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The science behind why saving for retirement is hard

Understanding your cognitive biases can help you get better at contributing to your 401k.

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4 MINUTE READ

The data is alarming: Most people aren't saving enough for retirement. According to the 2019 Planning & Progress Study nearly one in four of Americans have less than $5,000 put aside for retirement. In fact, because of low retirement savings, almost half of Americans say they'll be forced to work past the age of 65.

The majority of Americans—59% according to a 2019 study by Charles Schwab—say they live paycheck to paycheck, making saving money a challenge. But beyond the that, there are lots of reasons why people don't prioritize planning for their future, even though they know they should. It's here where research in behavioral science can help.

Surprisingly, the data shows that one of the primary reasons why we don't make choices that set ourselves up for a secure retirement is because of how our brains are wired. Each of us has cognitive biases that lead us astray. Yet, by understanding these biases, you can make sure that you do not fall under their influence.

Here's a look at three of them—and what you can do to counteract each:

BIAS #1: TEMPORAL DISCOUNTING

Would you rather receive $1,000 today or $1,200 in four months? If you're like most people, you'll choose the $1,000 now. Yet, what if the options were modified, so that a year is added to each. This means you could receive either $1,000 in a year or $1,200 in a year and four months. When presented with this new choice, you'll likely select the second option: a gain of 20%.

What you've just experienced is a bias known as "temporal discounting," which is when more weight is given to something in the present than something greater in the future. Temporal discounting is one of the biggest obstacles to saving for retirement. Why? Because it requires you to choose not to enjoy your money now, so you can enjoy it later in retirement.

The good news is that there are things you can do to minimize the effects of this. One potent way is to engage in what social scientists refer to as Elaboration on Potential Outcomes, or EPO. EPO prompts you to focus on what you want in the future, which helps you say "no" to present temptation that steal funds you should be putting toward retirement.

For instance, in one study, participants who struggled with self-regulation were prompted to think through the outcomes of investing or not investing in a 401k. These participants invested almost twice as much as those who did not think through the potential outcomes.

Another way to reduce the impact of temporal discounting is connecting with your future self. Scientists who study why people don't save for their retirement have found that temporal discounting is magnified when there is a disconnect between you today and you at retirement. This disconnect triggers an "empathy gap," which causes us to perceive our future selves as less real and underestimate the pain our choices will inflict.

The research also shows that by imagining your future self in retirement, you can promote yourself to act in ways that will positively impact your future self. For instance, when participants were shown a virtual image of themselves at retirement age while making the decision how much of their current income they would save for retirement, they increased their savings rate in comparison to those who had not seen the image of their future self.

BIAS #2: LOSS AVERSION

Loss aversion is one of the most well-known biases. Decades of scientific studies have shown that our brains are more impacted by potential losses than potential gains. This is a major stumbling block when it comes to retirement, because you will have losses. Between now and when you retire, there will be ups and downs in the economy. These losses will sting and cause many to pull back or stop investing. Yet, this is the opposite of what you should do. Here's why.

What separates great investors from poor ones (literally) is how they view down years. Successful savers take advantage of losses and view losses as a signal of a time to purchase more, because things are "on sale." What history has proven is that there will be ups and downs, but over time, traditional investments like real estate, stocks, and bonds grow.

Not fearing losses, but understanding them as a part of investing and seeking to use them to your advantage is a hallmark of successful investors. As famed investor Warren Buffett aptly said, "Be fearful when others are greedy and be greedy when others are fearful."

BIAS #3: RECENCY BIAS

A third bias that often prompts regrettable investment decisions is the recency bias. It's the presumption that whatever trend you are currently witnessing, regardless of whether it is favorable or not, will continue in the future. If you're not careful, it's this bias that will prompt you to make investment decisions based on the recent past and not objective data or historical precedent.

Nobel prize-winning economist Harry Markowitz summarizes this flawed perspective when he said, “The chief mistake of the small investor is they buy when the market goes up, on the assumption that it’s going to go up further, and they sell when the market goes down, on the assumption that the market is going to go down further.”

A successful retirement is created through careful planning and wise choices. By becoming aware of the biases that can lead you astray, you’ll be equipped to make smart investment decisions that will set you up for a financially secure retirement.

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