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Behavioural finance biases in the decision-making of pension trustees

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Financial decisions of pension fund trustees

- Project introduction
- Ethnographical qualitative research
- Relevant literature for quantitative research
- New empirical research
- Conclusions

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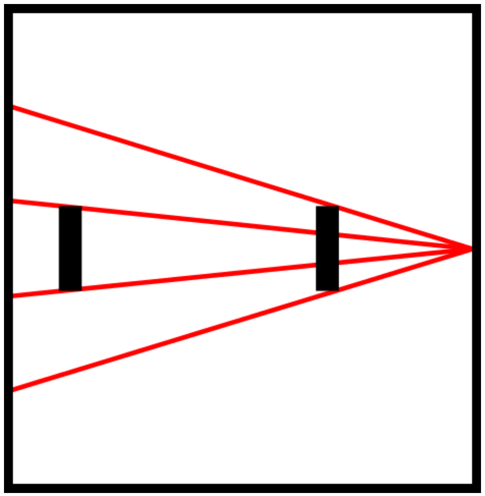
Project Introduction

Project introduction

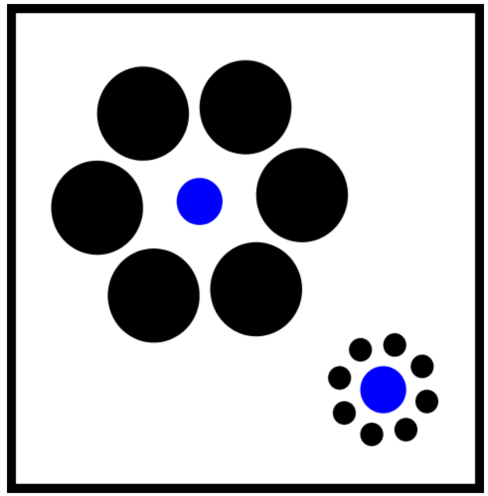
- Most of research in behavioural finance focused on individuals: limited research on institutional investors
- We have been funded by the IFoA to investigate decision-making biases in pension fund trustees
- This is joint academic research by City, Leeds, and UEL, together with Ipsos and supported by Aon
- Combination of qualitative and quantitative research

Cognitive biases

- Cognitive biases such as visual illusions do not imply that we cannot navigate the world successfully

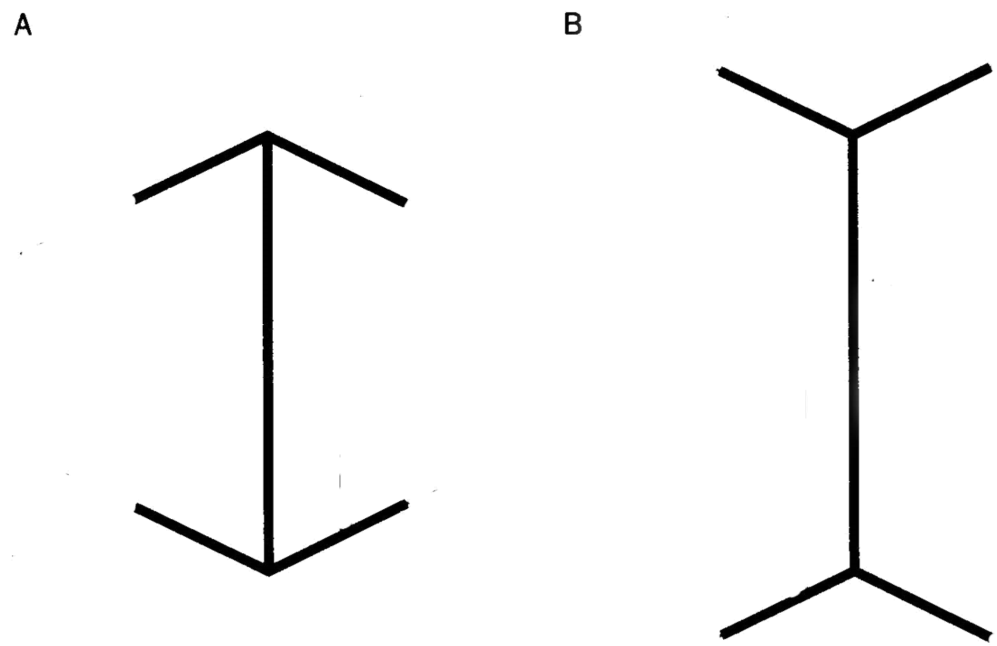


Ponzo Illusion

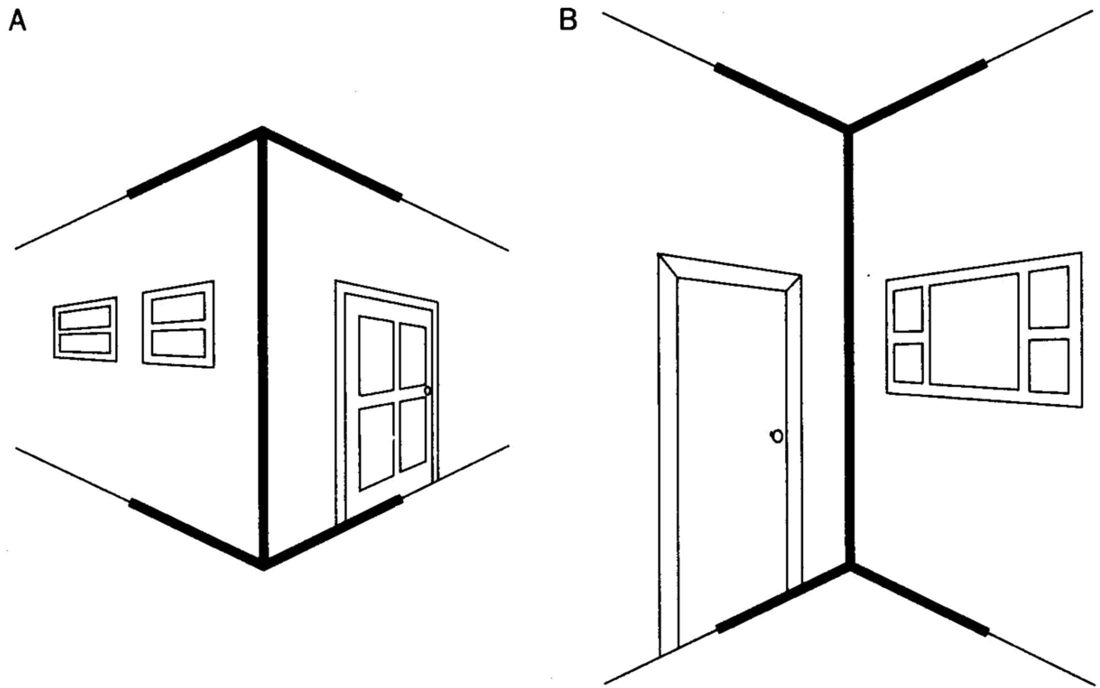


Ebbinghaus Illusion

Muller-Lyer illusion:
Adaptation to a rectangular world?



Muller-Lyer illusion: Adaptation to a rectangular world?



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Pension trustee decision-making

Ethnography, qualitative & advisors report

Objectives

1 Landscaping exercise: what kinds of decisions do trustees make and in what contexts?

2 Learn how pension trustees go about making investment decisions

3 Wanting to better understand organisational (as opposed to individual) decision-making

Methodology

Ethnographic research (3-4 hours) with 6 trustees

In-depth interviews (1 hour) over the phone and face to face with 18 trustees

Telephone / online interviews (15 minutes) with 23 corporate pension advisors *[low base]*

Sample

- UK trustees (6 ethno, 18 qual)
- Mix of employee nominated, employer nominated, chair people, and member of independent governance committee
- Mix of Part time/full time
- Mix of DB, DC and both
- The sample fell out as all businesses of 500 plus people
- Mix of sector

- Corporate pension advisors - decision making capacity and advising on investment decisions
- Mix of IFAs, Managing Directors, investment consultants and other decision makers

The sample across all three studies fell out as predominantly male

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Who are trustees and what motivates them?

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Homogenous group

- We know from other research that this is a homogenous group made up of similar demographics (e.g. older, male)
- They are a financially secure group of people
- They are often confident, conscientious and many are workaholics
- They see themselves as altruistic and this role allows them to feel they are “giving back” in a meaningful way

Changing role

- Some expressed that the role is becoming more specialised and demanding
- There is a perception among some professional and employer nominated trustees that the member nominated trustees struggle with decisions
- Advisors feel that the pension trustee role has become more difficult and that the importance of the role of the trustee has increased.
- With this heightened importance, the role becomes higher profile and requires more education, training and knowledge.

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How are decisions made?

Diligent preparation

- Decisions are made together at meetings, but trustees have a lot of preparatory homework
- They expressed that there was a large amount of paperwork to get through prior to meetings
- Information packs are long, dense and take time to digest. Trustees conscientiously read through everything. Some felt this to be a little daunting, and felt a sense of achievement *just* from digesting it

Consensus style

- ***Consensus* rather than voting** is seen as the norm and was part of the official process for many of the trustees we spoke to
- Most report limited conflict and instances of strong disagreement amongst members are rare
- Most cannot recall situations where they were unable to reach a compromise
- There is often a process in place for decision making on boards
  - For example most had separate subcommittees, to debate details around various topics

Impact of the chair

- The chair is often felt to either have the final say, or need strong convincing if other trustees wish to contradict them
- The chair's personality and professional background can effect the tone of meetings and the way things are done

"I have seen groups where chair is dominant and will make it known that ultimately its their decision that calls the day."

Informal Discussions

- As well as the given processes, they rely on a number of social strategies that they weren't necessarily aware of
- This includes
  - Chats in the pub
  - Corridor catch ups
  - Email exchanges
  - Friendly phone calls

Weight of responsibility

- Whilst all trustees feel communication with members is important, they are hyper aware of the fact members show low interest and engagement
- Trustees varied in their opinion of how involved members should be
    - Some trustees felt it was better to avoid over communicating with DC members as they believe they won't have an opinion
    - While others fret about ways to get them more engaged

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Relationship with advisors

The 'beauty parade'

- Many mentioned the 'beauty parade' to determine who to choose as their advisors, consultants and fund managers
- Personal chemistry plays a role in selection as well as assessing performance
- Judging their performance is felt to be very difficult
  - Comparing performance versus wider market
  - Assessing long term and short term performance
- Changing advisor is seen as risky and expensive (due to penalties and fees) with no guarantee that the new person's performance will be superior
  - As a result, there is a tendency to stick with the same advisor for a long time

Deferring to advisor

- Though they 'kick the tyres' and challenge advisors to ensure they have a good understanding, most won't go against them
- The fact that everything trustees say in meetings is captured in the minutes can influence decision-making activity
- There is the feeling for some that they will be held more personally accountable if they go against the advisor on the record, and things go wrong at some point in the future

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Influences and attitudes towards investment and risk

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Risk averse

- Trustee boards appear to be quite risk averse. Many describe simply choosing their tolerance for risk-level and the desired return and leaving more of the decision making to the advisors
- As previously mentioned, there is an awareness among trustees of their personal liability. Therefore, there is a strong disincentive to diverge too sharply from recommendations from experts

Advisors agree…

- The majority of advisors (14 of 23) think that trustees are too cautious in their attitude to risk

Checks and balances

- Following process give them the feeling that important checks and balances are in place which will help them avoid catastrophic risks
- There was wariness around ‘flavour of the month’ strategies or products touted by advisors and managers; this was reported by some qualitative participants
- Some asset classes / trading behaviour is seen as inherently risky e.g. trading or investing in currency, or inherently safe e.g. infrastructure or property

Areas covered

- Qualitative research helps us to see that whilst there is a wide range of regulatory guidance concerning the way in which pension trustees dispense their duties, this will only ever be part of the story.
- Alongside the formal processes guiding the work of any institution, there are a wide variety of norms, rituals, customs and practices that will also operate, often conferring as much, if not more importance on the final judgements and decisions that are made.

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Review of previous relevant research

Behavioural finance biases

- There are many behavioural biases which have been identified
  - Almost exclusively conducted with individual/retail investors
  - Limited research with professional/sophisticated institutional investors
- Some (selected) examples:
  - Naïve diversification and home bias
  - Disposition effect – buying high and selling low
  - Mental accounting and framing
  - Overconfidence – excessive trading and excessive market entry
- Comprehensive reviews:
  - Shefrin (2009). Behavioralizing finance. *Foundations and Trends in Finance;*
  - Barberis & Thaler (2003). A survey of behavioral finance. *Handbook of the Economics of Finance;*
  - Benartzi & Thaler (2007). Heuristics and biases in retirement savings behavior. *Journal of Economic Perspectives.*

The unique setting for trustees' decisions

- **Judge-Advisor Systems**
  - Trustees employ expert advice
- **Surrogate decision-making**
  - Trustees make decisions on behalf of others
- **Group decision-making**
  - Trustees make decisions in groups

- Published in-depth review:
  - Weiss-Cohen, L., Ayton, P., Clacher, I., & Thoma, V. (2019). Behavioral biases in pension fund trustees' decision making. Review of Behavioral Finance

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Judge-Advisor Systems

- Judges egocentrically discount advice received
  - Individuals only partially adjust from their beliefs towards the advice given
- However advice can receive higher weights in certain situations
  - When the decision is cued, and not independent
  - To diffuse responsibility (legal liability of trustees)
  - When the task is complex/important
  - When the adviser is confident and articulated
  - When advice is paid-for
- All of the situations above apply to trustee decisions

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Surrogate decision-making

- Surrogates are poor at making decisions for others
  - Most of the research is on medical decision-making
- Surrogates project their own preferences
  - Even when the preferences of the other is discussed beforehand
  - Surrogates tend to insufficiently adjust from their preferences towards the other's
- Choose what other *should* do, instead of what they *would* do
- Choices are more regressive towards social norm / less extreme
  - E.g., what is the socially acceptable gift, instead of what the other really wants
  - Can lead to wrong levels of risk taking (both too high and too low)

Group decision-making

- Group decisions are not as efficient as commonly thought
  - Fewer ideas generated during brainstormings than individually
- Information is not shared
  - ‘Hidden profiles’
- Process losses
  - Loafing
  - Free-riding
  - Self-censorship
- Choices become more extreme: shifted and polarized
  - No one wants to be ‘average’

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New experimental research

Experiments

- During our project, we have collected experimental data from pension scheme trustees and other pension professionals
  - With the help of Aon and AMNT
  - Throughout, we observed differences in financial experience and expertise. Employer-nominated trustees are more financially sophisticated than member-nominated trustees.
- Two main research themes:
  1. Menu effects
  2. Surrogate decisions

1. Menu effects

- Financial decisions should be based on principled underlying financial fundamentals
  - However, the method of describing the alternatives can be perceived as communicating relevant information (Fox, Ratner, & Lieb, 2005, J. Exp. Psych. Gen.; DellaVigna, 2009, J. Econ. Lit.)
- Menu effects are subtle variations in the description/presentation of options which can affect decisions
  - Adding irrelevant decoys
  - Changing the number of menu options
  - Framing an alternative as middle or extreme
  - Changing the menu layout
- We tested three menu manipulations with 252 trustees

1.1. Menu items and naïve diversification

- We asked trustees to allocate pension scheme assets across different combinations of mutual funds
  - Menu of options presented was either balanced (50/50 bonds/equities), bond-heavy (75/25) or equity-heavy (25/75)
  - Based on similar research with retail pension investors by Benartzi & Thaler (2001) in AER
- The investment allocation between bonds and equities was influenced by the balance of options
  - More investment in bonds when there were more bond funds from which to choose

Condition	Average allocations	
	Bonds	Equities
Bond-Heavy	69.7%	30.3%
Balanced	61.3%	38.7%
Equity-Heavy	43.9%	56.1%

Condition	Concentration (Σw^2)	Funds Chosen
2 Funds	0.66	1.83
4 Funds	0.43	2.95

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1.2. Menu context and framing

- We asked trustees to choose one of 11 combinations of bonds and equities for their default pension fund
  - One option was labelled as “moderate”, either the 30% or 70% bond option; or no label
  - Based on research with retail investors by Benartzi & Thaler (2002) in J. Finance (also Sela, Berger, Li, 2009, J. Cons. Res.)
- The asset mix was influenced by the labelling. Member nominated-trustees were attracted by the “moderate” label but not employer-nominated and professional trustees

Average allocation into bonds	**Fund with “moderate” label**		
	30% Bonds	**No label**	**70% Bonds**
Member nominated	34.4%	37.1%	48.2%
Employer nominated / Professional	26.2%	32.1%	26.2%
Average	**29.8%**	**34.8%**	**38.9%**

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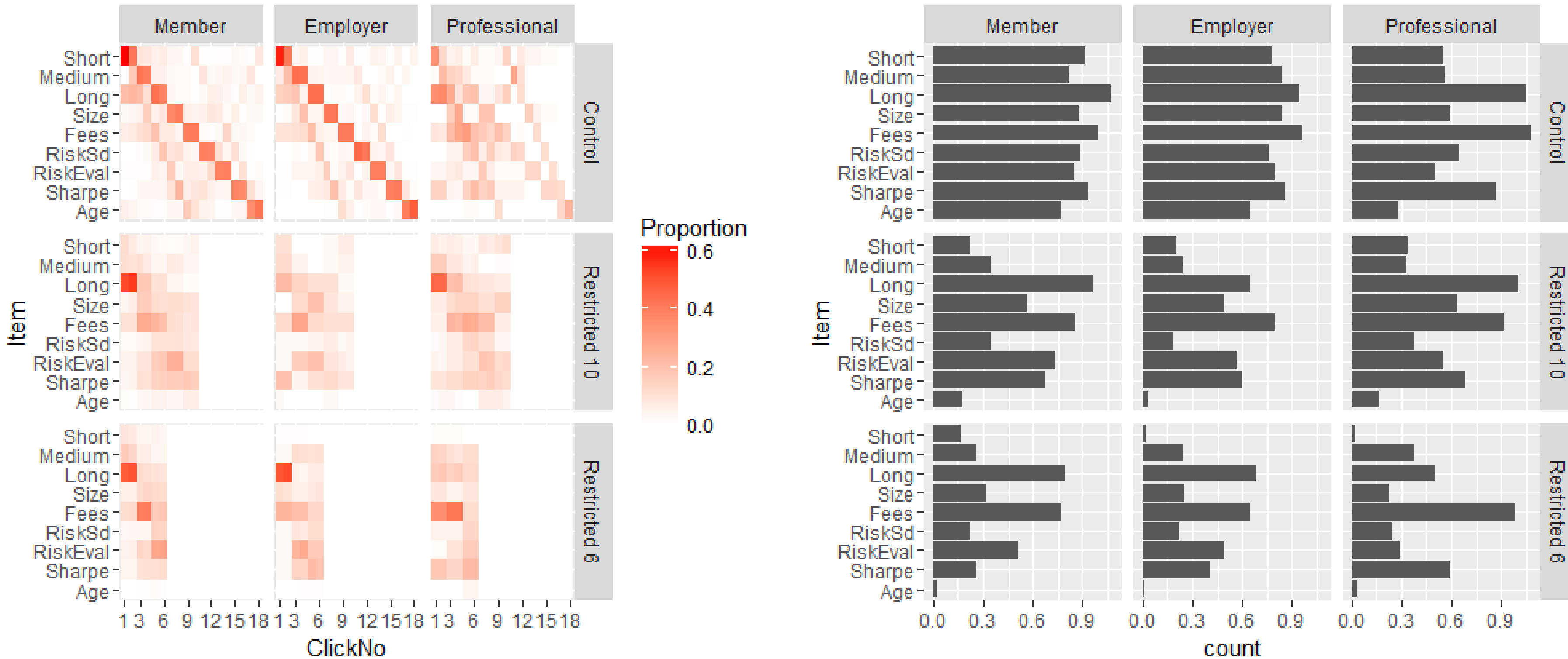
1.3. Menu layout and search patterns

- We asked trustees to choose mutual funds by clicking to reveal hidden information about each fund
  - Based on the “Mouselab” paradigm by Payne, Bettman & Johnson (1993)
  - We traced the order and frequency in which each item was revealed
  - There were 10 asset classes, each with two fund options
  - Some subjects could click in as many items as they wanted, others were limited to 10 or 6 items per asset class

	Fund A	Fund B
1-year short term returns		
3-year medium term returns		
5-year long term returns		
Size of funds (net assets)		
Fees (TER – Total Expense Ratio)		
Risk (one year Standard Deviation)		
Risk Evaluation (within its asset class)		
Sharpe Ratio (return per unit of risk)		
Fund manager’s age and gender		

1.3. Menu layout and search patterns



Trustees followed the choice layout closely when clicks were not restricted. They considered their search pattern more carefully when restricted, prioritizing the most important items (long-term returns, risk, and fees)

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2. Surrogate decision making

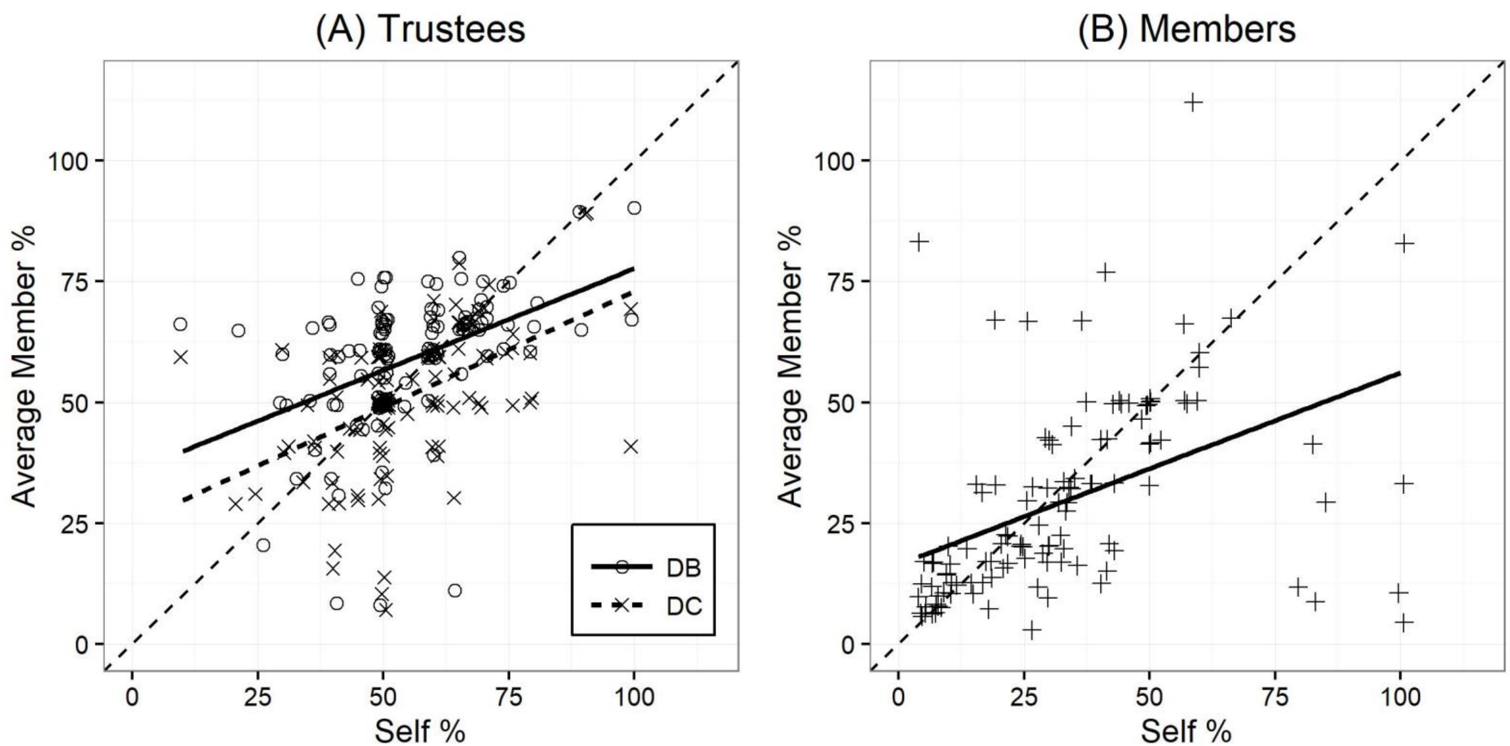
- Trustees make surrogate decisions on behalf of members
- Even in flexible plans, most members accept the default options with limited consideration
  - Effectively outsourcing their decisions to trustees
  - See Byrne, Blake, Cairns, & Dowd (2007) Default funds in UK defined-contribution plans, Fin. Analyst Journal; and Madrian & Shea (2001) The power of suggestion: Inertia in 401(k) participation and savings behaviour, Q. J. Econ.
- We tested 120 scheme trustees and 139 scheme members
  - We asked subjects what they believed to be ideal pension income replacement rates for themselves and for an average scheme member
  - Detailed information about the scheme and average member was provided to ensure consistent responses
- Review on surrogate decision making: Tunney & Ziegler (2015) Toward a psychology of surrogate decision making, Persp. Psych. Science

2. Surrogate decision making - findings

- Trustees projected their preferences
  - Positive correlation between the replacement rates trustees chose for members and those they chose for themselves
- Replacement rates chosen by trustees for members were higher than those chosen by members for themselves
  - Trustees are not demographically representative of members (richer and older, mostly retired on DB)
  - Would require considerably higher contributions
- Trustees' replacement rates for DB were higher than for DC: legacy effects
- Members' replacement rates were better aligned to the guidelines proposed by The Pensions Regulator of 35% (and contributions)

Condition	Pension replacement rate
Trustees	
Self	55%
Other: Average DB member	59%
Other: Average DC member	51%
Members	
Self	32%
Other: Average member	28%

2. Surrogate decision making - findings



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Conclusions

Findings

- Trustee decisions are set in environments that differ from the majority of behavioural finance research:
  - More sophisticated investors making decisions in group, with advice, on behalf of others
  - Level of sophistication differs by type of professional
- Trustees displayed behavioural finance biases, but to a lesser extent than unsophisticated investors
  - Less experienced member-nominated trustees generally more susceptible to biases than more experienced professional trustees
  - Trustees were influenced by the menu of options and how information was presented
  - Trustees projected their own preferences when choosing on behalf of members

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Conclusions

- It is important for pension professionals and regulators to be aware of the decision-making biases of pension trustees
  - Despite being more sophisticated, trustees are not immune from decision-making biases
  - Biases can negatively influence funding levels, risk, investment returns, and the outcome of pensions for members
- This knowledge is important to improve:
  - Training of trustees
  - Information presented to trustees
  - Advice and guidance provided to trustees
  - Regulation and policy around trustee decision-making
- Care should be taken to ensure that irrelevant factors do not unduly influence the decisions of trustees

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Questions

Comments

The views expressed in this presentation are those of the presenter.

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