How do savers think about and respond to risk?

Evidence from a population survey and lessons for the investment industry

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An independent study

a2risk.com

Attitude 2 Risk

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You can find the full paper at:

http://www.pensions-institute.org/reports.html

Background

- YouGov survey designed to elicit UK savers' attitudes to taking risk in order to achieve their savings goals.

- Breaking the savings process into two stages:
  - a savings stage
  - an investment stage

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Savings risk

- We invited respondents first to consider the 'savings risk' of falling short of the target established by the savings goals they set themselves.

Savings goals

- 46% of respondents consider what they are saving for in terms of specific savings goals.

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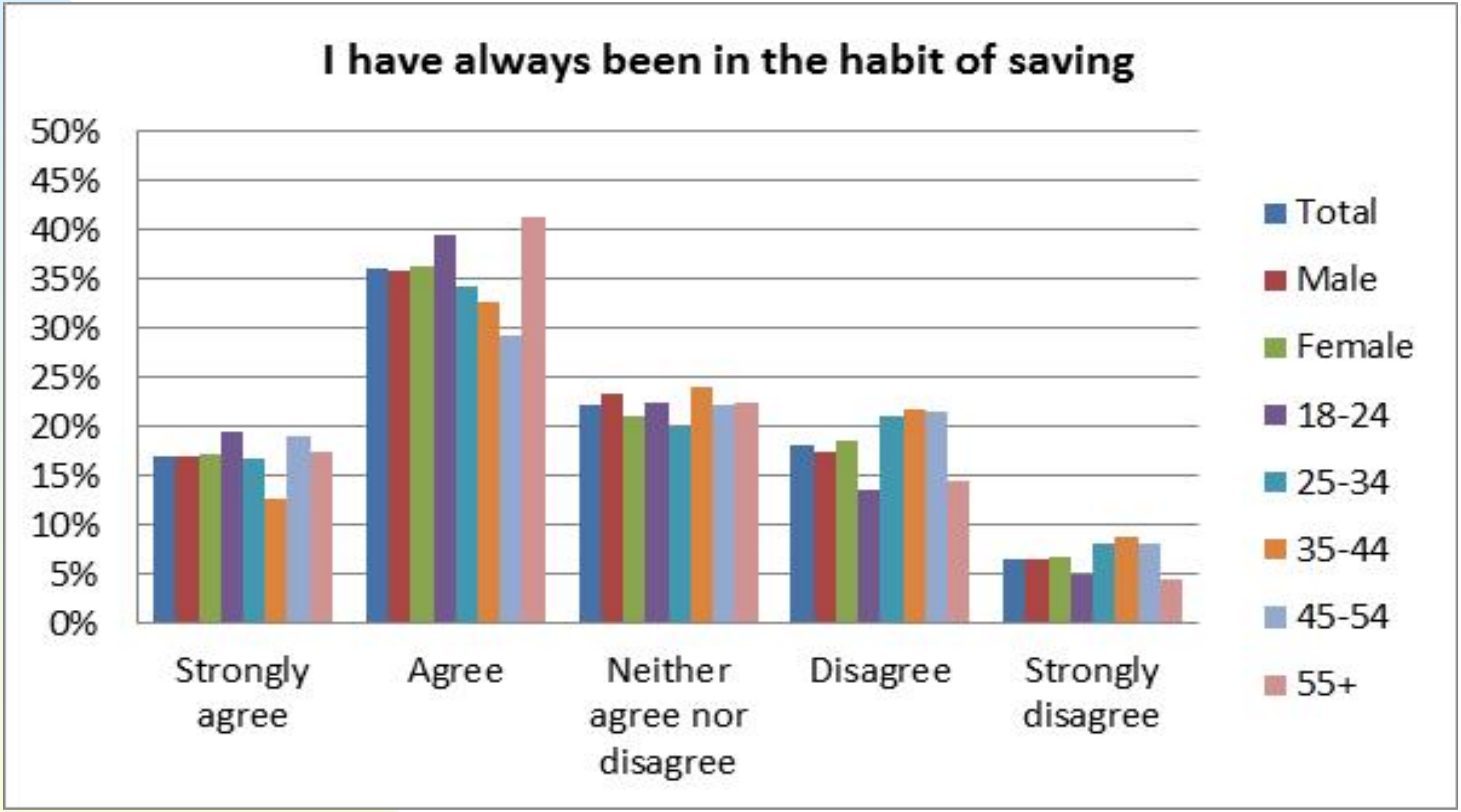
A culture of saving?



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People save for three reasons:

- Long term (over ten years)
- Short term (up to ten years)
- Rainy days – precaution against unanticipated expenses

People save for three reasons:

- Long term (over ten years) 29%
- Short term (up to ten years) 25%
- Rainy days – precaution against unanticipated expenses 45%

Saving priorities

Savers tend to prioritise what might happen:

- 45% prioritise precautionary goals

Rather than what most likely will happen:

- 29% prioritise long term goals

What if savings goals are not met?

- reduce spending
- accept a lower outcome
- wait longer
- ‘borrow’ from another fund
  (long-term, short term or ‘rainy day’)

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Investment risk

- We then ask respondents to consider the ‘investment risk’ that is associated with the investment funds that savers use to help them achieve their savings goals.

Attitude to risk

- 12 simple questions (A2risk Questionnaire)
- Question: at what level of fall in value of your investments would you start to feel very uncomfortable
- Equivalent to asking members of the public to report their personal Value at Risk

Risk and financial planning

Source: A2Risk Limited

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Lessons for the investment industry

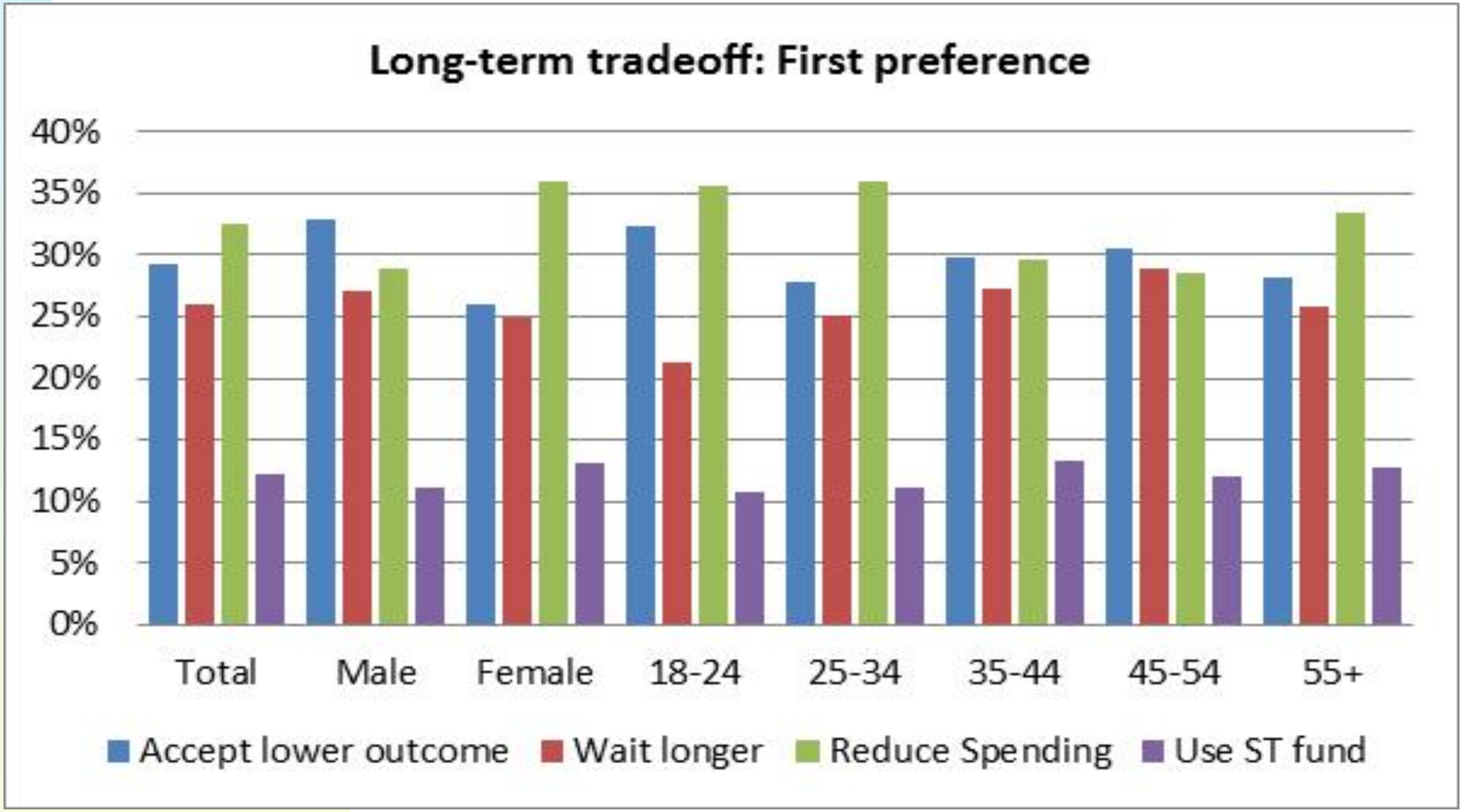
Lesson 1: Help savers focus on savings goals

- 46% have specific savings goals.
  - But tend to prioritise rainy-day savings
  - Not savings for anticipated future expenses
- Strongly suggests many savers are predominantly concerned with what might happen, rather than what they know will happen and can plan for.
- Lesson: more attention to longer-term savings goals

Savings risk

- In terms of dealing with a shortfall in long-term savings, we find that:
  - 33% prefer reducing spending and saving more as their first choice
  - 29% of respondents prefer accepting a lower outcome
  - 26% prefer to wait longer
  - 12% prefer to borrow from short-term fund

How savers deal with a shortfall in long-term savings goals



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Lesson 2: Provide better information to help savers understand adequacy

Adequacy:

- Show the relationship between savings and results
- (different investment horizons and interest rates)

Commitment:

- Pre-commitment devices e.g. ‘save more tomorrow’ plans and direct debit arrangements can be effective ‘nudges’

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Lesson 3: Explain the trade-off between investment risk and reduced spending

- 52% of respondents would prefer to miss their savings goals than take investment risk

- Highlights a reluctance to take the investment risk needed to achieve their savings goals.
  - Referred to as ‘reckless conservatism’

- The prudent alternative if savings goals are to be achieved on time is to reduce spending and save more (preferred by less than one third (30%) of respondents.

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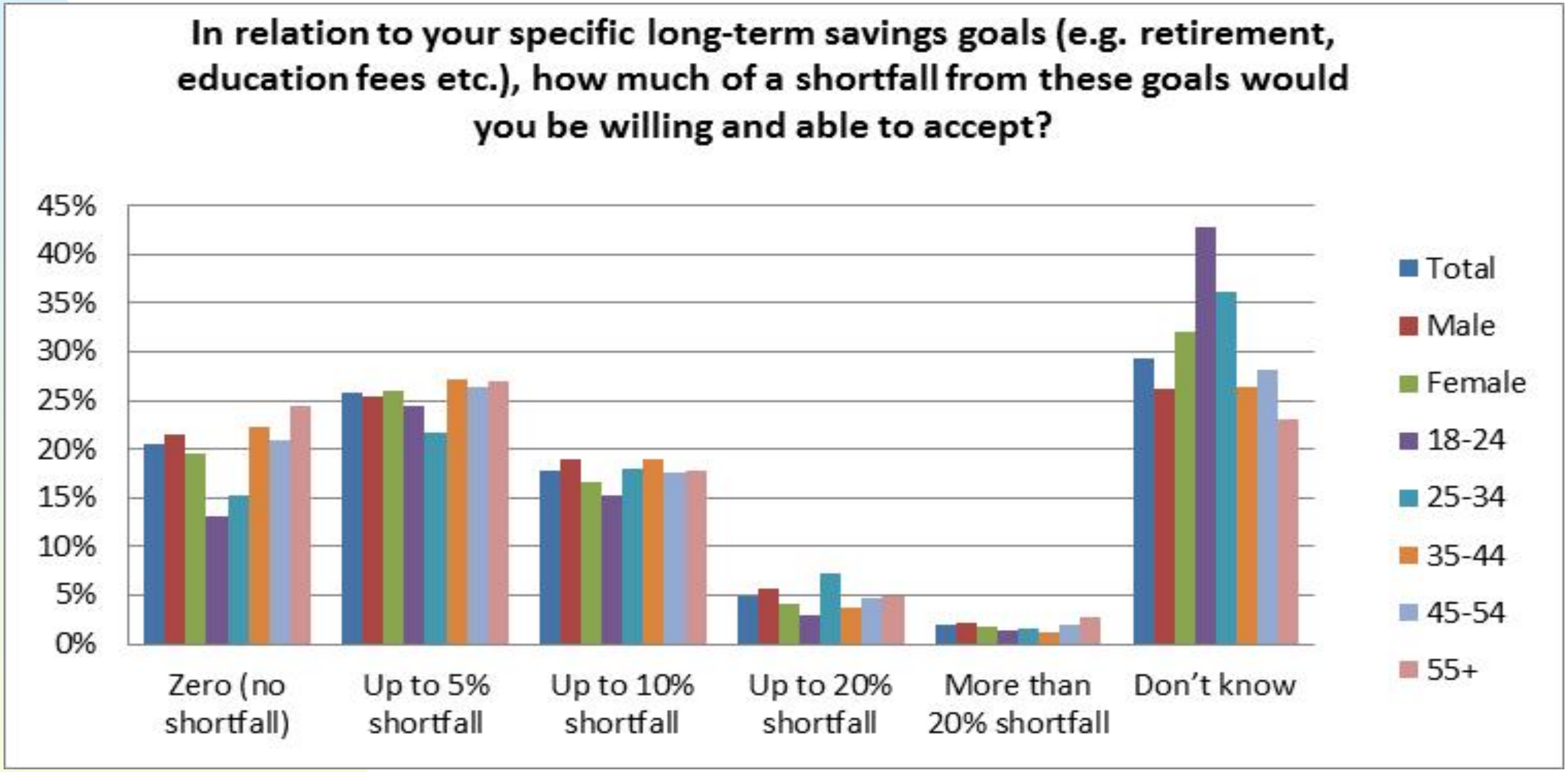
Quantifying savings risks

- In terms of quantifying savings risk, 38-46% of savers can be regarded as being strongly committed to meeting their savings goals

(willing to accept shortfall no more than 5%)

Quantifying long-term savings risk



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Quantifying investment risks

- Nearly 19% would feel very uncomfortable accepting any reduction in the value of their investments.
- Similar percentages would be very uncomfortable with a
  - 5% fall
  - 10% fall (18% and 22%, respectively).
- i.e. 59% of respondents are very uncomfortable with falls of up to 10%.

Lesson 3: (continued)

- Holistic thinking about investment and savings risk:
  - risk is an unavoidable feature of long-term savings

- If people want to meet their savings goals, they need to:
  - take controlled investment risks, or
  - or save a great deal more in very low-risk investment vehicles, which are not actually riskless once inflation is taken into account.

Lesson 4: Attitude to risk is vital for investment risk but not savings risk

- Relying solely on a saver's attitude to risk, or an associated investment risk rating might fail to reflect the level of risk needed to achieve their stated savings goals.

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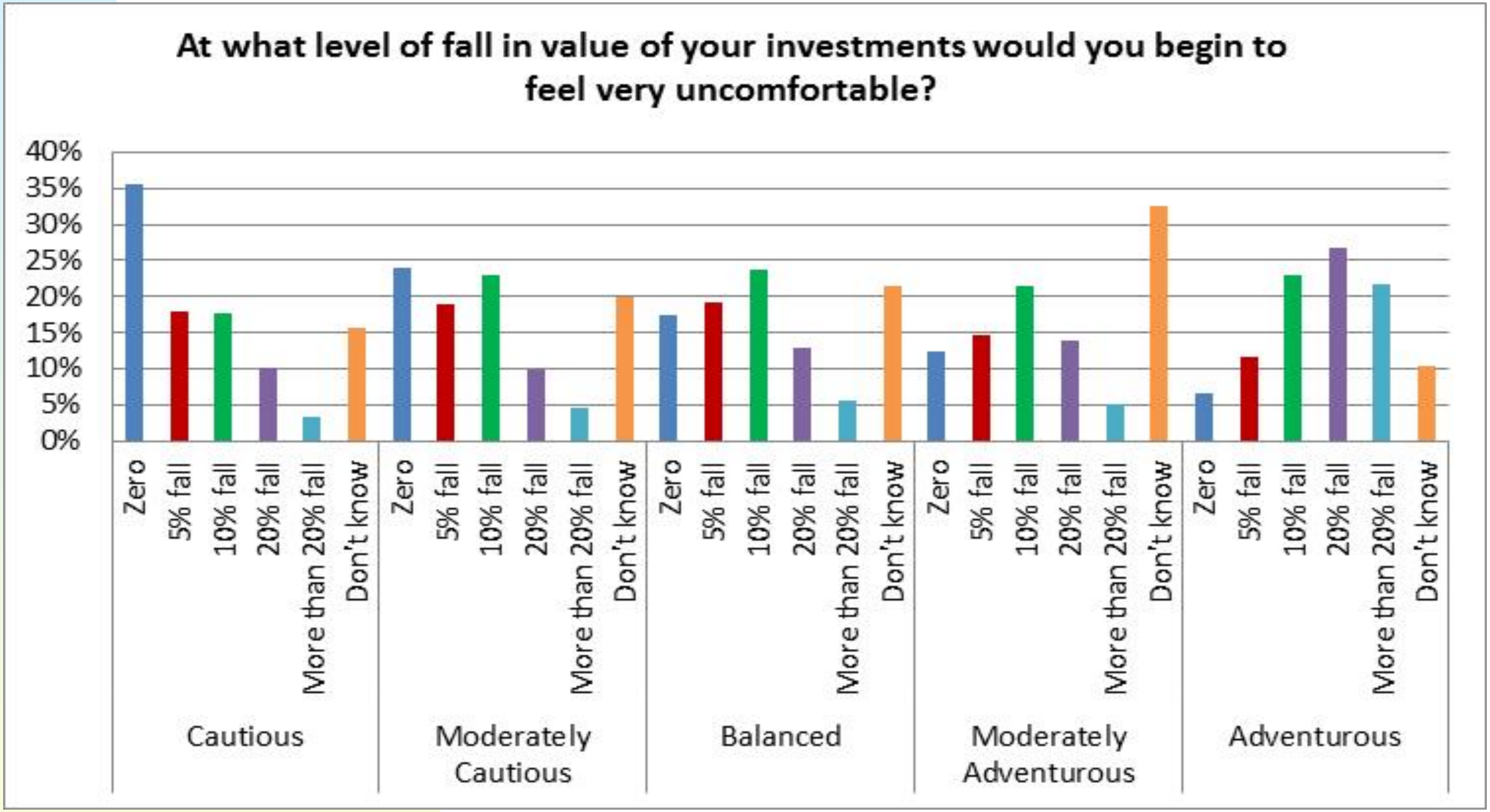
Quantifying investment risk sorted by attitude to risk

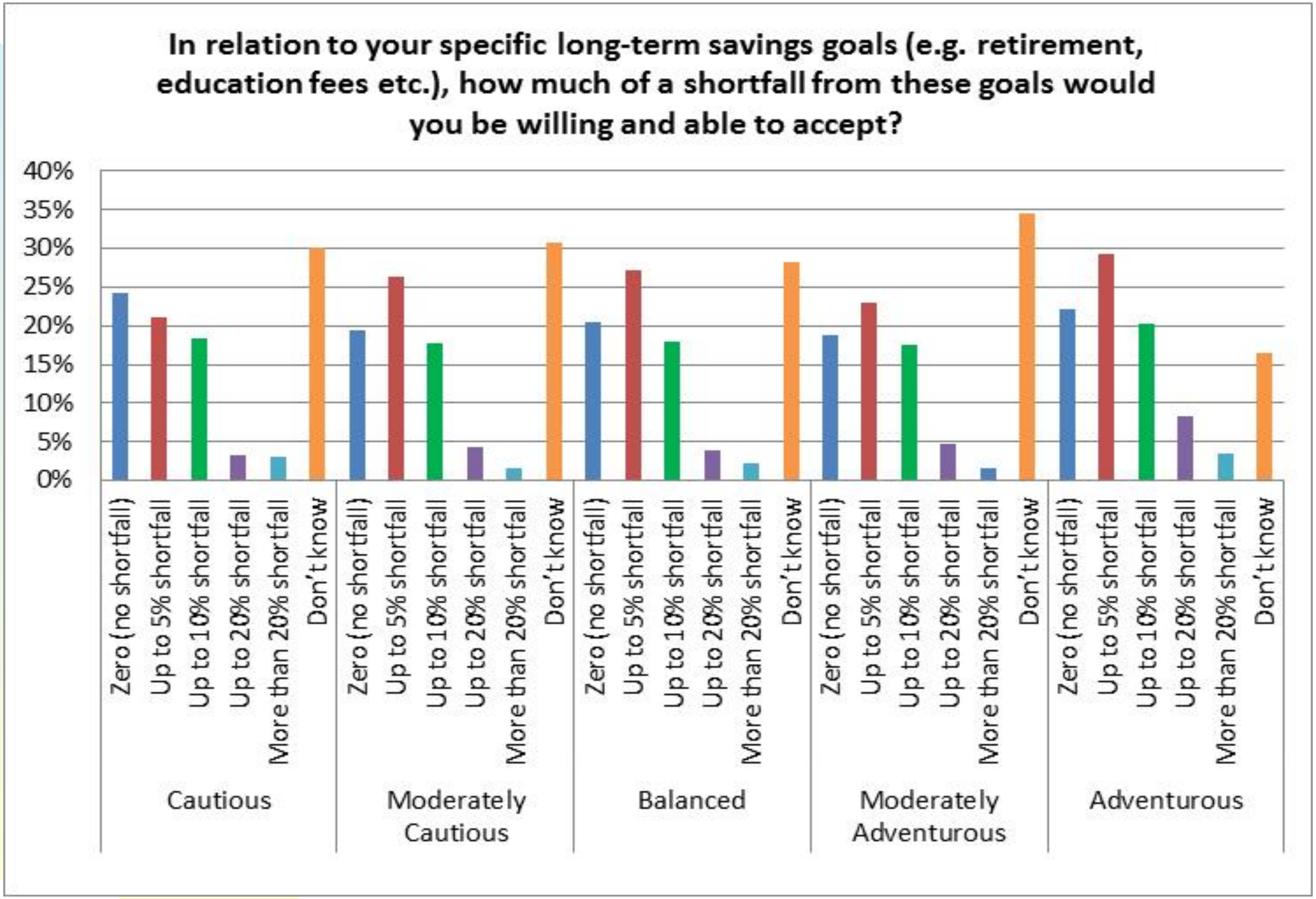


Lesson 4:

- There is a need to ensure savers are given better information about how much risk they are taking

- In respect of both savings risk and investment risk.

Quantifying long-term savings risk sorted by attitude to risk



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How are savings goals and investment shortfalls related to attitude to risk?

- In the case of adventurous investors, 27% would be prepared to accept a loss of 20%, while 22% would be prepared to accept a loss of more than 20%.
- These figures fall to 10% and 3%, respectively, for cautious investors.

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Answer: ATR cannot capture goals

- Attitude to risk is a good guide for investment risk and should be part of the process

- BUT we cannot expect to capture savings risk without referring to individual goals

Lesson 4:

Better communication tools explaining:

- Effect of inflation
- Trade-off between taking investment risk and meeting savings goals
- Investment risk is not simply the ‘downside’ of investing
- It also explains the potential value in terms of mitigating risk in relation to savings goals

  - and hence avoiding reckless conservatism.

Lessons

Better information to

- 1 Focus on savings goals
- 2 Address adequacy
- 3 Explain trade-off between
  - Investment risk
  - Saving (reduced spending)
- 4 Communicate risk in a holistic way

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Questions?

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