Fi360

Behavioral Finance
How Participants Make Decisions

Dr. Gregory W Kasten
Chief Executive Officer
Unified Trust Company

Welcome!

"Hello"

I am Gregory Kasten

What we will cover: Behavioral finance research shows most 401(k) participants are not active decision-makers. In fact, most participants are dominated by five key behavioral traits: inertia, procrastination, choice overload, endorsement and framing. Today I will explain these behaviors and how appropriate strategies can be enacted to allow for participant success despite these behaviors.

Presentation Agenda

1. The Purpose of ERISA
2. Five Key Financial Behaviors
3. How They Hurt Participants
4. Successful Strategies
5. Improving Outcomes
6. Adding Value As An Adviser

The Purpose of ERISA

Studebaker

“A catastrophe”

- For 27 years, Ray worked on the truck line at the Studebaker auto plant in South Bend, earning $2.60 an hour and a pension that company officials promised he could look forward to in his old age.

- “I loved my job,” said Ray, “I thought I was set for life.”

“Pensions: the Broken Promise” NBC News aired 9/12/1972

Studebaker

“A catastrophe”

- Then, in 1963, Ray showed up for work and was told there was no more job. No more Studebaker. And no more pension.

- The funds that had been promised to provide pensions for 4400 vested Studebaker employees were gone.

“Pensions: the Broken Promise” NBC News aired 9/12/1972

“It is hereby declared to be policy…to protect the interests of participants in employee benefit plans and their beneficiaries…”

ERISA'S VISION

Congress thought the trustee would be discretionary!

"The House bill also provides that all plans must be in writing, that plan assets generally are to be held in trust, and that trustees generally are to have the exclusive authority to manage and control plan assets."

unified trust

Where Did ERISA Go Wrong?

ERISA Was Written to Correct Defined Benefit Plans

But most employees do not have a defined benefit plan today.

401(k) Corporate Trustees

Most 401(k) Corporate Trustees Today are Directed

The relative cost calculation shows that for every dollar previously spent to achieve a successful participant, it will now cost the plans only $0.44, a savings of 56%.

Where Did All The (Discretionary) Trustees Go?

Directed Trustee

"Immune from judicial inquiry!"

"As we have explained, a discretionary trustee is essentially 'immune from judicial inquiry' because it lacks discretion, taking instructions from the plan fiduciary that it is required to follow."

Renfro v. Unisys Corp. 671 F. 3d 314 – Court of Appeals, 3rd Circuit 2011

unified trust

Better for the Vendor

But worse for the average employee

- Exempt from most fiduciary prohibited transactions
- Little fiduciary compliance cost
- Little risk (most risk remains with named plan fiduciary-plan sponsor)
- Requires employee to become an actuary and investment expert

Three In Four Fail

75% in DC Plans Won't Have Enough For Retirement

Three-quarters of defined contribution plan participants are projected to fall short of what they will need in retirement, said Christopher L. Jones, chief investment officer at Financial Engines.

By Robert Steyer
Source: Pensions & Investments
Date: September 22, 2010

unified trust

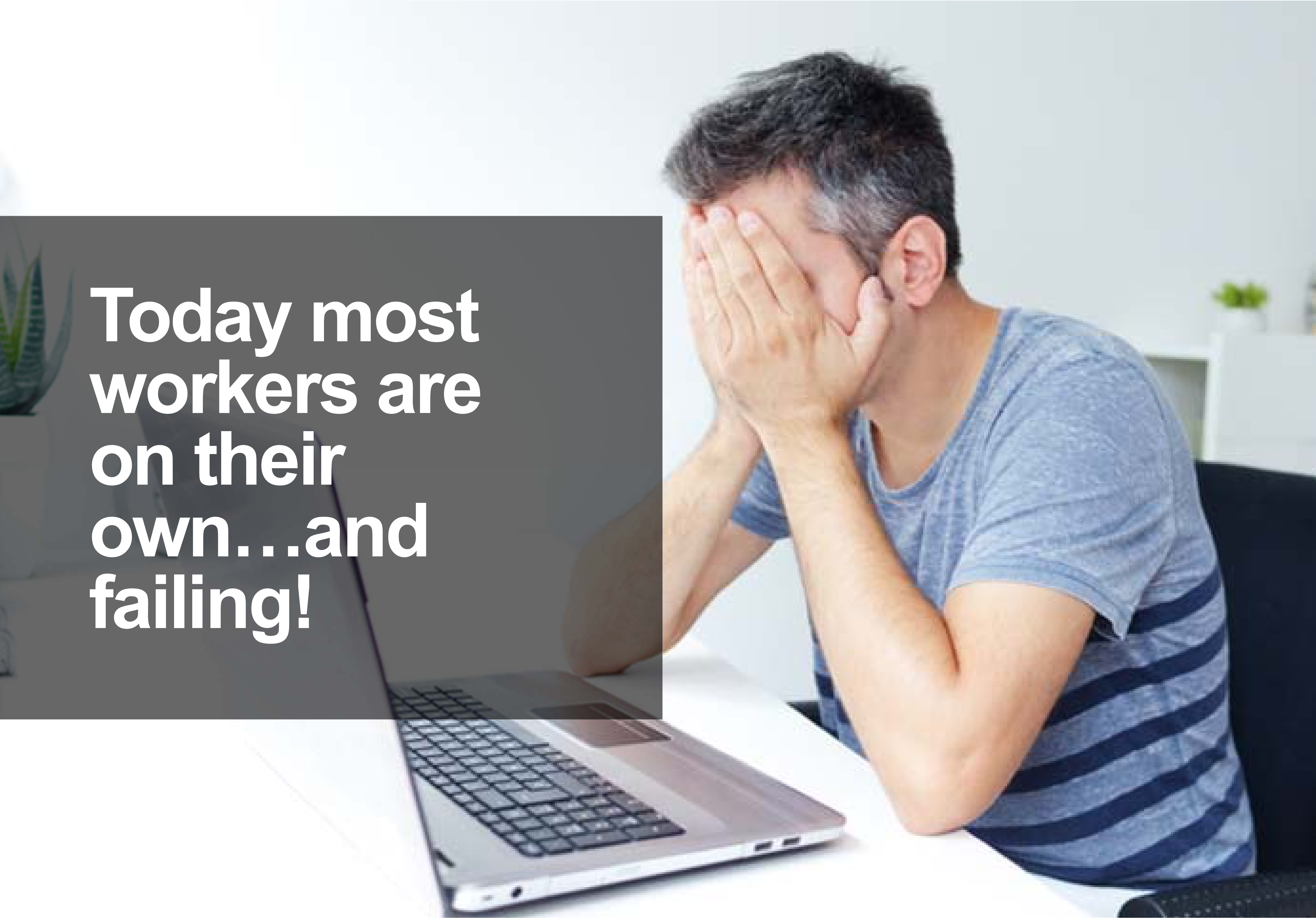
Industry Solutions

Retirement industry offers simple but ineffective solutions

- Automatic Enrollment
- Target Date Fund
- Email Campaigns
- Web Calculator
- Gap Report
- "Plan Health Reports"

Personalized Data

The industry has offered distinct homepages and account-specific dashboards, along with increased dashboard or homepage retirement readiness content and the integration of more personalized communication strategies.



Today most workers are on their own…and failing!


The Gap
Between where participants are and what they will need for retirement

Overconfidence

Mental Accounting

Overconfidence

It can be harmful.

Research has found that people tend to have unwarranted confidence in their decision making. In essence, this means having an inflated view of one's own abilities.

This trait appears universal, affecting most aspects of our lives. Researchers have asked people to rate their own abilities, for example in driving, relative to others and found that most people rate themselves in the top third of the population.

Few people rate their own abilities as below average, although obviously 50% of all drivers are below average.

Overconfidence

It can be harmful.

Many studies–of company CEOs, doctors, lawyers, and students–have also found these individuals tend to overrate the accuracy of their views of the future.

Most humans tend to view the world in positive terms. They tend to ignore mistakes.

While this behavior can be valuable – it can help a person recover from life's disappointments more quickly – it can also cause an ongoing source of bias in money-related decisions.

.

Overconfidence

Overconfident investors may overestimate their ability to identify winning investments. They tend to trade more often.

Portfolio Turnover and Return		
	Mean monthly turnover	**Annual return**
20% least active traders	0.2%	18.5%
20% most active traders	21.5%	11.4%

Source: Brad Barber and Terrence Odean (1999) 'The courage of misguided convictions' Financial Analysts Journal, November/December, p. 50.

Mental Accounting

Participants think about money and risk through 'mental accounts' – separating their wealth into various buckets or pools.

Mental Accounting

- Investors pay less attention to the relationship between the investments held in the different mental accounts than traditional theory suggests. This natural tendency to create mental buckets also causes them to focus on the individual buckets rather than thinking broadly, in terms of their holistic wealth position.
- Mental accounting creates "investment layers." The base layers represent assets designed to provide "protection from poverty", which results in conservative investments designed to avoid loss. Higher layers represent "hopes for riches" and are invested in risky assets in the hope of high returns.
- The base layer usually consists of cash, bank accounts and conservative bonds.
- The risky upper layer consists of stocks and buying lottery tickets.

Mental accounting

Simultaneous risk adverse and risk tolerant behavior

This idea explains why an individual investor can simultaneously display risk-averse and risk-tolerant behavior, depending on which mental account they're thinking about.

This model can help explain why individuals can buy at the same time both "insurance" such as short term bonds and "lottery tickets" such as a handful of small-cap stocks.

Mental accounting

Simultaneous risk adverse and risk tolerant behavior

The theory also suggests that investors treat each layer in isolation and don't consider the relationship between the layers.

They do not understand the correlation of various assets.

Established finance theory holds that the relationship between the different assets in the overall portfolio is one of the key factors in achieving diversification.

The Five Key Financial Behaviors

1. Inertia

Going along the same path, engaging in certain money habits, and finding it is difficult to break out of that situation.

2. Procrastination

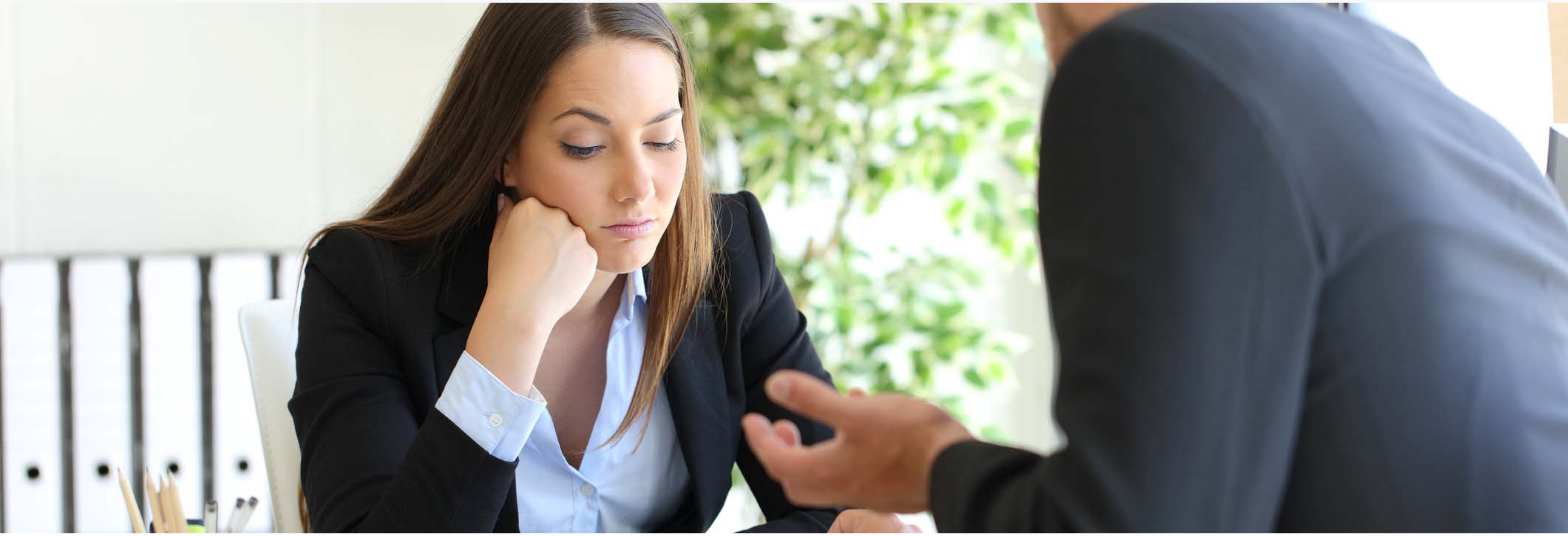
The strong tendency to put off until tomorrow what one should be doing today.

3. Choice Overload

The prospect of making the decision is so overwhelming that the individual refuses to make it.

4. Endorsement Effect

Substituting a perceived expert suggestion (their employer’s plan design) for their own individual reasoning about their financial needs and risk tolerance.



5. Framing

How a concept is presented to individuals matters in their decision. Framing can allow most participants to accept the help they seek.

The Key to Improving Outcomes Is Allowing Participants to <u>Keep</u> Their Behavior

Successful Strategies

“Robo Advice”?

What are the fiduciary aspects of the Robo Adviser?

Where does data originate?

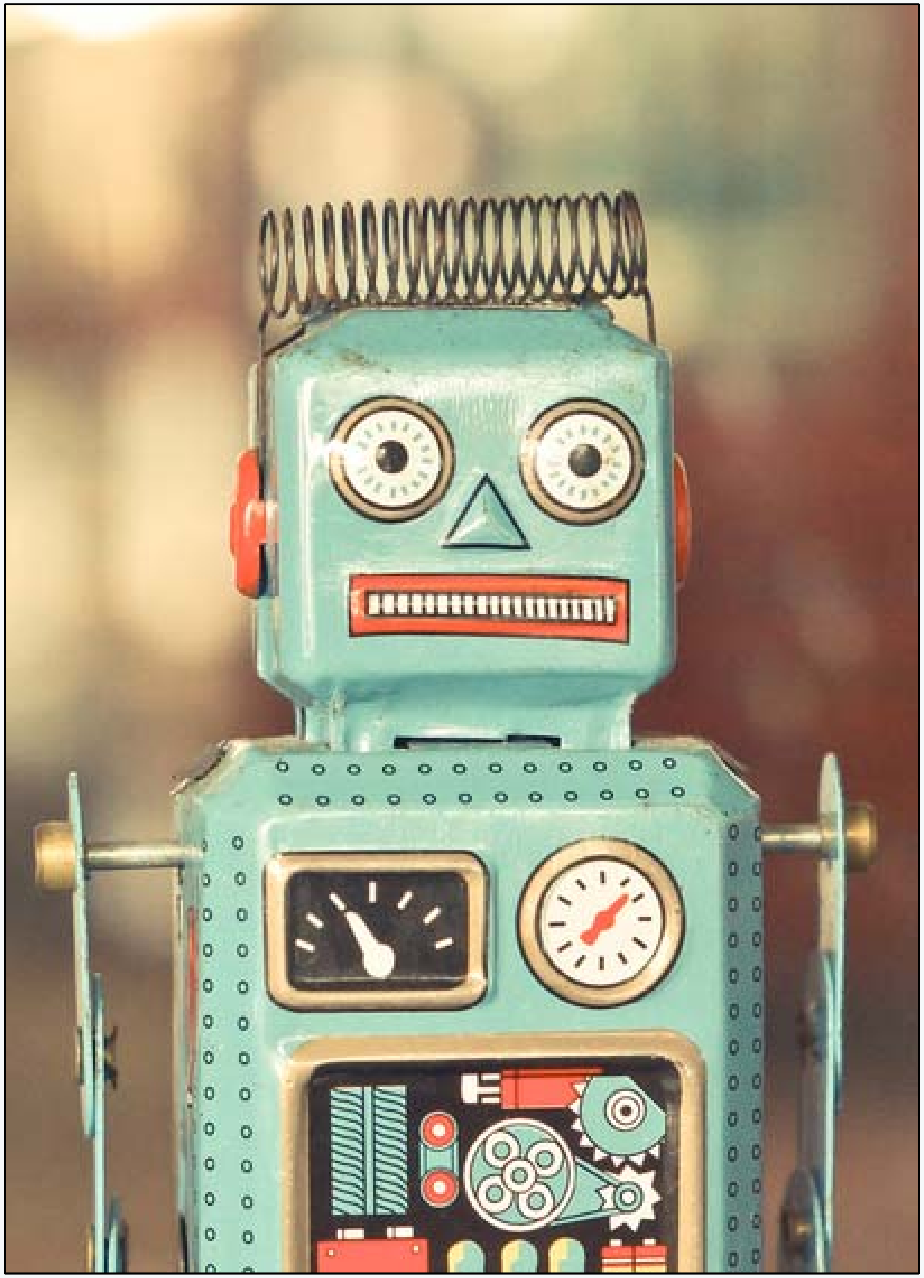
How often is account tested for errors?

Are FI360 CEFEX Best Practices in place?

Most robo advice systems have not been tested in a bear market.

This is a fiduciary act.

“Digital Fiduciary”



Usually Less than 10% of Participants Select a Managed Account

"Cost, complexity cited for the lackluster use of managed accounts"

"There's a wide variability of usage depending on whether a managed account is the QDIA"

"However, among Vanguard plans offering managed accounts, participant usage hovered between 6% and 7%"

"Cost, complexity cited for the lackluster use of managed accounts", Steyer, Robert; Pensions & Investments; January 25, 2016

Dealing with Inertia

In recent years behavioral researchers have designed autopilot systems to counteract inertia.

For example, it has been observed that many individuals fail to join their company's 401(k) plan, possibly as a result of inertia.

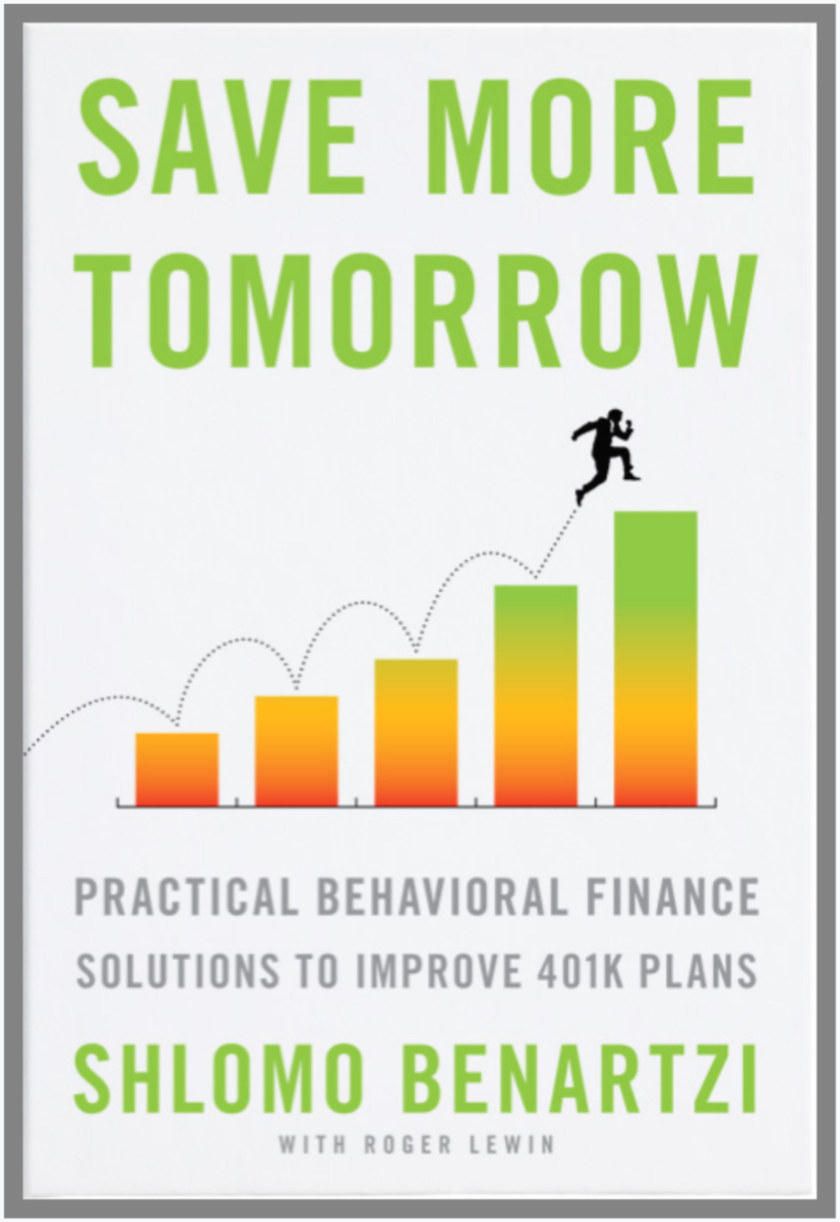
Changing the enrollment process so that employees are automatically enrolled, while retaining a right to opt out, tends to boost participation rates considerably.

Dealing with Inertia

In recent years behavioral researchers have designed autopilot systems to counteract inertia.

Likewise, automatically enrolling employees at a rate of 6% versus 3%, helps them save an amount more likely to fund their retirement needs.

Automatic enrollment in annual escalators of savings helps even more.



Dealing with Inertia

Default the employee into the correct solution.

Most employees do not have a retirement goal. Most do not know how to solve the actuarial solution for the goal.

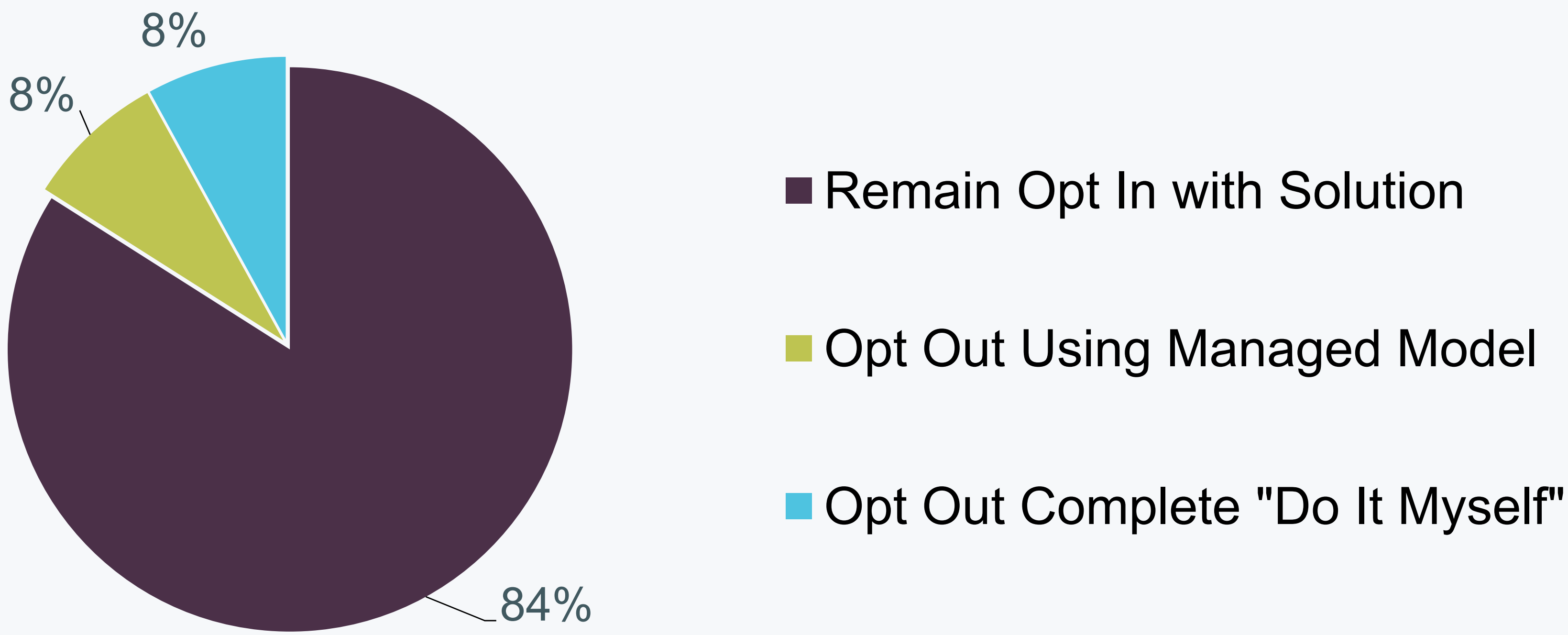
Defaulting employees into a goal, and solving for the goal, selecting the portfolio prior to the enrollment meeting ensures a very high acceptance rate of advice.

This is a fiduciary act.

Ongoing quarterly monitoring.

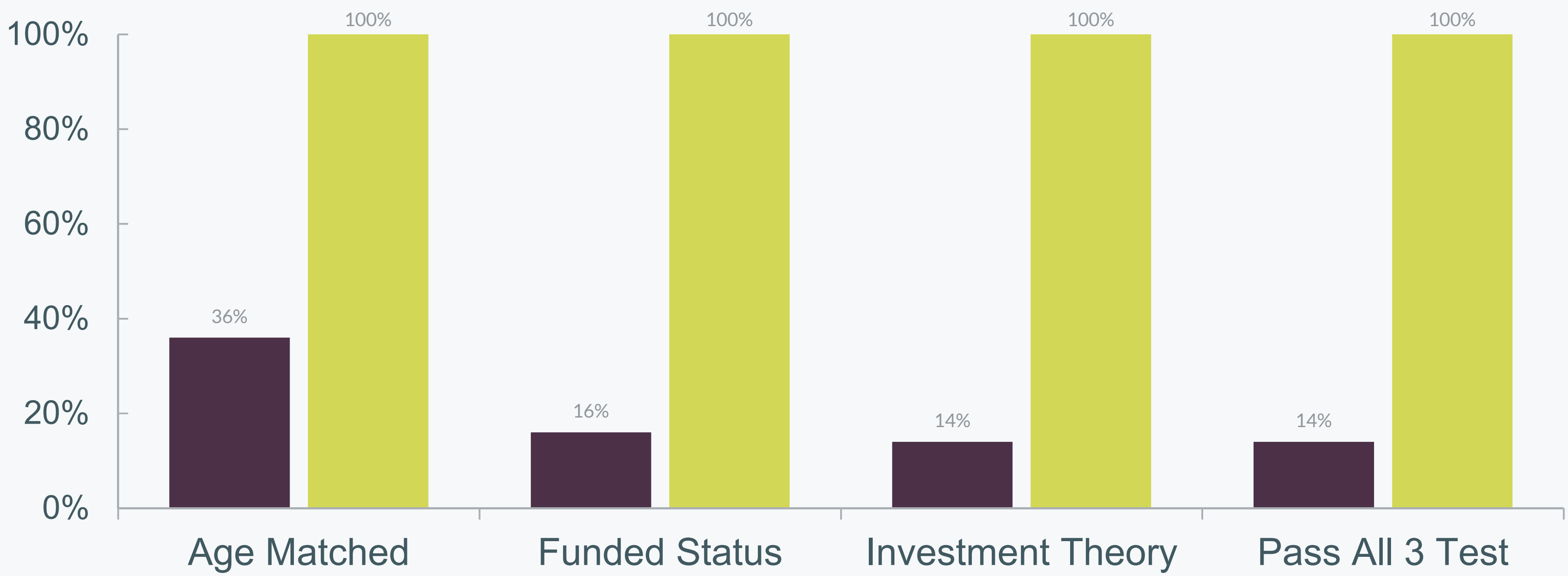
Opt Out Participants Are Few

Inertia and Procrastination Keep Most in the Program



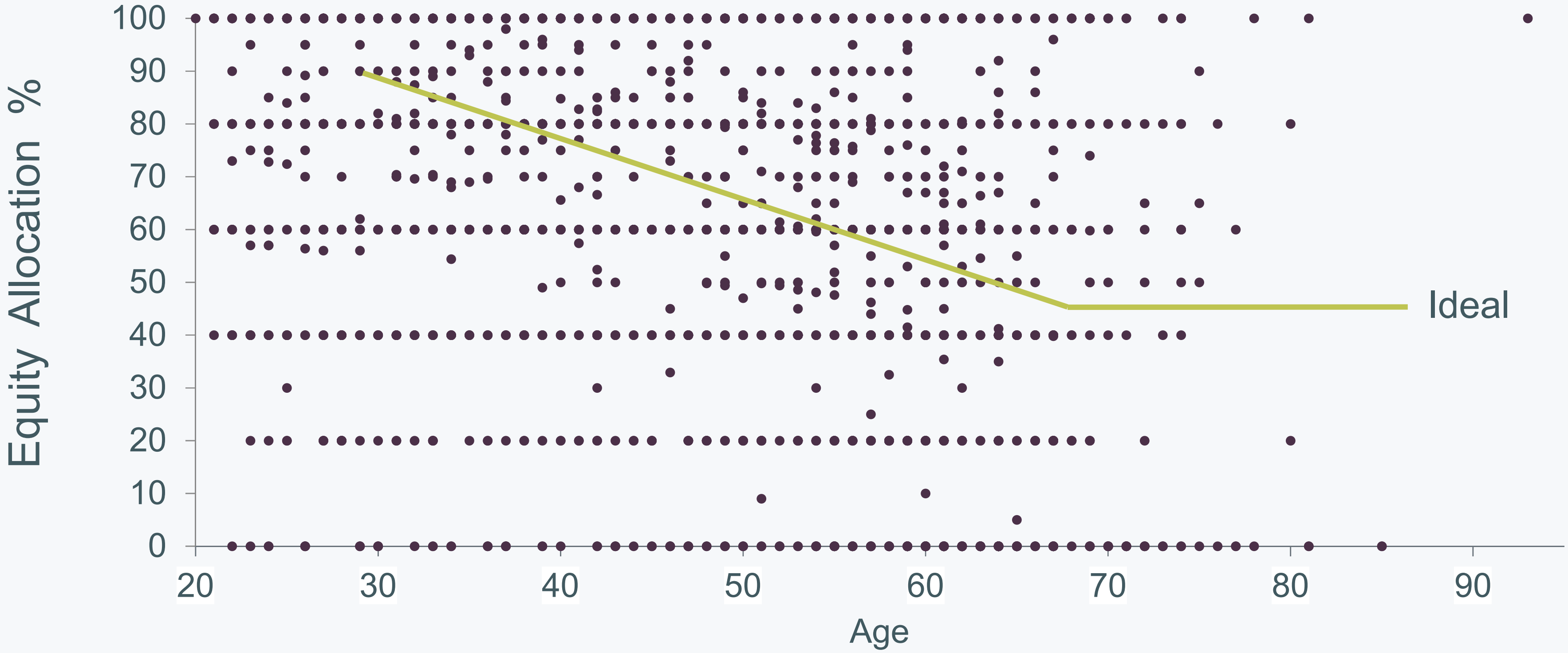
Improve Participant Investing

Investing is improved when done for the participant.



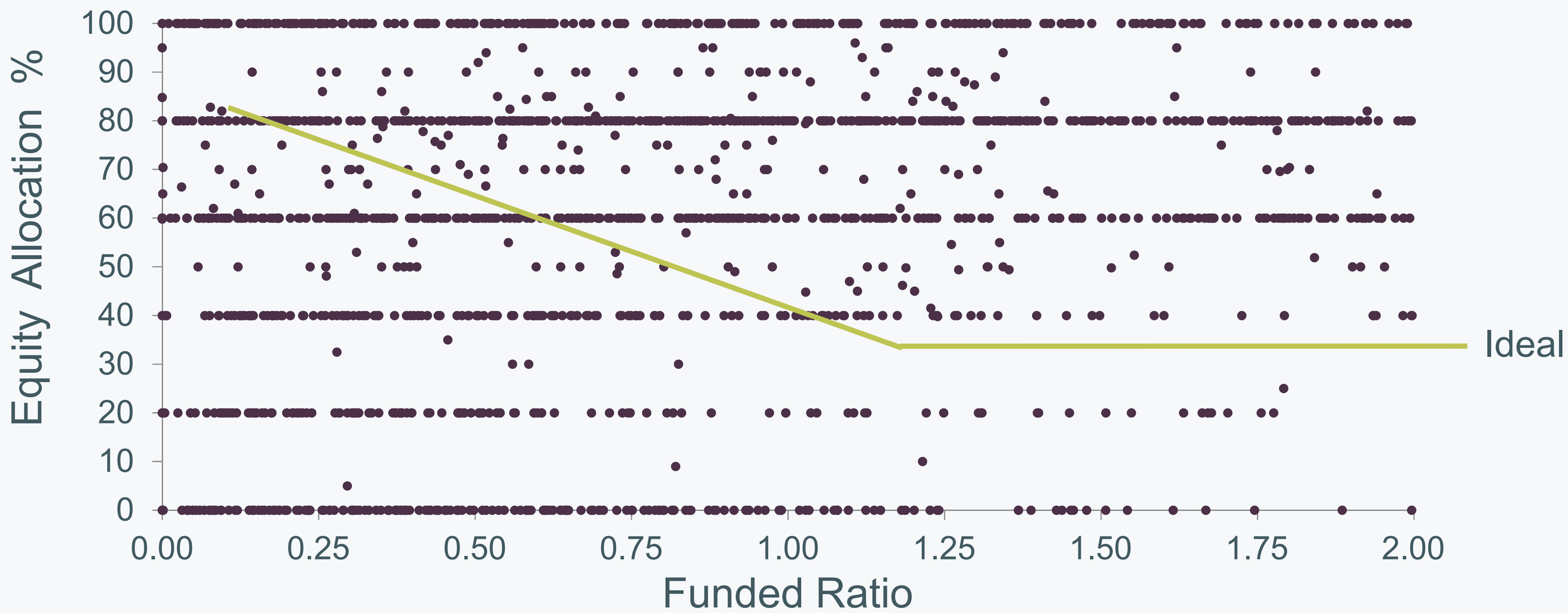
Opt Out Participants

Equity Allocation Not Related to Age



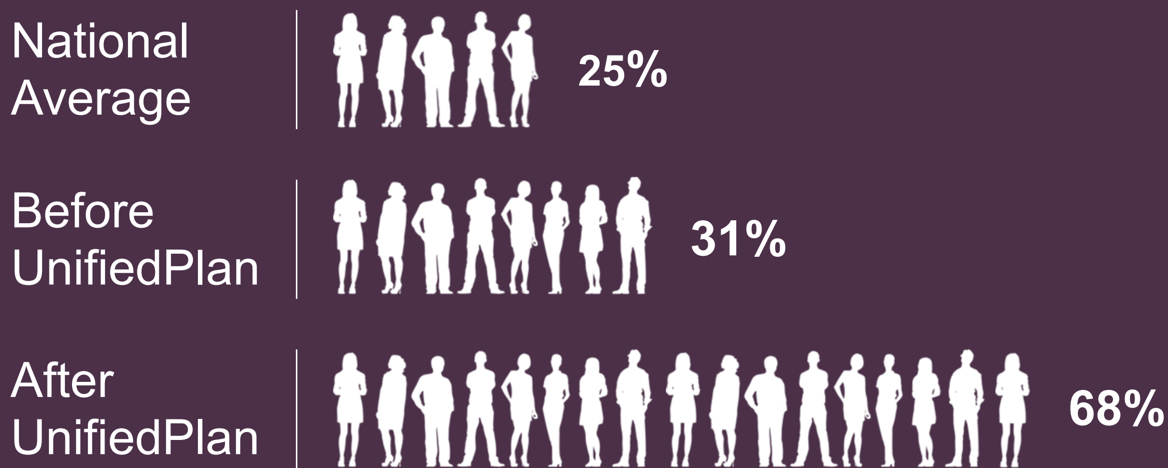
Opt Out Participants

Equity Allocation Not Related to Funded Ratio



unified trust

Most Participants Can Be on Track for a Fully Funded Retirement Benefit



"Fully Funded" means forecast Asset/Liability at least 1.00. Data from Unified Trust study of all UnifiedPlan clients through 2016.
National average data from Pensions & Investments September 22, 2010

The Process Lowers the Cost of Success

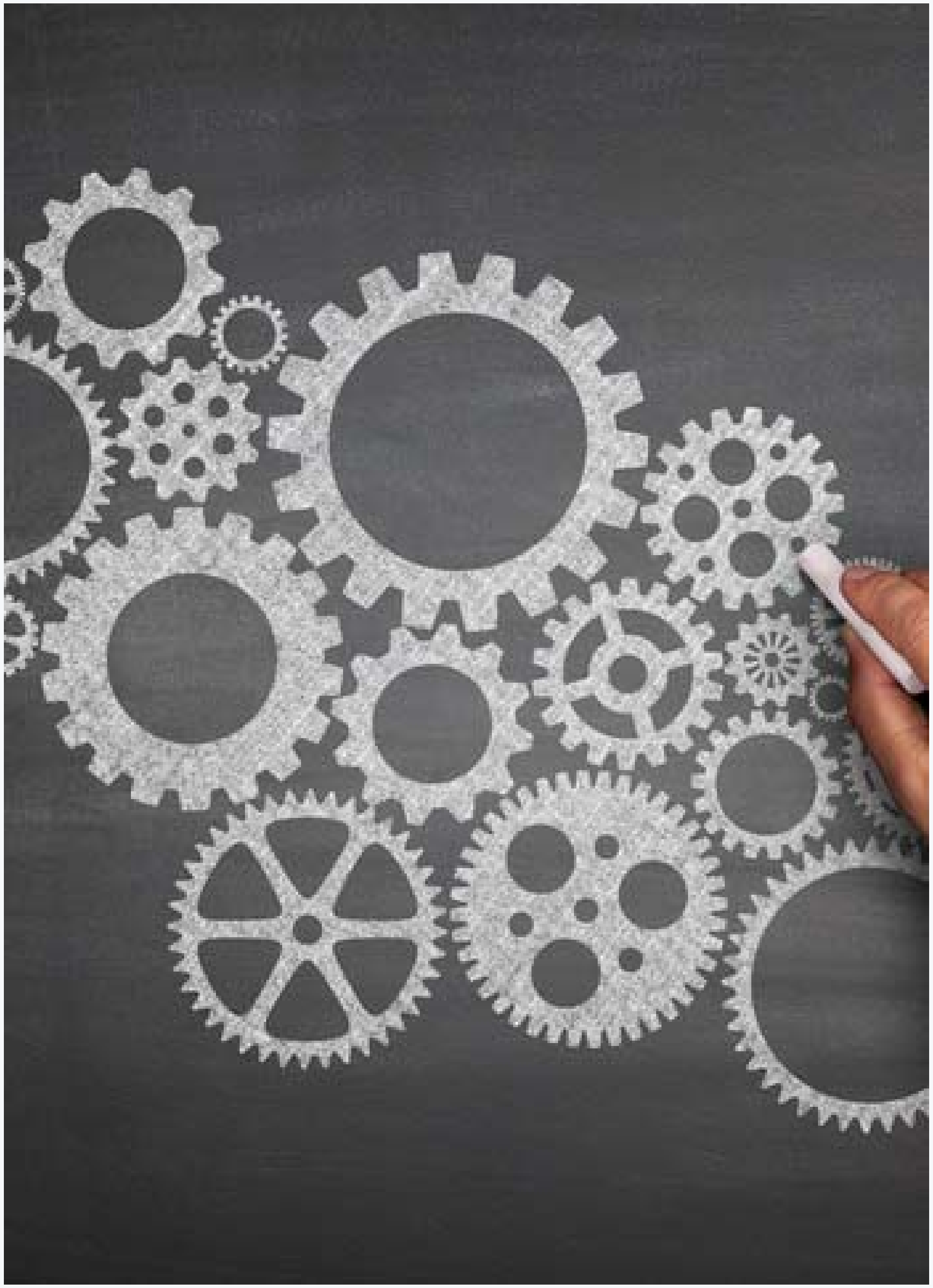
The relative cost calculation shows that for every dollar previously spent to achieve a successful participant, it will now cost the plans only $0.47, a savings of 53%.

Adding Value As An Adviser

Quantifying Results

“When going through the specifics of how the plan and the participants’ situations have improved over the past 12 months, it is vital for advisers to show plan sponsors how they drove those changes.”

PlanAdvisor July/August 2015



It Is Really Just Four Questions

Be able to answer them!

1. Is the participant in the right answer?
2. Are they in the correct portfolio?
3. Are their fees reasonable in light of services provided?
4. Have their outcomes improved?

Your Four Responses

Provide the Answers for the Twin Challenges

01

Retirement Success

Successful retirement outcome for employees

02

Manage Risk

Manage fiduciary risk for plan sponsor and committees


Participants don’t want to know how to build a watch.


They just want to know the time!

What's In It For…

The participant, the plan sponsor and the plan advisor

- **The Participant:** They have the answer! A retirement goal and a plan that's easy and doesn't require them to change their behavior.
- **The Plan Sponsor:** They have a plan that has improved employee satisfaction and retention while at the same time reduced their fiduciary risk.
- **The Plan Advisor:** You now have a scalable and deliverable service model that drives quantifiable results.


Success!

Thanks for Joining Us!

Gregory W. Kasten, MD, MBA, CFP®, CPC, AIFA®

Contact:

2353 Alexandria Drive, Suite 100, Lexington, KY
(859) 296-4407, Ext. 202
Greg.Kasten@unifiedtrust.com

Fi360

CONFERENCE

APRIL 25-27

2018

SAN DIEGO CALIFORNIA

HILTON SAN DIEGO BAYFRONT

REGISTER TODAY!

Early bird pricing ends on February 28, 2018!

Registration link:

fi360.com/fi360-conference

Disclosures

1. The UnifiedPlan reporting tool helps investors understand whether they are on course to achieve a successful retirement. The UnifiedPlan uses "asset liability" matching. The asset is the money forecast to be accumulated and the liability is the amount of money needed to pay for the retirement. For investors who are planning for retirement, the tool estimates the amount of funds required to meet their retirement spending goals and provides alternatives such as delaying retirement or lowering retirement spending for those who may not be able to save the required amount.

2. For investors who are already retired, the tool estimates the confidence that their portfolio will be able to sustain their desired spending throughout retirement. The tool uses a combination of deterministic methods and Monte Carlo simulation that consider factors that include saving and spending levels, long-term market expectations associated with the risk profile selected, pre- and in-retirement time horizons, and other sources of outside income.

3. The UnifiedPlan limitations relate to the large number of assumptions used in the analysis. The accuracy of these assumptions directly impacts the quality of the tool's assessment. Potential problems may include, but are not limited to, the use of inaccurate financial data by the investor, the selection of a risk tolerance by the investor that does not represent how their portfolio is actually invested, long term market expectations of risk, return, and inflation that are not achieved in the modeled time frame, the inclusion future income that is never received, and unforeseen life emergencies that require decreased saving before retirement, force an earlier retirement, or increase spending needs during retirement.

4. The UnifiedPlan is highly dependent upon assumptions of annual income and annual savings. Any variances or changes in the figures used should be reported immediately by the plan participant. Unified Trust is not responsible for any discrepancies in the data, or output from the UnifiedPlan tool.

5. All mutual fund and collective investment fund data was gathered from publicly available sources of information such as Standard & Poor's, Morningstar, Zephyr or vendors' own websites. We take reasonable care in collecting the data, and believe the data are accurate, but reserve the right to correct any errors. Individual mutual fund or collective fund performance data throughout the document are net of underlying fund expense ratios but gross of add-on expenses such as Trustee fees, administration fees, or advisory fees. The performance histories reported are simply dollar-weighted historical returns for the proposed funds and do not reflect the effects of rebalancing or fund replacements.

6. Any past performance information for the illustrated investment selections is not indicative of future returns but is merely a snapshot of historical performance. Past performance is not a guarantee of future performance. The investments are not FDIC insured.

7. Differences will probably exist between prospective and your actual results because events and circumstances frequently do not occur as expected, and those differences may be material, especially when making estimates over extended time periods. All figures are shown in current (inflation adjusted) dollars. The estimated inflation rate used in this analysis may vary over time.

Disclosures

8. The UnifiedPlan portfolio changes and time line changes for each participant are governed by the Plan Document, the Investment Policy Statement and the Benefit Policy Statement for their Plan.

9. The calculated 70% income replacement goal includes the estimated Social Security benefit. The actual Social Security benefit may be different from the estimated value.

10. Compensation in excess of the IRC 415 limit is excluded. All figures reported in current (inflation-adjusted) real dollars.

11. The projections or other information generated by the tool regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Projected growth of assets is based Unified Trust Company's Projected Future Modeled Returns and the asset allocation of your portfolio for this goal. The graphical representations are an approximation taken from the direct path between the pertinent events tied to your goal. Indices are unmanaged, do not incur management fees or expenses, and cannot be invested in directly.

12. Neither the Plan Sponsor nor Unified Trust can guarantee that any participant will achieve a successful retirement. The UnifiedPlan reporting tool helps investors understand whether they are on course to achieve a successful retirement. The UnifiedPlan uses “asset liability” matching. The asset is the money forecast to be accumulated and the liability is the amount of money needed to pay for the retirement. For investors who are planning for retirement, the tool estimates the amount of funds required to meet their retirement spending goals and provides alternatives such as delaying retirement or lowering retirement spending for those who may not be able to save the required amount.

13. Projections are made based upon expected asset transfers. Actual transfer amounts may be different and may require a new retirement solution.