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# The Well-Tempered Retiree: Fine-Tuning Investor Behaviors in Decumulation

*By Jennifer Gongola, PhD, and Avi Sharon, PhD*

INVESTMENTS & WEALTH INSTITUTE®

# The Well-Tempered Retiree

## FINE-TUNING INVESTOR BEHAVIORS IN DECUMULATION

*By Jennifer Gongola, PhD, and Avi Sharon, PhD*

After a lifetime of working and saving, retirement should be a welcome prospect. Unfortunately, for many the transition from saving to spending can be traumatic, both emotionally and economically. Uncertainty surrounding one's health, mortality, and the markets can make decisions about how to spend down retirement savings incredibly complex and anxiety-inducing. This "decumulation dilemma" can impair investment decision-making, and the consequences of such misbehavior can be costly.

An entire science—behavioral finance—has arisen around how to encourage better investment behaviors. Today, *homo economicus*, the perfectly rational investing hominid, is increasingly seen as a species dwelling only in the models of classical economic theory. Such mythical beings have predictable lifespans, self-controlled incomes, and infinite mathematical abilities. In stark contrast, actual investors are human beings—with brains constrained by limited time, information, resources, and myriad unknowns—and highly susceptible to the most predictable biases and errors. That's especially the case in retirement, where "good" behavior arguably matters more than in traditional saving contexts.

### NUDGING TOWARD DECUMULATION

Investors in the saving stage have long benefited from the insights gleaned from behavioral finance. A number of guardrails have been established by regulators, employers, and even asset managers to encourage better investment behaviors during this period. These include the obligatory "opt in" to a 401(k) plan early in one's working life, default target-date strategies that glide investors to a lifetime allocation, and auto-escalation to accelerate savings in their later years.

However, for those in (or about to be in) the decumulation stage of retirement, it's mostly a blank slate. There is little regulatory guidance, no single product solution, and only a handful of practitioner rules of thumb to guide their planning.

### THE WELL-TEMPERED RETIREE

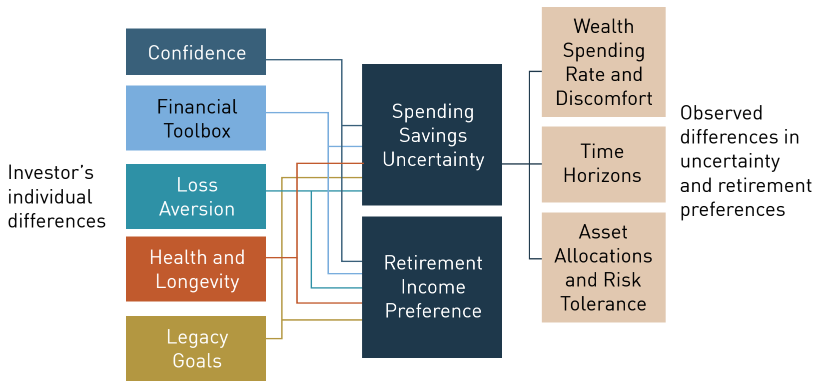
We conducted a study to better understand the interplay between investor psychology and retirement-oriented decisions and goals. It was designed by PIMCO and conducted online within the United States by The Harris Poll in December 2020, with 758 U.S. adults 55 years and older, including 255 with $500,000 to $999,999 in liquid net wealth and 503 with more than $1 million in liquid net wealth.[1] We asked investors about important retirement decisions, such as timing Social Security benefit claims and their approach to withdrawing from savings and investments, and we took measures of their individual human differences, including their sense of their own health and longevity, financial literacy, risk priorities, and desire for bequest or legacy. Then we explored and mapped how these factors intermix, probing the psychological mechanisms that drive these relationships.

We found that investors' often-latent behavioral biases are akin to a finely strung musical instrument: If one "string" is out of tune it can impact the whole. As with Bach's "The Well-Tempered Clavier," it's critical to understand and seek to fine-tune an investor's underlying "heartstrings" to achieve that harmony of intent and outcome central to goals-based retirement planning (see figure 1).

Figure 1

**THE WELL-TEMPERED RETIREE**

The web of feeling and action: fine-tuning the behavioral heartstrings

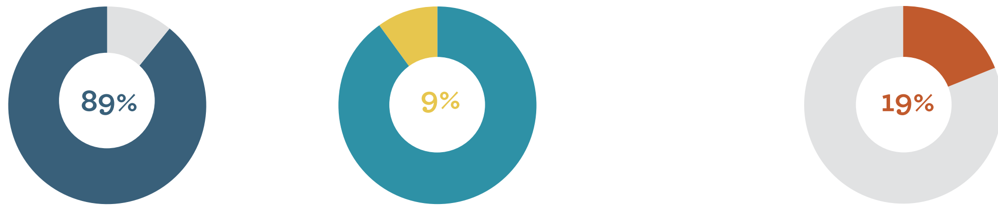



*Source: PIMCO Retirement Decumulation Study, 2021*

Figure 2

**INVESTORS HAVE OVERCONFIDENT ASSUMPTIONS ABOUT RETIREMENT INCOME**

83% were confident or highly confident they'd meet their future spending needs




89% rated themselves as above-average investors

Most expect to live to 90 years, and 9% expect to live past 100 years

19% had no plan for withdrawing money from their savings/ investments; and investors confident despite having no plan also expected their money to last the longest, anticipating 8.5 years of spending on average

BETTER THAN AVERAGE | OPTIMISM BIAS | PLANNING FALLACY

*Source: PIMCO Retirement Decumulation Study, 2021*

## OVERCONFIDENT—ABOUT THE WRONG THINGS

Despite the complexity of retirement planning, we found that overconfidence was a dominant factor in our study (see figure 2). Indeed, it creeps into the lives of well-intentioned individuals in many forms. For example, based on estimates of one's financial skill, we find that 89 percent of respondents rated themselves as better-than-average investors. In all, more than four in five respondents were highly confident that their retirement spending plans would be sufficient to ensure their needs would be met in the future.

But alarmingly, their confidence was not correlated with their retirement planning or based on any specific withdrawal approach. In fact, confidence measures did not differ across those who did versus those who did not have a specific retirement plan. Even more concerning, these investors who were confident despite having no plan also expected their assets to last the longest.

Overconfident investors tend to overestimate their own abilities or believe they're more informed than they really are. They mistake familiarity for deep understanding. For instance, investors may feel confident in their ability to grow their investment portfolios as accumulators, before it becomes their sole source of spending. They may not understand that, in decumulation, the portfolio is governed by new laws of gravity and exposed to greater levels of uncertainty.

In retirement, the portfolio becomes far more vulnerable, exposed to the impact of market shocks, persistent spending, and the size and timing of both. The earlier and deeper the market decline, the greater the damage can be. The difference is in the interaction between inflation-adjusted spending and the sequence of the market's returns on the portfolio—where one bad year, particularly early in retirement, can make the difference between success or failure. The frequency and depth of such unpredictable market movements, i.e., sequence of returns risk, and the natural proclivity to react badly in the face of them, is well known. But even highly skilled investors are subject to it. What often ensues in the face of steep market declines is the classic behavioral mistake: a reflexive capitulation to market volatility and a shift to a lower risk allocation. This can have especially devastating effects on one's success in retirement.

## LOSS AVERSION AND PAYCHECK REPLACEMENT

Another behavioral trait at the very heart of the decumulation dilemma is loss aversion—the powerful emotional response evoked when losses loom larger than gains. A large body of research has shown how it underlies negative investing biases.[2]

In short, there is an innate human drive to hold on to what we have. After a lifetime of scrimping and saving, we can't help but get emotionally attached to our assets, especially now that they seem so vulnerable. Unfortunately, though, loss aversion means that people are emotionally reactive to financial risks wherein they overreact in impulsive ways (through both risk-seeking and risk-avoidant behaviors) that, paradoxically, further damage their financial prospects. In our study, we found that about one in three respondents were particularly susceptible to loss aversion bias.

But our survey also suggests there are effective "nudges" to counter these behavioral tendencies. We find that among respondents entering retirement, those with an outside source of cash flow were 1.9 times less likely to be highly loss averse compared to the other groups of retirees (see figure 3). That is, a cash flow was associated with lower emotional reactivity to risks precisely when it is the most valuable. Further, the same cash flow was linked to higher confidence in all stages of retirement as well. Thus, the presence of steady, reliable income is likely to help retirees navigate temporary market disruptions and avoid de-risking at exactly the wrong times.

According to our research, the importance of sourcing or designating assets to deliver regular cash flows in retirement is paramount.

## UNCERTAINTY AND FLEXIBILITY

Of course, what makes planning so complex and reactivity so common is the uncertainty that permeates so many retirement decisions. In our study, we identified five particularly important risks that unnerved investors. These risks rattled investors with greater impact at the very beginning of the retirement journey when anxiety about the transition was at its peak. Interestingly, although we would expect to see market risk and longevity as concerns, it was uncertainty and risk around one's state of health—the likelihood that onset of disease would spur associated costs and family consequences—that ranked persistently high (a difference that was statistically significant). And health risks were rated the top priority for the majority of respondents regardless of their retirement status or wealth level.

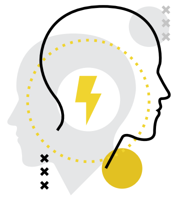
Clearly there is a need for any suitable retirement plan to be able to meet large, uncertain expenditures such as health care. One way to alleviate these anxieties is to allow more flexibility in the plan. In our study, 60 percent of respondents said they would be willing or very willing to cut back their retirement spending "budget" to cope with a difficult period in the markets, and willingness was even higher (74 percent) among those concerned about longevity risk. This is important because very small adjustments in spending can have an outsize impact on retirement portfolios, given the centrality of spending as a key gravitational weight on portfolio growth.

One's natural inclination to tighten belts following less cooperative markets and to allow "raises" (within established bands) when markets recover is both highly intuitive and spectacularly effective in managing the vagaries of markets. It's this kind of increased flexibility and control that can help retirees feel more freedom to indulge in the joys of retirement.

Figure 3

### CASH FLOW IS KEY: IT MOLLIFIES LOSS AVERSION, MITIGATES MISBEHAVIORS*

One in three survey respondents were particularly susceptible to loss aversion bias



**LOSS AVERSION**

The powerful emotional response evoked when losses loom larger than gains

- Emotional reactivity to financial risks
- Challenges with retirement features

**CASH FLOW IS KEY**

- Investors with cash flow entering retirement were 1.9 times less likely to be highly loss-averse compared to the other groups
- Investors with cash flow in both early and mid-late retirement had higher confidence

**High cash flow is defined as income greater than $125,000.*

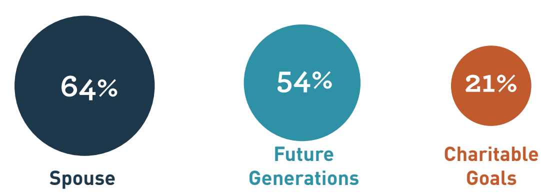
*Source: PIMCO Retirement Decumulation Study, 2021*

Figure 4

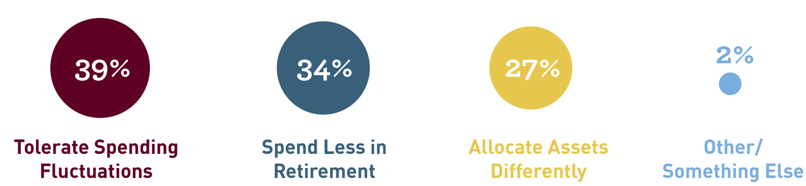
### RETIREMENT PRIORITIES BEYOND THE SELF: LEGACY GOALS

Flexibility is also critical to achieving the commonly expressed goal of leaving a bequest

**4 IN 5 RESPONDENTS HAVE A LEGACY GOAL**




**2 IN 3 RESPONDENTS ARE WILLING TO MAKE CHANGES TO ENABLE LARGER BEQUESTS**




*Source: PIMCO Retirement Decumulation Study, 2021*

## GETTING A LEGACY UP

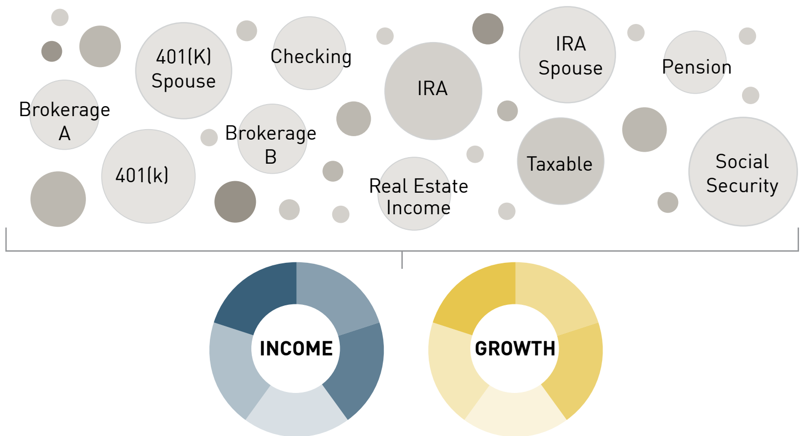
Flexibility also is critical to enable one of the commonly expressed goals among our survey population: leaving behind some form of financial legacy (see figure 4). We find that only one in five respondents said they had no legacy goals in their retirement spending plan, and investors were willing to pull all the levers at their disposal to enable larger bequests. In fact, bequest motives emerged as the strongest of all the other predictors to affect anticipated spending in retirement, with an impact that was almost three times stronger than the influence of risk priorities, e.g., health, household, longevity, and market and political.

There were also links between asset allocation and legacy goals. We find that

Figure 5

## TRADING SIMPLICITY FOR COMPLEXITY: TWO FUNDAMENTAL GOALS, TWO DEDICATED PORTFOLIOS

SOLVING FOR NEAR-TERM INCOME AND LONG-TERM GROWTH




*For illustrative purposes only.*

respondents who hold more in equities also tend to have stronger legacy goals, indicating that investors are acting on their desire to generate future growth.

### HARMONIZING INTENT AND OUTCOME: BEHAVIOR-BASED RETIREMENT PLANNING

The importance of behavioral biases in finance is clear. Predictable behavioral biases regularly appear in investor decision-making and can impact their wealth materially. This study helped us identify potential ways to help incline retirees to naturally fall into better behaviors. We've embedded these ideas (and these nudges) into our Income to Outcome Retirement Planning Framework.[3]

We first dedicate a portion of the client's existing fixed income allocation to "paycheck replacement."[4] The idea is to deliver the capital required to support the retiree's annual spending with a high degree of certainty—essentially replacing the lifeline of a paycheck's regular income stream. This mental accounting can be easy to understand, and we know that the presence of reliable income is correlated with reduced loss aversion biases and all the bad (reactive) behaviors that entails. Investments in this portfolio consist of a low volatility bond portfolio designed to help support short- and medium-term spending, such as laddered bonds geared to mature and deliver their principal and interest each year for the next five, seven, or 10 years (absent default) dependent on the retiree's need, or a portfolio of low-risk bond mutual funds with an income focus.[5]

In our behavioral approach to retirement planning, the near-term income portfolio is intended to address a retiree's annual spending. Importantly, this structure gives retirees flexibility to adjust their income up or down at any time to address their needs dependent on available assets, without restrictions, surrender fees, or contractual transaction costs.

Meanwhile, funding for more distant future expenses, predictable or not, is addressed by a different mental account—the growth portfolio—that is oriented toward higher risk growth-oriented investments and a longer investment horizon. These assets are meant to build additional wealth over time—and over inflation—that can be used for any purpose the retiree desires. In short, what isn't required to periodically top up the near-term income portfolio could be used for unforeseen costs, enhanced retirement spending, or legacy purposes (see figure 5).

The presence of a behaviorally compatible retirement plan allows for straightforward but thoughtful allocation of bequests: No longer must retirees scrimp and spend only the income from their portfolios and leave the balance to their heirs. Instead, legacy planning mirrors the clear trade-offs between the two portfolios: More potential assets for the future suggest a smaller paycheck portfolio. Likewise, it would imply a larger growth portfolio (allocated in line with a more extended time horizon), whether those assets are earmarked for their own consumption or that of future generations.

Retirement planning is hard even when emotions don't enter the fray. Investors' behavioral biases are akin to a finely strung musical instrument: If any string is out of tune it can impact the whole. As with Bach's "The Well-Tempered Clavier," it's critical to understand and seek to fine-tune an investor's underlying heartstrings to achieve that harmony of intent and outcome central to goals-based retirement planning.

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### ENDNOTES

1. Because the survey is not based on a probability-weighted sample, the findings from this study are not to be generalized to other populations (e.g., the general public). These survey results contain the opinions of the respondents and are not necessarily those of PIMCO. The survey data contained herein may not be related to any PIMCO product or strategy and should not be relied upon for any investment decision.
2. For notable examples see Thaler et al. (1997) on myopic loss aversion, Shefrin and Statman (1985) on the disposition effect, and Kahneman et al. (1990) on the endowment effect.
3. The retirement allocation framework presented here is based on what PIMCO believes to be generally accepted investment

theory. It is for illustrative purposes only and may not be appropriate for all investors. The retirement allocation framework is not based on any particularized financial situation, or need, and is not intended to be, and should not be construed as, a forecast, research, investment advice or a recommendation for any specific PIMCO or other strategy, product or service. Individuals should consult with their own financial and tax advisors to determine the most appropriate allocations for their financial and tax situation, including their investment objectives, time frame, risk tolerance, savings and other investments. Fixed income is only one possible portion of an investor's portfolio, which can also include equities and other products. Investors should speak to their financial advisors regarding the investment mix that may be right for them based on their financial situation and investment objectives.

4. Investment products contain risk and may lose value. There is no guarantee that an investment product will be successful in producing income. Investors should consult their investment professional prior to making an investment decision.
5. All investments contain risk and may lose value. A bond ladder or "targeted maturity" bond portfolio is only one potential income strategy and may not be the best solution or suitable for all investors. Income replacement needs may vary by household. An investor should consider and discuss how best to address their income needs with their financial and tax professionals. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counter party capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed.

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