Don’t throw away your final salary pension

Behavioural finance tells us that humans make decisions in ways that reflect their biases, and may not always operate with robot-like logic. The prospect of poor decision-making is particularly prevalent in complex decisions, especially when they are made infrequently and are irreversible. The influx of individuals looking for advice on their final salary benefits is such an area, and one that has the potential to do huge damage to advisers and clients alike.

Final salary transfer values have universally increased. Low interest rates, falling anticipated investment returns and the likelihood of higher inflation have led to significant uplifts — even from a year ago. Individuals’ tendency to “anchor”, that is to retain recent values in mind, means there is a perception that there is a benefit in transferring now. Values will inevitably fall in due course, but the trustees, in conjunction with actuarial advice, are simply offering the fair value at today’s dates. When transfer values fall it will be because one or more of the factors above has changed.

As one person learns their value has increased, herd thinking increases the likelihood that colleagues or other contacts will ask for a value. If one transfers out, the conventional wisdom that a transfer is not in most people’s best interests starts to be eroded.

Behavioural finance expects overconfidence, and I have spoken to a number of individuals who have done their own analysis before they speak to me. This analysis is often grossly inadequate, overlooking factors such as inflation or being unrealistically optimistic about potential future returns.

For a professional adviser it would be obvious not to use past returns as a proxy for the future, but I have heard from many people who, eight years through a bull market, seem overly confident of their ability to achieve high single or even double-digit returns for the foreseeable future.

The other side of this overconfidence is availability bias — that individuals value an accessible pot more than an inflexible guaranteed income. Too many people are looking for “flexibility” with no clear idea what that means. In my view, one can afford much greater flexibility with other pension and investment assets where a final salary pension offers a secure base. There is comfort in knowing you have a basic standard of living underwritten by your ex-employer, and can afford to take more risk with individual savings accounts (Isas), money purchase pensions and other assets.

Prospect theory tells us that individuals dislike losses more than they like gains. This exacerbates the issues above; when values inevitably fall, for example if gilt yields rise, those who did not transfer will regret not taking the “high” value (which is just the fair value based on conditions at that time). For those who do transfer, the risk is that things do not perform as they expect. If that wasn’t enough of a problem, the decision to transfer is irreversible, giving a false feeling of urgency.

Individuals with larger funds may have started their own analysis: I have spoken to chartered financial analysts, engineers and chartered accountants — all with a high degree of financial sophistication — who have done so. However they are not pension professionals and the analysis is invariably flawed. The key danger here is that they have made up their mind before seeking financial advice, which is most often not black and white, with a range of disadvantages and benefits.

Where someone has started to do their own analysis they will often have shown, with their own assumptions, the benefit of a transfer even if this is not the case. For such people, natural confirmation bias will draw them to the advantages of any potential transfer and lead them to discount the downsides. It is far harder for an adviser to dissuade these individuals from a potential harmful course of action than it would be to recommend a transfer.

Offering professional advice under these circumstances can aid a potentially harmful course of action. This is because it is generally accepted that while a scheme member must take advice, a recommendation to stay put is the first step to allow them to transfer. It is perverse that the process of giving advice can actually make it easier for insistent individuals to cause harm to themselves.

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>
> Alistair Cunningham

Finally, hindsight bias tells us that when things go wrong, those who have sought advice will conclude it was “obvious” it was not in their interests to transfer. The nature of this bias is that these bubbles are always judged retrospectively, and the human mind alters its perception of facts to fit the current attitudes. The adviser who tried to dissuade a transfer is labelled pushy, the warnings that annuity rates might not improve were not strong enough, and the expectation was that the bull market would always continue.

These foibles of human beings cannot be removed, but they can be mitigated. It is concerning that the unscrupulous are meeting with the unwise, and the biases that we all share assist the worst possible outcomes, when most individuals should be leaving their final salary pensions untouched.

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