



## Retirement blind spots: lessons from behavioral finance

A bat and a ball together cost \$1.10. The bat costs \$1 more than the ball. How much does the ball cost?

Many of us might immediately respond by answering 10 cents. However, the correct answer is 5 cents, which, after thinking about it, most of us would arrive at. Be honest, did you think fast or slow?

If the ball costs 10 cents, and the bat costs one dollar more than the bat, that would be \$1.10, making the two of them together cost \$1.20. However, if the ball costs 5 cents, a dollar more than that would be \$1.05, which added together equals \$1.10.

What causes us to think the way we do? As it turns out, our brain gets in the way. Consider what the field of behavioral economics teaches us about the way we approach a financial decision as critical as retirement planning.

Finding the right equation for our retirement means balancing current spending needs with future savings goals, choosing the right investments, optimizing government benefits, and a litany of other important decisions. In short, planning for retirement requires logical, rational, and conscious thinking.

Unfortunately, our brain does not like logical, rational, and conscious thinking.<sup>1</sup> In fact, Nobel Laureate Daniel Kahneman's book *Thinking Fast and Slow*<sup>2</sup> shows that the brain will take any shortcut it can to avoid complexity in the decision-making process.<sup>3</sup>

In his seminal research, Kahneman tells us our brains are wired with two operating systems: System 1 makes fast, intuitive decisions; and System 2 makes slow, analytical decisions. Even though we think we are rational human beings, most of our thinking is driven by System 1, and we're prone to making choices that are less optimal than we'd like to believe.

<sup>1</sup> Nicholas Hartley, Pulse, "Cognitive biases in underwriting," October 31, 2020.

<sup>2</sup> Astrid Groenewegen, Behavioural Science Insights, "Kahneman Fast and Slow Thinking Explained."

<sup>3</sup> Nicholas Hartley, Pulse, "Cognitive biases in underwriting," October 31, 2020.

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Kahneman describes the two different decision-making processes as Cognitive Ease and Cognitive Strain. While they serve different roles, System 1 and System 2 actually need to work well together instead of working against each other.

### System 1 Cognitive Ease

System 1 is designed to react spontaneously and is our brain's automatic, intuitive thinking process. It represents 98% of our overall decision-making. It is intuitive, simple, effortless.

### System 2 Cognitive Strain

System 2 is the conscious, controlled, deliberate, and rational thinking process that takes its time. It represents only 2% of our overall decision-making. It is analytical, complex, even laborious.

### The speed-accuracy tradeoff

So, if we are naturally inclined to think fast 98% of the time, it stands to reason that some of the rapid decisions we make might not be in our best interest. This is particularly true regarding financial matters where accuracy is essential. Since we are predisposed to avoid the slow, thoughtful analysis financial planning requires, the speed versus accuracy tradeoff often creates a costly gap between "what I should do" and "what I actually do."

And if the planning process weren't challenging enough, three common biases often cloud our ability to engage our rational brain's logical perspective. We call these behavioral blind spots.

## Behavioral blind spots

### 1. Planning fallacy

An easy way to understand this behavioral bias is to know we often make plans based on limited, imperfect information.



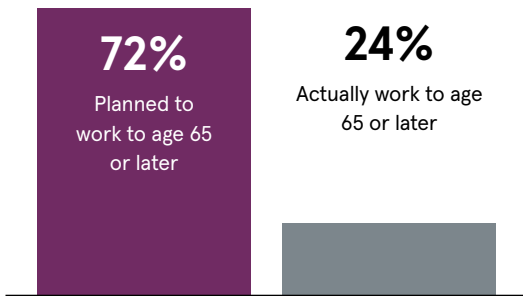
Overestimating the likelihood of positive future events.



Underestimating the likelihood of negative future events.

Most individuals planning for retirement aim to leave the workforce at age 65 or later. Unfortunately, that's a prime example of the planning fallacy at work. Two out of three people who expect to retire after turning 65 ultimately leave the workforce before they intended. Statistics show what we plan to do and what we actually do are often miles apart.

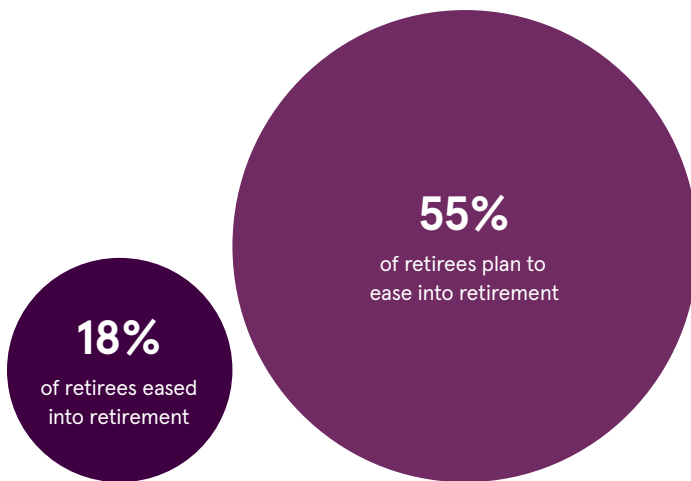
## PLANNED VS. ACTUAL RETIREMENT AGE



Source: Society of Actuaries, 2019 Risks and Process of Retirement Survey.

The reasons behind such disparity? We often have limited control over important factors related to our employment. Layoffs and health complications affecting us and the people we love are too common. And no matter how well we plan for retirement, we often have little control over one of its most critical components: the age we retire.<sup>4</sup>

Here is another common mistake pre-retirees make. Think about someone who says, “I plan to retire, but I’ll probably pick up some consulting work along the way so I can ease into retirement.” That sounds like a solid plan; however, reality says something different.<sup>5</sup>



Source: Society of Actuaries, 2019 Risks and Process of Retirement Survey.

<sup>4</sup> Society of Actuaries, 2019 Risks and Process of Retirement Survey.

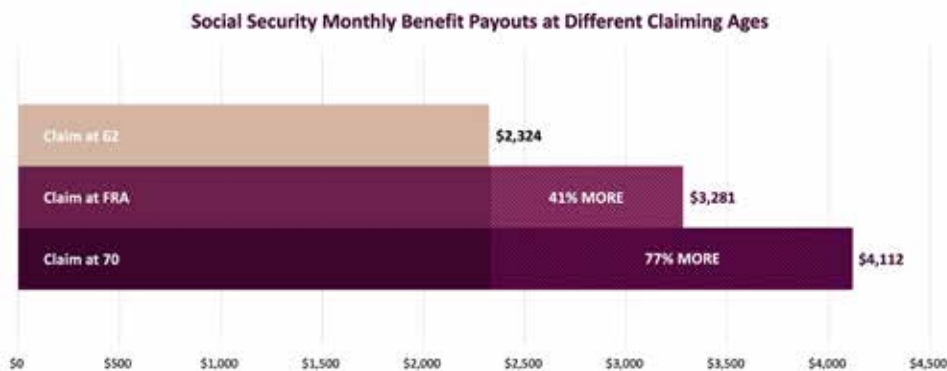
<sup>5</sup> Ibid.

## 2. Anchoring bias

Another behavioral gremlin we wrestle with is anchoring bias—when we rely too much on the first piece of information we receive.

Anchoring bias can cause us to make poor, ill-informed decisions without consciously knowing it. Consider this example, which can have a long-lasting, detrimental impact on one's retirement income.

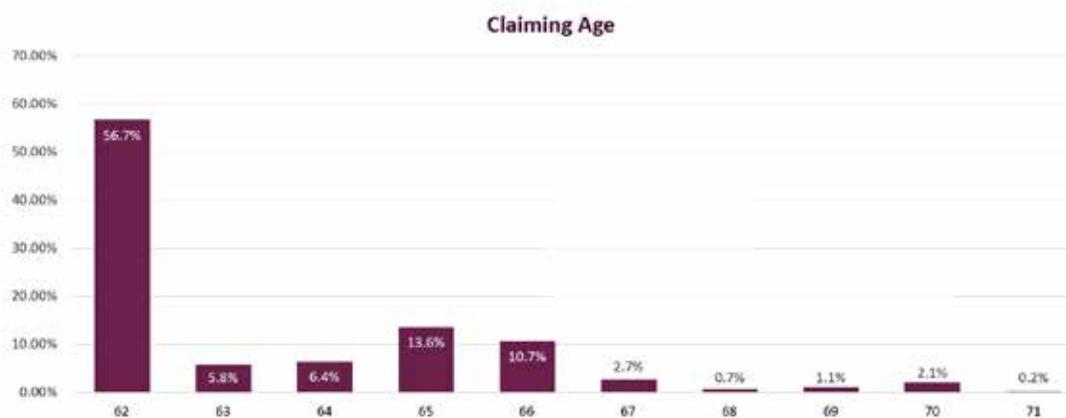
Someone comments, **"I heard the earliest I could claim Social Security is age 62."** Sounds innocent enough. But in many cases, 62 becomes an anchor that can drastically reduce a retiree's cash flow.



Assumes average earnings of maximum taxable amount, claiming at age 62 in 2021 (FRA 66 years, 10 months).  
Sources: Social Security Comparison, Maximum Taxable Benefit Examples. SSA, "Effect of Early or Delayed Retirement on Retirement Benefits. SSA, "Workers With Maximum-Taxable Earnings."

Financial professionals and the government spend a lot of time convincing people to wait to claim their Social Security benefits with charts like the one above.<sup>6</sup> They try to make it painfully clear that there are immense gains to be had by waiting to claim at a later age.

Unfortunately, all of this information is presented in comparison to claiming at 62. These types of educational materials ultimately create anchors that can affect our thinking in ways that we don't realize. How influential and extensive can the "62 anchor" be for Social Security recipients? The numbers are concerning.



Source: John B. Shoven et al, NBER Working Paper Series, National Bureau of Economic Research, "Social Security Claiming Decisions: Survey Evidence," August 2017.

<sup>6</sup> Jackson calculation from SSA benefits tables.

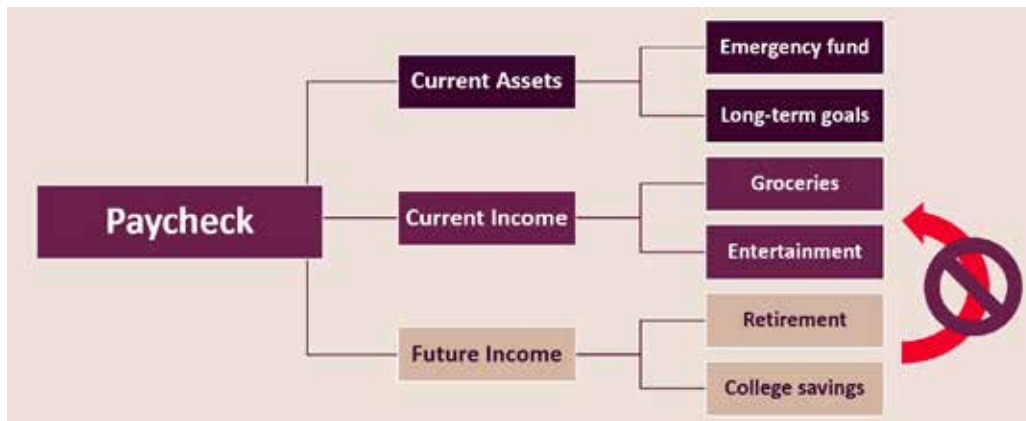
More than 50% of people take Social Security at age 62, potentially leaving tens of thousands of dollars on the table they could have claimed had they just waited a few years. So yes, anchoring bias can hurt.<sup>7</sup>

### 3. Mental accounting

Our last bias is mental accounting. The mind divides money into three buckets. For example, when someone gets a paycheck, they'll likely set some aside in a **"current assets" bucket** for a future expense like a rainy-day fund or a down payment on a house. They plan to spend that money in specific circumstances that they know will come.

They use another portion from a **"current income" bucket** to pay for their everyday needs like groceries or entertainment.

Lastly, they have a bucket of **"future income" money for expenses** like retirement or college savings. In their minds, they think once they reach retirement, they'll essentially move money out of the **"future income" bucket** into the **"current income" bucket**. In reality, that doesn't happen. Retirees have saved in a 401(k) or IRA for years, and they have a difficult time re-characterizing those dollars from being something they never touch to becoming current income. Instead of using that money as a pool to withdraw from—to manufacture their own paychecks, so to speak—they let the money sit, and whatever cash flow it produces passively is what they spend.



Source: Hersh M. Shefrin, Richard H. Thaler, *Economic Inquiry*, "The Behavioral Life-Cycle Hypothesis," October 1988.

As illustrated in the chart above, mental accounting provides a positive framework, allowing individuals to meet their current needs while also planning for future expenses that require months or years of disciplined savings. This is how some retirees plan to manage expenses in retirement once regular paychecks stop. To cover expenses, money will be moved out of the future-income bucket into the current-income bucket.

<sup>7</sup> John B. Shoven et al, NBER, National Bureau of Economic Research, "Social Security Claiming Decisions: Survey Evidence," August 2017.

But research shows us this is not what typically happens in retirement.

According to the Employee Benefits Research Institute, retirees “spend money that comes in as regular income flow, such as pension or Social Security income, and try to preserve their assets for uncertainties or bequest.”<sup>8</sup> Once assets have been mentally classified as “future income,” retirees cannot flip the switch to start spending that money. For decades, they’ve respected a mental wall that’s prevented them from spending it, and they can’t demolish that barrier overnight.

In this case, mental accounting engaged our rational, disciplined mind to frame a retirement plan, but then our rapid-thinking brain takes over and determines how we spend what we have accumulated. And this desire to preserve doesn’t just apply to those who have limited assets.



Surprised? These retirees could afford to spend a great deal more by almost any objective standard, but they choose not to. Why? Like most of us, even the wealthiest have an emotional fear of running out of money. Most of us could spend more than we actually do.<sup>9</sup>

### Most people underspend

Many retirees could:	Wealth Level	Actual Spending	Could Increase
• Set aside 40% of their wealth	\$120,034	\$33,219	20% - 27%
• Increase their budget by 20%			
• And still not be in any danger of running out of money in a 30-year retirement	\$666,152	\$43,325	60% - 90%

Consider the retirees with nest eggs reflecting moderate wealth of about \$120,000. People in this group spend about \$33,000 per year. But when we do the math around the financial planning, we see they could set aside 40% of that nest egg, almost \$50,000, and increase their spending by \$6,000 to \$9,000 per year over the course of a 30-year retirement and still not be in any danger of running out of money. That’s a 20%-plus increase in their retirement spending. This is quite meaningful.<sup>10</sup>

<sup>8</sup> Sudipto Banerjee et al, EBRI, Employee Benefit Research Institute, "Asset Decumulation or Asset Preservation? What Guides Retirement Spending?," April 3, 2018.

<sup>9</sup> LIMRA Secure Retirement Institute, The Retirement Income Reference Book, Fourth Edition, 2018.

<sup>10</sup> Chris Browning, Ph.D. et al, FPA, Financial Planning Association, "Spending in Retirement: Determining the Consumption Gap," February 2016.

## BIAS RECAP

Let's quickly review the three biases we discussed.

We began with **Planning Fallacy**. Because there's so much outside of anyone's control, it's easy to get narrowly focused on what we think should happen and fail to consider all the risks that can come with a big life decision. That's why it's so important to get outside perspectives.

We then addressed **Anchoring Bias**. We saw how easy it is to overweight the first option we hear and consequently how hard we need to work to anchor on optimal strategies rather than the first thing we hear.

And last, we looked at **Mental Accounting**. We saw money saved for retirement is often underspent to the detriment of a fulfilling retirement. Building plans and portfolios around cash flow is one way to help mitigate mental bias.

As we have seen in the mental accounting example, retirees generally prefer to spend income rather than assets. They tend to hold on to their assets and want to preserve them.

That premise is supported by an analysis of more than five million households conducted by JP Morgan Asset Management in 2019,<sup>11</sup> which revealed that more than 70% of the time, ending assets were higher than the starting retirement wealth. This is another example suggesting retirees are not spending enough to make the most of their assets in retirement.

The point is not to spend more money for the sake of spending more money. Rather, it is about having a comprehensive retirement "spending plan," and having the confidence to stick with it. It is also about putting that money to use and creating a rewarding, fulfilling retirement and having confidence that our assets will last as long as we do.

## THE VITAL ROLE OF AUTOMATION

As you begin to embrace this concept of how you will put your money to work in retirement, which you may not have given much thought to before, know you have an ally on your side. That ally is automation, and most likely, you've been using it for years as you saved for retirement.

Many 401(k) plans reflect the best strategies of leading behavioral economists and automate much of the saving process. Employees are often automatically enrolled in their workplace retirement savings plans and then have their contributions increased a little bit every year. Participants are defaulted into investments rather than into ultra-conservative cash accounts.

Savings Years 401(k)	Spending in Retirement Years
Automatic enrollment	
Automatically escalated contributions	?
Default investment options	

<sup>11</sup> Katherine Roy, Yoojin Kim-Steiner, JP Morgan, "Three retirement spending surprises," January 1, 2019.

Unfortunately, when we look at spending in retirement, there is little default automation. Outside of Social Security, it's on the investor to figure out how to convert their savings into dollars they can spend. Are there tools to make it easier for retirees to leverage the concept of automation?

In addition to Social Security and pensions, an annuity can be automated to produce guaranteed\* and protected income for life.† This cash flow features most of the best features of automation, creating certainty and confidence around spending while systematizing the cash flow. And through automated and steady income, spending is more comfortable and desirable, allowing us to live and spend with meaning and purpose.

## The next step forward

The next time your financial professional wants to discuss your retirement plan, you will know why you may be inclined to resist. You'll also know why you need to engage with logical, deliberate, and analytical thinking. Most important—you will be better equipped to do so.

You will recognize how the three behavioral biases we discussed—planning fallacy, anchoring bias, and mental accounting—can negatively influence your decisions, so you can be on the lookout for those tendencies.

And last, you will know how you spend your money in retirement can be a source of happiness, and automating your income with a strategy, such as an annuity, can give you the confidence to spend with purpose.

Work with your financial professional to build a retirement plan that helps you enjoy a retirement as rich and rewarding as any other phase of your life. Go ahead, you have earned it!

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