BEworks

Building Financial Wellbeing

Using Behavioral Science Every Step of the Way

An Uncertain Journey

Extensive evidence and experience demonstrate that people often make sub-optimal financial decisions. We struggle with self-control. We tend to spend too much, take on too much debt, and save too little. When investing, we often risk averse, short sighted and often seem low-risk but also offer insufficient returns for long-term growth. On the flip-side, we can also be overconfident, taking too much risk and trying to perfectly time the market only to experience losses. The result is reduced financial well-being.

On top of all this, our financial needs and status change across our lifespan, making us more, or less, influenced by various factors as we age.

Consider investing for retirement at 24 years old versus 48 years old. In our early 20s retirement feels far off and more immediate expenses, like buying a car or a first house, take our focus. Saving for retirement can feel like the lowest of our financial priorities. In our late 40s, retirement is much more immediate concern, and we are likely close to our peak of accumulated wealth before we start living off this saved wealth in retirement. At this stage we may face choice overload in considering our options for investment, leading us to stick with the status quo (keeping investments we have already selected) whether they are still right for us or not.

The importance of financial well-being can't be overstated as it has been shown to have a comparable impact on overall well-being as the effects of job satisfaction, relationship satisfaction, and physical health combined.[1]

Helping people improve their financial well-being is not always straightforward. Increasing financial literacy is one approach commonly deployed, as it's a natural first step. As the saying goes, we 'need to know better to do better'.

[1] Netemeyer, R. G., Warmath, D., Fernandes, D., & Lynch Jr, J. G. (2018). How am I doing? Perceived financial well-being, its potential antecedents, and its relation to overall well-being. Journal of Consumer Research, 45(1), 587-671.

Behavioral Science Guides The Way

Although there is evidence that increased objective knowledge (what we actually know) is beneficial[2], substantial research shows that our behavior does not always improve with financial literacy training[3]. Often overconfidence and subjective knowledge (what we think we know rather than what we actually know) cause sub-optimal decisions[4].

Improving financial literacy is one part of the equation, but research indicates it is not sufficient to improve financial well-being.

How can we help people make better financial decisions? Understanding how our financial journey changes across our lifespan can provide the key. Mapping this journey allows us to consider the unique decisions people face along their lifespan and apply a behavioral science lens to diagnose the most common barriers to optimal decision-making at each stage. With these hidden barriers identified, we can then develop and apply proven solutions to create better outcomes.

The most effective interventions will include financial literacy to increase objective knowledge along with interventions grounded in behavioural science to support behavior. For example, we can help younger investors better understand how much they should be saving right now, and at the same time, help them feel closer to the person they will be when they retire to increase their willingness to save for that stage of life. Our research indicates that traditional demographics (age, wealth, marital status, education, etc.) do not truly explain behaviours and do not inform strategies to enhance decision-making[5].

Instead, understanding the social, cultural, psychological, and emotional factors that influence people's attitudes and beliefs, and ultimately their behaviors will create a necessary foundation for enhanced well-being.

[2] Willis, L. E. (2011). The Financial Education Fallacy. *The American Economic Review, 101*(3), 429-434.

[3] Willis, L. E. (2008). Against financial-literacy education. *Iowa L. Rev., 94*, 197.

[4] Lewis, D. R. (2018). The perils of overconfidence: Why many consumers fail to seek advice when they really should. *Journal of Financial Services Marketing, 23*(2), 104-111. doi: 10.1057/s41264-018-0048-7

[5] Lewis, D., Hilscher, M., Peters, K., Carpentier, S., Malé, P.-J., & Cooper, A. (2021). The Value of Behaviorally-Informed Financial Advice. Toronto: BEworks Research Institute.

Stage 1: Accumulating and Protecting Wealth

From Childhood to Early Adulthood

In the early years of this life stage, one is focussed on understand financial and monetary concepts. As a child and teenager, much of one's exposure to finance is through learning and observing others and less so taking part in financial transactions. The foundations to financial literacy are set in this stage.

In the latter part of this stage, one is beginning to experience first-hand the practical realties of earning, budgeting, saving, and spending money. Budgeting is the crucial financial skill one must master when one first starts earning a living. Creating a workable budget and cultivating the discipline to live within one's means to avoid becoming caught in a debt cycle.

Servicing student loans, entering part time or permanent employment and getting married are key moments that expose one to a broader range of financial challenges, transactions, and instruments.

Key first purchases are made such as a motor vehicle, a first house or apartment and perhaps travel expenses are incurred. At the latter part of this stage, one's expenses and income start to increase and financial planning kicks-off in earnest as wealth is being accumulated. One also engages with a range of insurance products be it for assets (motor vehicle), medical or life.

The financial decisions people are making at this stage in their lives are challenged by hidden biases that can lead to sub-optimal outcomes unless they are identified and mitigated through behavioural interventions. For example, we know

that *Present Bias* occurs since people identify more with their current self than their future self in retirement and are more likely to allocate resources to current spending over saving for their distant future[6]. We assisted one global bank in getting younger clients to save substantially more for their future by making that future self more real.

Another example is *Atypicality Neglect* which is common when people are setting up a budget[7] and trying to estimate future expenses[8]. To help guide this estimate, people look back on past expenses they have incurred and take notice of their routine monthly expenditures (e.g., groceries, gas, rent). What they fail to take notice of and therefore do not factor into their budgeting decision, are the atypical expenses that crop up month-to-month that are tied to unexpected events such as emergency pet care, a home or auto repair, or family coming to visit.

[6] Hershfield, H. E., Goldstein, D. G., Sharpe, W. F., Fox, J., Yeykelis, L., Carstensen, L. L., & Bailenson, J. N. (2011). Increasing saving behavior through age-progressed renderings of the future self. Journal of Marketing Research, 48(SPL), S23-S37.
[7] Peetz, J., & Buehler, R. (2009). Is there a budget fallacy? The role of savings goals in the prediction of personal spending. Personality and Social Psychology Bulletin, 35(12), 1579-1591.
[8] Howard, R. C. C., Hardisty, D. J., Sussman, A. B., & Lukas, M. F. (2022). Understanding and Neutralizing the Expense Prediction Bias: The Role of Accessibility, Typicality, and Skewness. Journal of Marketing Research, 59(2), 435-452.

Failure to establish sound behaviours at this stage can create a pattern of over-spending and borrowing that leads to too much debt, possible default, and failure to save for retirement.

To ensure that atypicality neglect isn't getting in the way of people's judgment about future expenses, a simple technique called atypicality priming has been developed to help people focus their attention on what would otherwise go unnoticed – unanticipated expenses. This technique can take many forms, but in its simplest form, consists of asking people to think and list three reasons why their expenses for the following month might be different from a typical month before making their prediction.

Embedding a behavioural technique like atypicality priming into the financial life journey helps to change how people think, and ultimately, what they do.

In this case, making atypical expenses easier to notice influences how people budget. In a recent study the impact of this intervention was quantified - when atypical expenses get noticed, people set aside up to $400 more per month to cover the costs of unexpected events.

Stage 2: Distributing Wealth

From Early Adulthood to Middle-Age

Distribution of wealth is a difficult phase since many aspects of financial planning must be addressed. Because one probably has dependents, life insurance is a vital component of security. Equally important is including one's family in the coverage of health insurance.

From a young family to empty nesters, in this life stage one reaches one's highpoint in terms of wealth accumulation and value of investable assets. One's amount of debt begins to decline as mortgages, and other lines of credit are paid off. Revision to financial plans is undertaken and as one's family grows and children get older, saving for children's education becomes a priority followed by the need for estate or legacy planning.

As one's career matures, incomes increase but costs and complexity also increase with a growing family and more assets (e.g., house, second car, etc.). Costs also increase as children attend post-secondary education and there may be a desire to assist the next generation in establishing their own household. As one heads towards retirement, managing debt effectively is key, ensuring there is little to no significant debt commitments that would require repayments from retirement fixed income. Overall, a well-managed budget during this phase will ensure a healthy financial position is achieved prior to retirement.

Much like in the prior phase, a number of hidden biases are at play during the Distributing Wealth phase and can lead to sub-optimal financial behaviours unless detected and addressed through behavioural interventions.

In this life phase, *Choice Overload* can be a particular problem as people navigate multiple financial products – life insurance, property insurance, and different savings vehicles, including those intended for funding children's education[9]. When many options exist and choice is abundant, this often hurts decision-making. Choice overload can lead people to procrastinate in making a choice and make them less satisfied with whatever they eventually do choose, merely because many other options exist.

Choice overload doesn't need to be a barrier. By identifying where and when it is happening in the financial life journey, it is possible to intervene and help people better weigh their options.

"Boosts" are a general category of interventions that behavioural scientists apply to extend people's ability to process information and compare products or services.

Boosts are often applied through behavioural design of communications. For instance, we know that people's visual systems are most sensitive to information displayed on the upper-left of a page, so a "boost" can be delivered by placing often-missed information about a product there. Traffic-light labeling can also give people a "boost" when they are trying to compare options. The utility of this technique has been documented with respect to food labeling, where at a glance, people are able to make healthier choices in the grocery store because they can quickly spot "green" options that they should reach for, for instance those that are low in sodium. Similar methods can be used to help people decide between different financial products, which vary on a number of attributes including price, value, risk, and time. Traffic light labeling can be used to signal what the best and next-best options are for a particular person, given their specific needs.

[9] Chernev, A., Böckenholt, U., & Goodman, J. (2015). Choice overload: A conceptual review and meta-analysis. Journal of Consumer Psychology, 25(2), 333-358. doi: http://dx.doi.org/10.1016/j.jcps.2014.08.002

Stage 3: Living off Saved Wealth

Retirement

During retirement, budgeting once more takes centre stage. Controlling spending is the goal in order to maintain sufficient assets to maintain a comfortable retirement in the future. The main investment activity at this point is managing investments to provide income and guard the corpus against inflation.

Since health expenses can send one's income off course, having adequate health insurance is essential. Debt shouldn't make up a significant portion of your money right now, and life insurance may only be necessary to preserve the spouse's retirement income.

At the start of retirement, simplifying finances is a crucial task. This entails reducing the number of accounts and assets, organising records, updating information, and consolidating investments into a small number of pertinent ones. Ensure that all of one's financial records are current and easily accessible.

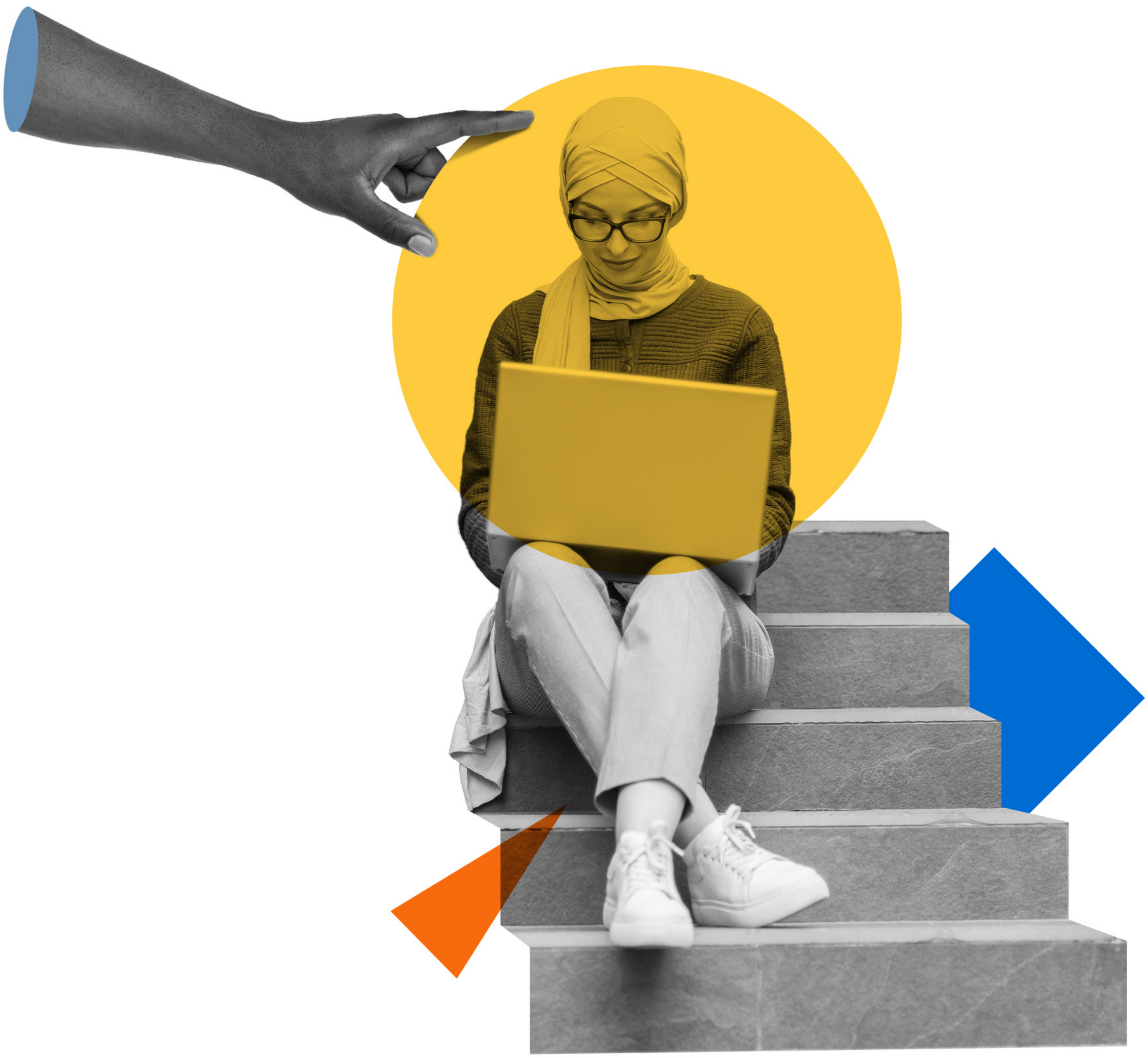
Utilize your time, money, and energy wisely by focusing on the tasks that are most crucial and necessary at each stage of your life. You will eventually discover that you have connected all the pieces without finding the entire procedure too overwhelming.

Numerous factors influence financial behaviours as people navigate their ultimate financial life stage of living off saved wealth. A decline in cognitive ability and memory that comes about as our brains aged, coupled with reduced risk tolerance can make it challenging for people to do the things that are necessary to protect themselves and their wealth to sustain them throughout their retirement. Necessary behaviours, such as asking for help from a relative, increasing one's reliance on professional financial advice, or spending cash instead of taking on more debt, may not happen because they feel uncomfortable and risky[10].

[10] Campbell, M. C., & Goodstein, R. C. (2001). The moderating effect of perceived risk on consumers' evaluations of product incongruity: Preference for the norm. Journal of Consumer Research, 28(3), 439-449.

Behavioural interventions can be applied to help bring about the actions needed to protect people in this final stage of the financial life journey.

This could include using pre-commitment, a technique that could be integrated pre-emptively into an earlier life stage when people are setting up their financial plans and getting things in order for the future. Pre-commitment nudges can be deployed in a number of ways, including by having people pre-appoint a trusted relative or financial professional whom they could turn to if they need support or advice in the future.



The Path Towards Enhanced Well-Being

Good financial decision-making is the foundation for financial well-being and critical for overall well-being. While enhancing well-being is a complex challenge, we are guided by many years of research and examples of proven strategies to guide us. Increasing financial literacy and objective knowledge is an excellent start, however:

- We know from our research on many prior initiatives over many years and across many cultures that financial literacy alone is insufficient to change behaviors.
- We need to leverage the insights of behavioral science regarding social, cultural, psychological, and emotional factors that influence people's attitudes and beliefs, and ultimately their behaviors.
- Applying behavioural science to the entire life journey will create the necessary conditions for permanent enhancement of well-being.

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