Alexandria, VA, says that while those in the plan had high savings rates, only 56% of the employees were in the plan, "which is kind of scary." After Whitmire, also a CBFA, explained that automatic enrollment would likely help the plan sponsor achieve 90% participation, the plan committee agreed to a plan overhaul based on strategies in "Save More Tomorrow." And it did so over the objections of an ERISA attorney who cautioned the firm might be exposed to liability if even a couple people were accidentally omitted. "But those on the committee thought it was the right thing to do. They didn't want to leave 44% of their employees without retirement security," Whitmire says.

Once employees join a plan, increasing their savings rate is the next hurdle. Take the Haskell Company, an architecture, engineering and construction firm based in Jacksonville, FL. Haskell automatically enrolled its employees in its 401(k) plan, and typical of many firms, the initial default savings rate was just 2%. It already had an automatic-increase feature, but it was only 1% of pay, and capped out at 6%. David Thaeler, executive vice president for human resources at Haskell, said that after a review of the program, "there was a feeling we have to do more. We wanted our people to be ready for retirement." Jamie Hayes of Fiduciary-First in Maitland, FL, Haskell's plan advisor, explained to the firm that not only are plan participants comfortable with a 6% default savings rate versus lower rates, but they also accept higher automatic annual increases, say 2% versus 1%, as well.

So Haskell took the steps necessary to overhaul its plan, and followed Hayes' recommendations of a 6% initial default savings rate and 2% automatic annual increases, maxing out at 10%. Thaeler said the changes were widely accepted by Haskell's diverse and far-flung workforce, which includes engineers, architects and craftsmen, covering a range of salaries and levels of education. "I think there was surprise, but we're very pleased that it did happen."

Hayes adds that one cause of resistance among some plan sponsors is rooted in the herd mentality, another behavioral concept. Plan sponsors tend to measure their success against how other companies are doing. "I hear arguments such as, 'we're at 75%, and our industry average is 70, so we're happy with that.' And I say, why? Who cares what your peers are doing when 25% of your employees aren't saving?" says Hayes.

Not every discovery that comes out of behavioral finance research, however, will be applied successfully in the real world. "Part of my job working with the Center is helping to separate the wheat from the chaff for clients," Benartzi says. The industry has to recognize the nature of research and science, and that we need to test ideas with some companies, see if they work, and if they work, then and only then offer them industry-wide. "We will fail sometimes. That's the nature of research and science." But success isn't the main issue with behavioral finance, over-promising results is, says Benartzi. If expectations are set too high, and not met, resources will dry up. "Future improvements will take time and learning, but there's tremendous upside potential."

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ment with their record keeper was fairly weak and entirely different from the plan sponsor's.

Another causal factor leading to the vast differences between plan sponsors' and participants' satisfaction with the relationship is the available response to poor services, products or pricing. That is, if the plan sponsor receives poor services, etc., for a period of time, the company has the option to, and often does, change record keepers. In a sense, the system purges itself of bad relationships and new, more satisfying relationships are established. As a result, satisfaction scores remain high. However, if the participant receives poor service, doesn't like the products or finds the pricing too high, he or she has no option to switch to another record keeper. They could drop out of the plan, of course, but that would deny them access to a valuable employee benefit.

Over time, this toxicity of unhappy participants builds in the employee base as unhappy customers cannot seek out more satisfying providers. This results in a significant reduction of the overall satisfaction percentage score. Essentially, the participant operates in a monopolistic market; the plan sponsor operates in a purely competitive market.

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Satisfaction: Sponsors vs. Participants

Let's look at some supporting data proving that with respect to specific participant service channels satisfaction, sponsors are far more pleased than participants. Looking at the participant website, 70% of plan sponsors are "very satisfied" while only half (54%) of participants feel the same way. The same is true for satisfaction with the participant statement – 75% of sponsors are "very satisfied" while only 50% of participants agree with plan sponsors. The two groups also vary somewhat on education services: 41% "very satisfied" among participants; 51% among plan sponsors. Lastly, although low in both cases, 50% of plan sponsors are "very satisfied" with the performance of the plan's investment options, compared with only 31% of participants.

The point is that participants and plan sponsors live in different service-quality worlds. Plan sponsors obviously receive a far different level of handholding, explanation and customized treatment than do participants. And it is worth reiterating that if participants are unhappy with the service they receive from the record keeper, they have little choice about what they can do next, other than complain to HR or to their co-workers or leave the plan.

Advisors and record keepers should keep these different worlds in mind, and encourage (and possibly assist) plan sponsors to keep their participant feedback loops open as wide as possible to detect the need for quality improvement.

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And what future innovations does the Center for Behavioral Finance have its eye on? We continue to build on the strategies presented in *Save More Tomorrow,* but we're also taking on the challenge of financial decision-making for those who have already reached their spend-down years. This new program, the Retirement Trail, is a multi-step, multi-year program, in part because the challenges facing retirees are much more complex than those facing people saving for retirement. In addition, there is comparatively less academic research directly addressing this phase of financial life. Our team, guided as always by Benartzi and our academic advisory board, is hard at work plumbing the deep well of research on topics like decision-making under uncertainty, values and risk, and grappling with how to most effectively apply all of this knowledge to improve the welfare of retirees.

Since identifying a clear set of goals is the critical first step for advisors and their retired clients, that's also the starting line for the Retirement Trail. Our goal setting system will encompass content, but will also include a user-friendly app for advisors to use with their clients. Future stages in the retirement trail may also include virtual reality games and other digital solutions. "The future of behavioral finance lies at the crossroads of science and digital technology," says Benartzi. "And that's where we'll be focusing a lot of our attention."

We believe effective, science-based tools like our behavioral audit tool for DC plans and the apps we're now developing for the Retirement Trail can help transform the retirement industry. "It's still early but we are seeing a growing impact," says Glenn Dial, head of U.S. Retirement for Allianz Global Investors. "Early adopters in the DC world have seen how well applied behavioral finance works, and that they can spend fewer resources to affect major changes," he says. "For example, we're not seeing participation rising from 73.5% to 75%, it's rising to more than 90% — and without an army of people working to enroll employees." He sees that many industry leaders recently have become believers, too. "This is quickly catching fire."

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