The urgency to invest now is removed

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Overcoming clients' long-term investment aversion

By understanding behavioural economics, brokers can turn long-term investment challenges into wins.

When faced with spending now for future gain, from investing in a retirement fund to buying long-term insurance against disability or chronic illness, our society is dominated by a psychology loosely termed the 'intention-behaviour gap'. Because the investment will only be required in the distant future, or not at all, the urgency to invest now is removed.

Leading on from this theory, developed by behavioural economists, is the effect that the perception of 'self' has on investment behaviour. There is a clear disconnect between what the present self believes will benefit the future self.

This mind-set leads to decisions which obviously undermine long-term investment goals – yet despite the losses, the behavioural trends are dominant in our savings culture. For example, when given the choice between a comfortable retirement and a new car, too many of us choose the new car as it's a form of instant gratification that appeases the wants and desires of the present 'self'. The positive effect of a comfortable retirement only benefits the future self and is so far off that the present self can't adequately comprehend the value of it.

For brokers or intermediaries trying to sell the undeniable advantages of long-term investments to clients, overcoming these behavioural trends is imperative.

The immediacy effect

Further influencing the buying decision is the concept of temporal discounting, sometimes referred to as 'the immediacy effect'.

It refers to the tendency of people to discount the value of rewards that they will receive in the distant future. The magnitude of this value discounting is also said to increase exponentially in accordance with the length of time before the reward is realised. The impact of this behaviour is highlighted in the studies conducted by behavioural economist, Professor Richard Thaler. His 1981 paper, "Some Empirical Evidence on Dynamic Inconsistency" demonstrates this discounting curve by comparing short-term preferences with long-term preferences.

Of interest to intermediaries is the following behavioural example: when offered a dollar today or three dollars tomorrow, or a dollar in one year or three dollars in one year and one day, a significant fraction of subjects in the study took the lesser amount immediately, but were willing to wait one extra day in a year to receive the higher amount. Individuals with such preferences are described as "present-biased".

Obviously when given the choice of a new car now or not being homeless in a month, most people would choose to not be homeless. However, when the time frame is extended 15-20 years, people who have a greater present-bias aren't able to decide as easily.

In addition, it has been found that those with a strong present-bias are far more likely to get into trouble with debt. According to a 2010 study by Meier and Sprenger, published in the American Economic Journal, these people are more likely "to have credit card debt, and to have significantly higher amounts of credit card debt, controlling for disposable income, other socio-demographics, and credit constraints."

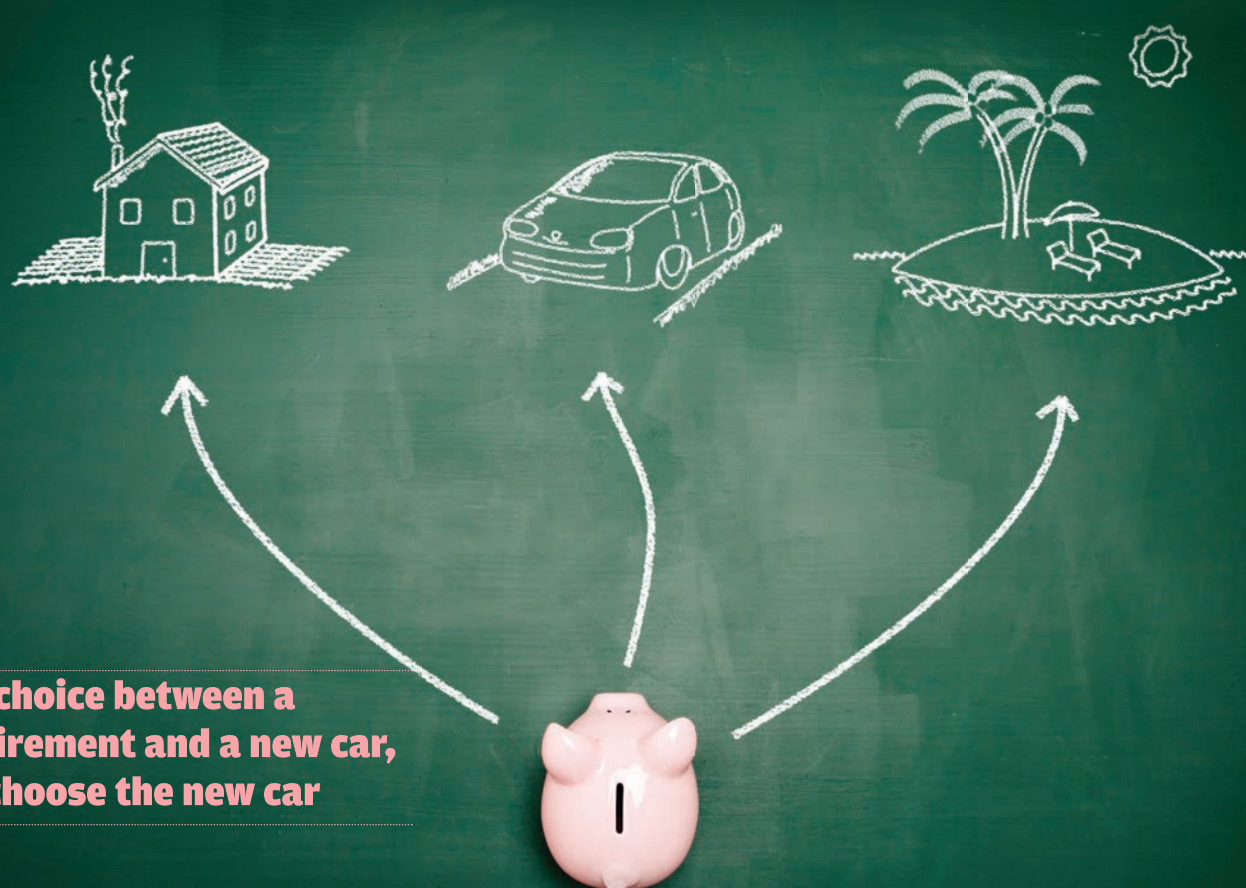
This presents a particular challenge to the industry, when challenging a society affected on a fairly large scale by this psychology.

Time preference

The concept of time preference when it comes to making spending and saving decisions has a dire impact on the financial independence and health of individuals.

There is good news, however. Savvy brokers who properly understand these behavioural tendencies can swing them to their advantage. For instance, if someone chooses to escalate their retirement contributions on an annual basis, by more than inflation at the fund inception stage, when the immediacy effect of the money being committed is lower, they are effectively agreeing to contribute more to their retirement savings over time.

Similarly, one could set up a future-dated lump sum transfer into an investment vehicle that will come off their account just after they get paid. This is often easier to commit to because there is no attachment to that 'future' money, and the time frame is long enough that the effects aren't really tangible. With this approach, advisers are able to improve the future financial position of their clients through a better understanding of their own psychology.



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