

Using Behavioral Finance To Help With 401k Participant Decision-Making

By Robert C. Lawton, AIF, CRPS, President, [Lawton Retirement Plan Consultants, LLC](#)

Recent behavioral finance studies have shed new light on how investors cope with the challenges of making financial decisions. Study results shared by Fidelity illustrate the following concepts as they relate to investor decision-making:

- Regret;
- Worry; and
- Ambiguity.

These investor emotions are described below along with advice for plan sponsors and their investment advisors on how to overcome the obstacles to good decision-making these emotions create.

Regret

Investors may experience "action regret" after making a poor investment decision. In contrast, they may experience "inaction regret" after choosing to do nothing when given an opportunity to make an investment that later proves to be successful.

Differences Between Action and Inaction Regret

Research published by Fidelity has shown that, of the investors in a study who made bad investment decisions, 92% regretted that decision and suffered feelings of action regret. However, only 8% who had the opportunity to choose an investment opportunity that did well, but chose not to invest, suffered inaction regret. Researchers concluded that investors are much more afraid of making a bad investment decision than they are of doing nothing and missing an opportunity.

Researchers also found that these initial, stronger feelings of action regret tend to fade over time. When study participants were asked about those decisions they regretted most, 25% responded that they regretted the bad decisions they made. Conversely, 75% indicated they regretted not taking action when faced with an opportunity. Study results showed that, while the initial feelings of action regret were stronger, they also faded quicker. In contrast, feelings of inaction regret that were initially low grew over time.

The Impact of Regret on 401k Plan Participants

The fear of making a bad decision leads participants to invest more conservatively than they should. As a result, they elect allocations in their 401k plan accounts that favor fixed income investments over stocks. Consequently, most never accumulate a balance that is large enough to fund their retirement goals.

Overcoming Participant Regret in 401k Plans

Many participants, once they become aware of study results, are able to relate to their feelings surrounding regret. However, since most participants lack a strong background in economics and finance, they are unsure how to change the way they invest. As a result, professionally managed investment options tend to work best for them. These would include target date funds and managed portfolios. Most experts believe that 75% of all 401k plan participants are probably best placed in professionally managed options.

Worry

We all worry. While worry is never constructive, it is even less helpful when it alters the way we manage our 401k plan investments. Recent behavioral finance studies have shown that the more we worry about our investments, the more conservatively we invest.

We Run from Stocks Due to Worry

Recent study results shared by Fidelity have shown that the more frequently investors review their portfolios, the more conservatively they invest. This is not a positive outcome. Investing too conservatively keeps 401k plan investors from building an account balance large enough to retire without making significant changes to their standard of living. Investors who reviewed their portfolio's on a monthly basis had allocations of roughly 60% bonds and 40% stocks. Those that reviewed their portfolio's annually had allocations of 70% stocks 30% bonds - a huge difference.

Volatility Causes Loss Aversion

Researchers found that the more frequently investors reviewed their portfolio's, the more they became aware of short-term volatility and the impact it had on their balances. More frequent exposure to volatility resulted in feelings of loss aversion - study participants became more afraid of the negative impacts of volatility. Even though losses due to volatility were not realized (since participants took no action) the paper losses monthly viewers experienced caused them to adopt much more conservative portfolio allocations.

Overcoming Participant Worry in 401k Plans

Unfortunately, participants are most likely to review their portfolio's when the market falls. Fear of additional loss causes many to realize losses by selling equities and electing a more conservative allocation. Plan sponsors should make sure, in times of volatility, to encourage participants not to deviate from their savings and investment plans. They should also strongly

encourage participants to call the plan's investment advisor before making any changes to their investment allocations.

Ambiguity

With regard to investing, ambiguity is represented by potential outcomes that can't be quantified or measured. Typically, when assessing risk for investment decision-making purposes, outcomes are expressed in terms of their probability of occurrence. Ambiguous outcomes are non-quantifiable and therefore unpredictable.

Ambiguity is an uninsurable risk. We can purchase insurance to help deal with loss from most risky events. We can lay-off risk, spread risk and avoid risky situations. Although ambiguity is a form of risk, there is no way to insure against it.

Example of Ambiguity

The potential of the euro zone crumbling is a good example of ambiguity in the markets today. There are too many factors at play (countries, economies, political environments, cultures, etc.) for outcomes to be calculated with any degree of certainty. What would the end of the eurozone mean to investments in participant 401k plan accounts? No one knows for sure, nor can anyone make a reasonable educated guess.

Effect Ambiguity has upon 401k Plan Participants

Since the impact ambiguous events could have on participant investments is unknown, ambiguity tends to lead participants to become more conservative investors. Participants end up favoring fixed income or safer allocations in their 401k plan accounts, rather than equities. The results are lower account balances than needed to meet retirement goals.

Overcoming Ambiguity in 401k Plans

The key to overcoming ambiguity is for participants to adopt age-appropriate asset allocations and stick to them. Ambiguous events come and go. If participants let the fear of ambiguous outcomes impact their decision-making, they will never implement an allocation strategy that is aggressive enough.

Keep in mind that for 35 out of the 40 years of each participant's career they should be long-term investors, unconcerned about short-term market events. An age-appropriate asset allocation that is not changed in response to market events can reduce the effects of ambiguity.

Summary: Items to Include in Your Next Employee Education Session

In response to recent behavioral finance studies, 401k plan sponsors and their investment advisors should consider including the following points in their next employee education sessions:

- **Professionally managed options.** An outline of the professionally managed options available in the plan, and how participants might use them. These options may include target date funds, risk-based portfolios, balanced approaches or asset allocation models. Explanations on usage should include, for example, illustrating the positive participant election required to move from an Aggressive to Moderate risk-based portfolio and at what age that adjustment should occur.
- **How to react to volatility.** An explanation of volatility in the stock and bond markets and how participants should react in their 401k plan accounts.
- **Required contributions.** A description of the annual required contribution to a participant's 401k plan account necessary to yield an appropriate balance at retirement.
- **Savings tools/strategies.** An outline of the savings tools/strategies most participants have available to achieve their goals. These tools/strategies include 401k before-tax and Roth 401k after-tax contributions to a 401k plan account, regular IRA and Roth IRA contributions and after-tax investment strategies.
- **Risk.** A thorough discussion of risk which includes the presentation of sample age-based portfolio recommendations (using the plan's core funds) to demonstrate an appropriate age-based investment strategy.
- **Talk to the investment advisor first.** A strong recommendation to contact the plan's investment advisor before making any changes to investment allocations.

In addition, plan sponsors should mandate one-on-one meetings with the plan's investment advisor for any employee within five years of retirement. Plan sponsors should recommend one-on-one meetings for all employees ten years from retirement and require all employees to attend at least one employee education session per year.

About the Author

Robert C. Lawton, AIF, CRPS is the founder and President of Lawton Retirement Plan Consultants, LLC. Mr. Lawton is an award-winning 401(k) investment adviser with over 30 years of experience. He has consulted with many Fortune 500 companies, including: Aon Hewitt, Apple, AT&T, First Interstate Bank, Florida Power & Light, General Dynamics, Houghton Mifflin Harcourt, IBM, John Deere, Mazda Motor Corporation, Northwestern Mutual, Northern Trust Company, Trek Bikes, Tribune Company, Underwriters Labs and many others. Mr. Lawton may be contacted at (414) 828-4015 or bob@lawtonrpc.com.

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