

Trustees and actuaries are only flesh and blood and according to Richard Murphy and Mark Alexander Lane Clark & Peacock, they need to choose their weapons wisely or risk being maimed by murderous members

# Stab *in the* dark?



People's choices are influenced by how information is presented to them, with small differences potentially leading to very different decisions, particularly where risk and uncertainty are involved. Our ancestors were naturally risk averse to avoid being killed by woolly mammoths. However, they were willing to evaluate and take risks where necessary, otherwise they would have died shivering in a cave rather than attempting to kill the beast for food, clothing and (let us be honest) to impress members of the opposite sex.

Fast forward 50,000 years and our natural ability to assess options and make decisions is being used by trustees to manage pension schemes and the decisions they make matter. With most arrangements in deficit, members' benefits are at risk. Trustees need to invest assets wisely. Also, having assessed the scheme's position they must agree sufficient employer contributions to fund the deficit without endangering the business.

### Basic instinct

The Pensions Act 2004 gives trustees real power over the contribution rate for the first time, increasing their responsibility at a time when the Pensions Regulator (TPR) is making it clear that trustees need to be able to show they have followed a proper process. It is no longer a case of just following the actuary's expert opinion; trustees are expected to take advice, understand the position and make decisions.

However, most decisions in day to day life are made through intuition not careful consideration of the facts. Oxford professor, Gordon Clark, recently investigated trustee decision making for the National Association of Pension Funds (NAPF). He considers that most decisions rely on intuition, "an automatic response to circumstances based on past experience filtered through some kind of elementary coding device that determines the relevance of one response over another" (phew!). Economic theory as a whole relies on



rational investors making decisions to maximise their economic utility. Behavioural finance is the study of the human factor, how the "elementary coding device" leads to non-rational decisions.

For defined contribution (DC) schemes we see members behaving in seemingly illogical ways, for example, the well known effect that employees are more likely to join an opt out scheme than an opt in one, even if there is no other difference in its terms (see **Box 1**).

In defined benefit (DB) arrangements, decisions are made by a trustee board, usually individuals more familiar with financial matters than average members and who have had

### Box 1: DC and behavioural finance

For defined contribution (DC) schemes the amount saved and the way it is invested are heavily influenced by the way it is communicated to employees. People find making decisions difficult. When they do make active choices they are swayed by the information is given to them and how it is presented.

The Pensions Commission looked at two sets of new employees from the same US firm. 90% of staff who were auto enrolled joined immediately, compared with less than 20% of those given the option. Over time the proportion of members in both groups steadily increased, as more people made the active choice to join, whereas inertia prevented those in the scheme from leaving.

Behavioural finance explains why people make these apparently irrational choices; individuals simply put off difficult decisions. Each separate decision – be it to change contributions, move investment funds or to leave – is put off, so schemes experience inertia.

If a default is offered (normally a lifestyle option or something similar), 80-90% of people choose it rather than making an active choice. Even with no default, the investment selection can heavily influence what people do. The DC scheme for pilots at (now defunct) airline TWA offered five equity funds and one fixed income fund and members chose on average to invest 75% in equities. However employees at the University of California were offered one equity fund and four fixed income funds – they chose to invest only 34% of contributions in equities.



Murphy: on the knife edge

substantial training. Further they are advised by various experts. So you would expect their choices to be much more rational.

Professor Clark (with colleagues Emiko Caerlewy-Smith and John Marshall) put trustee decision making powers to the test. They found trustees answered questions more consistently and more correctly than a sample of undergraduate students, suggesting they follow sensible decision making processes. This was particularly the case where problems were

“immediately relevant to trustee roles and responsibilities”.

Good news, but the actuaries still need to take care, knowing trustees can be swayed by how results are presented. **Box 2** sets out some of the key features that trustees should have in mind when making decisions. Trustees also need to remember that actuaries are vulnerable to the same human traits when they prepare advice. Some effects are simple, eg an approach can be considered to have an 80% chance of success (“sounds good, let’s take it”), or a 20% chance of failure (“are we taking too much risk?”)

believe that salary increases will be in line with their inflation only policy, despite years of evidence that they actually operate so many exceptions to the policy that the real expectation is for growth around 2% a year ahead of inflation.

Mortality presents particular difficulties. For 30 years mortality projections in standard actuarial tables have consistently underestimated the rate of improvement actually experienced (suggesting that actuaries have been guilty of anchoring). It is tempting to assume members do not live as long as the latest standard actuarial tables suggest, in the hope that, unlike every previous occasion, the tables are now overstating rather than understating life expectancy. For those interested in finding out more, there is a wealth of material available on this topic.

Trustees are now expected to challenge the advice they receive, rather than just accepting it on faith. When considering actuarial advice you should also question how the information is presented. To make the best decisions, it pays to be aware of your human nature and to remember that your actuary is only human too. **PW**

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### Box 2: Decision making pitfalls

- **anchoring/adjustment:** decision making often involves adjusting from an existing position. A weak mortality basis adopted for the previous actuarial valuation may mean trustees are reluctant to move as far as they should
- **prospect theory:** people are generally risk averse when seeking gains but risk seeking when facing losses. This may explain the high equity content of the investment strategies for schemes with large deficits
- **availability** means easily imagined events are considered more likely. Many trustees find the failure of their sponsoring employer unimaginable and agree to very long deficit funding periods, although they do know that apparently successful businesses fail
- **representativeness** means events which have happened recently appear more likely to happen again. Assets classes and investment managers that have done well in the last year are more likely to be selected than recent underperformers, whatever the evidence of likely future performance
- **myopic loss aversion:** more frequent measurement can make people more risk averse. At least some of the greater concern about schemes reflects the move from valuations every three years to yearly or even quarterly
- people tend to ignore underlying **probability distributions** (even when they are known)
- **almost everyone is over confident** (ask anyone if they are a “better than average driver”, more than half say yes).

### Mortality miasma

Too many options can be confusing and if it is hard to decide, the middle option often looks attractive. Experience shows a

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set of trustees, when presented with three options, will tend to pick the middle one. The actuary should take that into account – the easiest solution perhaps being to present four or two alternatives so there is no middle one!

People are likely to focus on the first option presented and compare all others to this, so careful thought needs to be given to the order in which results are presented. Actuaries are often asked to provide provisional results before the full analysis of experience has been carried out. Trustees and employers may then be reluctant to move substantially from that initial basis, even if evidence shows it is no longer appropriate.

Expected salary growth is a particular actuarial favourite. Employers firmly

### In a nutshell

- people are risk averse in their nature
- most trustee decisions are based on intuition and how information is presented
- remember that actuaries are only human

### References

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