

The Psychology of Decumulation

ACADEMIC PERSPECTIVE

As the generation of baby boomers reach the end of their working years, decumulation (the drawdown of savings during retirement) is an issue facing pre-retirees and retirees in large numbers. There are a variety of sources from which a retiree can possibly draw income during retirement.

Retired workers may have access to a pension or 401k through a former employer, some individuals will have generated private savings, such as through IRAs or housing wealth, and most Americans will be eligible for retirement benefits from Social Security. The financial environment of decumulation has grown more complex as individuals choose among these various options of 401(k) and IRA dispersals, pensions, Social Security benefits, life annuities, reverse mortgages and other products designed to provide income during retirement.

Figuring out which of these resources to tap, when to start doing so and how fast to deplete each resource are major decisions within the complex problem retirees face. Beyond these decisions, however, decumulation is even more complex because optimal decisions require considerations of uncertainty in financial outcomes, health status and lifespan expectations. In other words, decisions about how to best spend retirement resources are contingent on assessing a variety of other possible outcomes.

Both of these layers of decision-making are susceptible to behavioral factors that interfere with decision-making more generally. In this article, I explain why decumulation is such a difficult process for most retirees, focusing especially on the psychological biases that interfere with optimal choices. I end with several ways financial advisors can help clients make better plans for the decumulation stage of life.



SUZANNE B. SHU, Ph.D.

John Dyson Professor of Marketing
Cornell Dyson School of Applied
Economics and Management

The Start and End Points of Decumulation

Let's begin with thinking about the outlines of the decumulation problem: How many years will a retiree need income during retirement, and what should the glide path look like during those years? The starting point depends on what age she wants to stop working, and the ending point depends on how long she is expected to live. The decision of when to stop working is often financially and emotionally difficult for people and there is no one-size-fits-all solution; each case will depend on a variety of personal considerations.

Current workers are likely to think about the financial impacts of giving up their current income in contrast to the immediate benefits of stopping work (such as less physical effort, less commuting and more leisure time). However, there are also emotional costs to retiring, since retirees can report feeling bored, lonely and lacking in identity without a job to go to every day, and it is important to take those costs into account as well.

In recent research, my coauthor Helen Colby and I found that consideration of both those positive and negative aspects of retirement can affect workers' interest in retirement income solutions.¹ Individuals who feel positive emotions about retirement are often more open to exploring the full range of retirement income solutions. Financial advisors who work with their clients to reduce the stress of thinking about retirement tradeoffs, and who encourage greater positive emotions about the years ahead, may thus find them more willing to consider a wider set of decumulation options.

Speaking of stress from thinking about retirement, thinking about the planning endpoint of life expectancy is also highly stressful and yet an important piece of the process. None of us can see the future to predict life expectancy, but we know enough about our family histories and own health status to make a guess. These guesses have some predictable psychological bias built into them that needs to be considered, as found in research I've done with John Payne of Duke University and our coauthors.²

First, individuals tend to be overly pessimistic when thinking about the likelihood of dying at younger ages (e.g., before age 75) and overly optimistic about surviving into older ages. Second, women tend to underestimate their life expectancies more than men do. And third, when asked to think about the likelihood of dying at a certain age rather than the likelihood

of still being alive at that age, people tend to end up underestimating their life expectancies by as much as 10 years. In particular, we asked individuals questions like, "What is the chance you will live to age 85?" and found they thought about all the reasons they would live to a healthy old age, and then generated higher life expectancies, than if we had asked, "What is that chance you will die by age 85?" This simple change in wording had a major effect on their planning horizon for how long retirement income would need to last.

Complexities of Managing the Glide Path

Once the start and end points have been chosen, estimating the ideal glide path for resource drawdown is also a difficult task. Should withdrawals be higher in early years when a new retiree is able to travel and enjoy life? Or should they be higher in later years when additional health expenses may arise?

Research on consumption, in general, typically finds that people prefer increasing sequences in which income and consumption go up over time. However, research also finds that people are generally impatient and want rewards sooner rather than later. These competing factors can play out in surprising ways. For example, impatience may win when the money is coming from an external source, such as Social Security or a pension. The majority of Americans claim Social Security before their full retirement age and give up significant monthly income by doing so.

In contrast, many retirees are overly cautious in spending down their personally held retirement funds such as those in a 401k or IRA. Some of this reluctance originates in feelings of psychological ownership over those funds.³ After 30 years of careful savings, it can be difficult to change one's mindset toward spending those hard-earned golden eggs. Some retirees even report a sense of fear of spending their retirement savings. Here, it can be useful to remember that the savings was for the purpose of spending it when the time came, and retirement is that time.

Additional psychological biases also affect the decumulation decision in predictable ways. Paying attention to individual differences in investor psychology for each of these possible biases can be useful for understanding how to avoid particular decision traps during the decumulation planning process.

In our research, we have identified five key psychological inputs to the decumulation decision: self-control, temporal discounting (patience), loss aversion, fairness and psychological ownership.⁴ Self-control and patience can both affect the speed at which a retiree desires to spend their retirement savings, as noted above. Loss aversion represents the higher importance that individuals place on financial losses versus gains. In contrast to high levels of risk aversion, which should predict a higher desire for life annuities and other products that provide insurance against running out of money, high levels of individual loss aversion can lead individuals to be averse to anything that reduces their retirement savings account balance, such as converting savings into an annuity. Individual concerns about fairness also influence demand for products, such as annuities, as individuals think about how possible outcomes are allocated between the customer and the firm.⁵ Finally, as noted above, high levels of psychological ownership toward resources, whether individually held savings or earned benefits like Social Security and pensions, can cause individuals to demand earlier access to and more control over those resources.

How Advisors Guide Decumulation Planning

Given all these influences on optimal decision-making for decumulation, how may financial advisors best assist investors in planning for retirement?

1. Move beyond a focus on financial outcomes and have conversations about goals for retirement. In other words, what plans and activities are they saving for? Reducing stress about retirement can lead to more positive emotions when thinking about the future and should make individuals more open to conversations about financial options to support that future.
2. Structure the conversation about life expectations to focus on how long one expects to live and not on the age at which they expect to die. Small differences in wording prompt different thoughts, which translate into large differences in life expectancies and the associated need for income during retirement.
3. Assess levels of self-control and patience. Is this someone who is anxious to spend retirement wealth quickly, or someone who is fearful of spending it too fast and thus may underconsume their saved wealth? Good planning takes the full length of retirement into account and encourages smoothing consumption across all years. Encouraging pre-commitment to a long-run spending plan can be helpful in this regard.
4. Investors with outsized concerns about fairness can benefit by learning more about the processes and possible distribution of outcomes underlying the products being discussed. Greater transparency about how outcomes are determined (such as how the market for life annuities works, or how the Social Security system operates) can ease concerns about unfair outcomes.
5. Loss aversion and high psychological ownership can easily lead to non-optimal decisions if retirees demand control and faster access to retirement wealth. “Silver linings” that provide immediate access to some resources, while keeping the remainder under more optimal management, can provide a balance of the desired level of control without disrupting the overall financial plan.

More generally, it is important to note how the role of the advisor evolves as individuals move from the savings years to the decumulation years. During savings, the focus is on quantifiable outcomes such as increasing savings rates and choosing the right investment options to maximize wealth. During decumulation, the goals can be harder to quantify. How does one measure a satisfying retirement? Is it through the number of years, consumption of wealth or amount of wealth left over at the end of life? Regular check-ins about personal retirement goals, and then pre-committing to plans that can accomplish those goals, can help retirees stick to a strategy that makes the best use of their full set of retirement income options.

SUZANNE B. SHU

Suzanne is the John Dyson Professor of Marketing at Cornell University's Dyson School of Applied Economics and Management within the SC Johnson College of Business. The types of decisions she analyzes in her research include consumer self-control problems and consumption timing issues, with important implications for both negative behaviors (e.g., procrastination) and positive behaviors (e.g., saving).

Her work on financial decisions has focused specifically on decumulation during retirement (e.g., annuities, Social Security claiming) as well as perceived fairness for financial products. Professor Shu received a Ph.D. from the University of Chicago; she also holds bachelor's and master's degrees in Electrical Engineering from Cornell University. Professor Shu has taught marketing and decision-making courses to MBA students at the University of Chicago, Southern Methodist University, INSEAD and UCLA.

She also currently serves as a National Bureau of Economic Research Faculty Research Fellow, holds a joint faculty appointment at the UCLA Medical School and has been a visiting scholar for several years at the Consumer Financial Protection Bureau.

ENDNOTES

¹ Helen Colby and Suzanne B. Shu, "The Role of Affect and Social Norms in Preferences for Guaranteed Income Streams in Retirement," TIAA Institute, June 2020.

² John W. Payne, Namika Sagara, Suzanne B. Shu, Kirstin C. Appelt, and Eric J. Johnson, "Life Expectancy as a constructed belief: Evidence of a live-to or die-by framing effect," *Journal of Risk and Uncertainty* 46, no. 1 (February 2013): 27-50.

³ Suzanne B. Shu, "Psychological Ownership in Financial Decisions," in *Psychological Ownership and Consumer Behavior*, eds. Joann Peck and Suzanne B. Shu (New York: Springer Publishing, 2018), 165-176.

⁴ Suzanne B. Shu and Stephen D. Shu, "The Psychology of Decumulation Decisions During Retirement," *Policy Insights from the Behavioral and Brain Sciences* 5, no. 2 (October 2018): 216-223.

⁵ Suzanne B. Shu, Robert Zeithammer, and John W. Payne, "The Pivotal Role of Fairness: Which Consumers Like Annuities?" *Financial Planning Review* 1, nos. 3-4 (September-December 2018): 1019-1022.

This material has been prepared for educational purposes only. It is not intended to provide, and should not be relied upon for, investment, accounting, legal or tax advice.

The contents of this Avantis Investors® presentation are protected by applicable copyright and trade laws. No permission is granted to copy, redistribute, modify, post or frame any text, graphics, images, trademarks, designs or logos.

Avantis Investors®