

6 Common Behavioral Biases when Transitioning to Retirement

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Key Takeaways

- Behavioral biases often affect investors when they're faced with overwhelming information and decisions with uncertain outcomes, such as transitioning to retirement.
- These biases can cause investors to make less than optimal decisions that can put their investments – and retirement – at risk.
- We believe that investors can improve outcomes by considering a handful of biases that may be particularly relevant when approaching retirement and using appropriate techniques and strategies to manage them.

Overview

Transitioning to retirement can be one of, if not the most stressful period of our investment lives. The shift can be filled with a mix of anticipation and stress – anticipation of finally reaching a goal you've been working and saving for, often for decades, and stress about embarking on a major life change and a shift from saving to spending. When these emotions and the decisions surrounding retirement combine, certain behavioral biases – that is, tendencies or inclinations – emerge that are often counterproductive to financial goals. We believe that being aware of them, and then developing strategies to manage them, are key steps for a retirement transition plan.

Biases tend to fall into two categories: (1) cognitive biases, or biases that arise from mental shortcuts or beliefs; and (2) emotional biases, or biases that arise from feelings without a rational explanation. Having biases is entirely human, and not all behavioral biases are bad – like our preferences for the type of food we eat or the hobbies on which we choose to spend time. But when investors are faced with overwhelming information and financial decisions with uncertain outcomes, it's important to recognize the potential for biases to lead to poor financial decisions.

For investors who are transitioning to retirement, here are common biases to be aware of and ways to mitigate them.

Overconfidence

Overconfidence is a cognitive bias where people tend to overestimate their knowledge and abilities, including the ability to make sound financial decisions. Aging subtly changes some of the ways we think and process information. Normal age-related cognitive decline can affect our attention span, ability to multitask, word recall, and the amount of information we can remember.¹ We may

not want to admit it, but in general, aging does impact decision-making. Knowing, and then accepting this, can have profound impacts on retirement.

Research has shown that normal aging may affect how overconfident people feel with their financial decision-making ability. One study of nearly 4,000 people age 60 and older found that financial literacy declines with

age, but confidence in financial decision-making does not.² The chart below shows average financial literacy test scores (green line) declining as one ages, while average confidence levels about financial knowledge (blue line) remain fairly high within a small relative range.

How to mitigate this bias: Saving and investing for retirement is one stage of our financial lives. Aging through retirement is another. Most retirees and near-retirees may not recognize the subtle changes in decision-making as they age. We suggest that it can be helpful to have trusted third parties in place to anticipate and cover for this potential. Create a [trusted contact](#) for your financial accounts, assign [powers of attorney](#) consistent with your estate plan, and use the help of a trusted advisor, as a second pair of eyes, for managing your financial assets or as a sounding board for important financial decisions.

Loss aversion

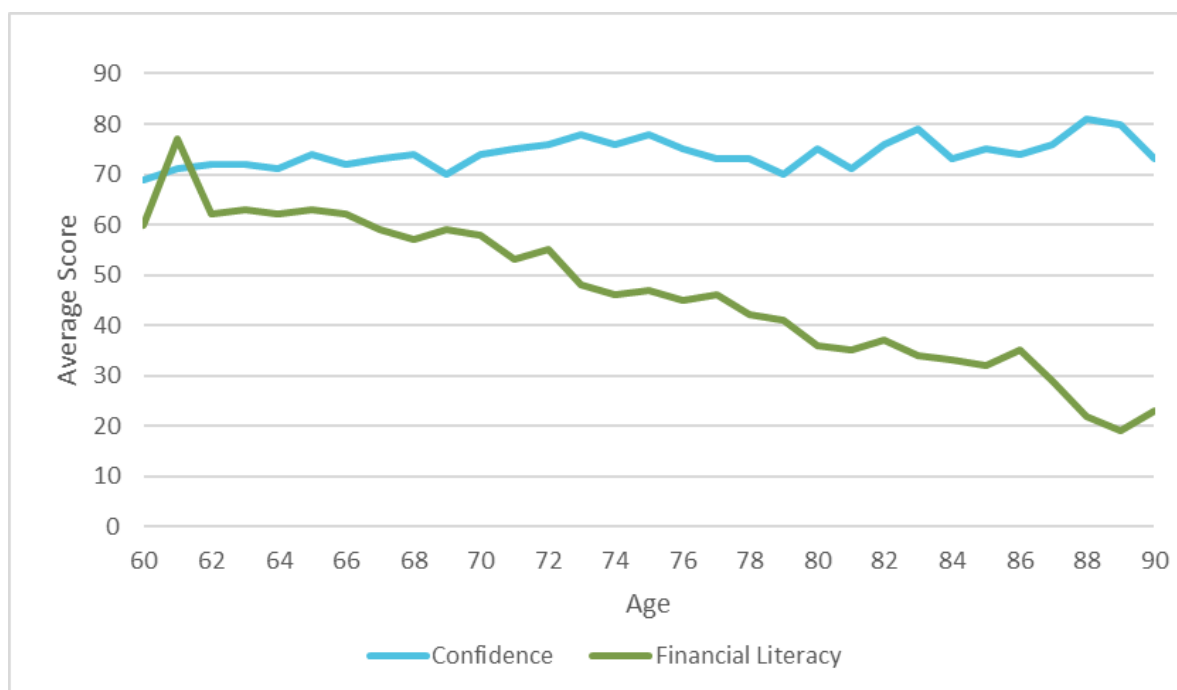
Loss aversion describes the tendency to prioritize avoiding losses over earning equivalent gains. It is an emotional bias that is prevalent in financial decision-making and it can lead to portfolios that are too conservative to provide the growth potential some retirees and near-retirees need.

Most retirees and near-retirees may not recognize the subtle changes in decision-making as they age.

Although this bias can impact anyone, loss aversion tends to increase with age. For example, one study found that investors between the ages of 41 and 55 showed more loss aversion in their investing decisions compared to those between ages 25 and 40. The fact that older investors have fewer number of years to recover from losses than younger investors was noted as a reason for the increase.³ In other words, older investors tend to prioritize avoiding losses.

While high loss aversion is understandable, the main problem with this bias is that it leads to investment

Average Decline in Financial Literacy and Relative Consistency in Confidence in Financial Decision-Making



Source: "Old Age and the Decline in Financial Literacy," by Michael S. Finke, John S. Howe, and Sandra J. Huston. Published Jan. 21, 2016 in *Management Science* 63 (1): 213-230. Also available at [SSRN](#).

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portfolios that can be too conservative or, potentially, not invested at all. We believe loss aversion may be even more of an issue for those who don't already have substantial retirement savings and may be at risk of not having enough to sustain their lifestyle during retirement. They may feel that they can't afford to risk losing a significant portion of their wealth.

Many retirees with this bias are trying to avoid "sequence of returns" risk, which is the risk that a particular series of portfolio returns will prematurely deplete their investment portfolio (see the table below). Or, they want to avoid longevity risk – the risk of outliving their money.

How to mitigate this bias: To mitigate loss aversion, investors can start building a short-term reserve of two to four years of stable, liquid assets (like cash, cash equivalents, CDs, and short-term bonds) to support expected retirement expenses in the near-term in order to weather through a potential market downturn, if needed. Or, they can bolster spending on essential retirement expenses with an income annuity that can provide a lifetime source of guaranteed income (based on the claims-paying ability of the insurance company), or a combination of the two.

We also believe that everyone should be invested, to some degree, throughout their retirement. As shown in the hypothetical example on page 4, even a conservative allocation is highly likely to outperform cash, even over a relatively short time frame.

Loss aversion is a natural – and at times, rational – tendency. But a balance between preserving wealth and growing it is important to managing wealth over a long retirement and potentially leaving a legacy.

Anchoring bias and availability heuristic

Anchoring is a cognitive bias where people rely on a certain piece of information (the anchor) as a baseline and make decisions based on that information. Any adjustments based on new information are made in relation to the anchor. A slightly different bias is the availability heuristic where people use information that is easily recalled or accessible to make decisions. Both cognitive biases commonly show up in retirement transition planning, including deciding at which age to retire.

Choosing when to retire is unique to the individual, but people often use a specific age as a reference point,

The Sequence of Returns Can Have a Significant Impact on a Retirement Portfolio When Taking Withdrawals

Year	Withdrawal (\$)	Poor Early Years		Poor Late Years	
		Return	Ending Portfolio Balance	Return	Ending Portfolio Balance
0			\$1,000,000		\$1,000,000
1	\$50,000	-15%	807,500	7%	1,016,500
2	51,250	-15	642,813	7	1,032,818
3	52,531	-15	501,739	7	1,048,906
4	53,845	7	479,247	7	1,064,716
5	55,191	7	453,740	7	1,080,192
6	56,570	7	424,972	7	1,095,275
7	57,985	7	392,676	7	1,109,901
8	59,434	7	356,569	7	1,123,999
9	60,920	7	316,344	7	1,137,495
10	62,443	7	271,674	7	1,150,305
11	64,004	7	222,207	7	1,162,342
12	65,604	7	167,565	7	1,173,509
13	67,244	7	107,343	7	1,183,704
14	68,926	7	41,106	7	1,192,812
15	70,649	7	(31,610)	7	1,200,715
16	72,415	7	(111,307)	7	1,207,281
17	74,225	7	(198,519)	7	1,212,370
18	76,081	7	(293,822)	-15	965,846
19	77,983	7	(397,832)	-15	754,683
20	\$79,933	7%	\$(511,208)	-15%	\$573,538
Average		3.7%		3.7%	

Source: Schwab Center for Financial Research. This hypothetical example assumes an investor withdraws an initial \$50,000, or 5% of their \$1 million portfolio at the beginning of the year, and then a same amount in subsequent years grows at a constant 2.5% rate of inflation. Poor returns during the first few years a retirement portfolio is drawn down can deplete the portfolio earlier than anticipated. This example does not assume taxes on investments. For illustrative purposes only. Markets generally do not follow return patterns like the example.

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like 62 or 65. Not surprising is that 62 and 65 are ages related to common retirement milestones; 62 is the earliest age to claim Social Security benefits, and 65 is the age when someone can first apply for Medicare. The problem with these ages is that people may retire earlier or later.

Another area where these biases can show up is in retirement spending. The [4% rule](#) is a ubiquitously known rule of thumb that simplifies the approach to turning retirement savings into a paycheck. The 4% rule basically states that you can withdraw 4% of your initial portfolio value at retirement, then adjust subsequent annual portfolio withdrawals for inflation. The simplicity of the rule could lead individuals to use it in their own retirement plan without considering current market conditions and their unique spending needs.

How to mitigate this bias: Recognize that your retirement decision is complex (we suggest a personalized plan and ongoing review). A simple rule of thumb is not based on your unique situation, so it may not be feasible for you, or it might even prevent you from enjoying the next chapter of your life. Use do-it-yourself tools to review a plan based on your life and financial goals or get help from an advisor. The decision to retire is not simple and requires time, analysis, evaluation, and thoughtful execution.

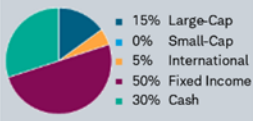
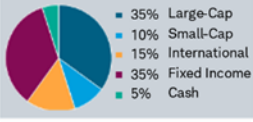
Herd mentality bias

Herd mentality is an emotional bias that describes the tendency of investors to copy the behaviors of others. It is the peer pressure of the investing world. Those who might be behind on their retirement savings or fear missing out on the returns their family and friends are getting may be especially susceptible to this bias as it preys on people's fear of falling behind or being left out.

Piling into a hot stock or cryptocurrency may seem like a good idea to make quick money, but it can lead to taking on more risk than you're comfortable with and a potentially much worse outcome if prices fall. The problem is that timing trends, stocks, or market turning points – going down as well as going up – is difficult or impossible to do in a moment, or over time. Neither investors, nor advisors, can know the final length and severity of market highs and lows until they've already passed.

Using news, perceptions, or a general sense of how markets are performing are not good [benchmarks](#) for your own needs or performance. Research has linked herding behavior to the extremes of the 2020 and 2021 bull market.⁴ Optimism led to euphoria and a feeling that prices would only go up. But the market struggled in 2022, with the S&P 500 losing 25.4% at its lowest. Some individual investments had even more severe losses.

Staying Invested, Even Conservatively, Can Outperform Cash

Conservative	Holding Period	Average Portfolio Value	% of trials beating cash	% of trials lower than initial investment
 <ul style="list-style-type: none"> 15% Large-Cap 0% Small-Cap 5% International 50% Fixed Income 30% Cash 	3 Years	\$1.18M	81%	1%
	5 Years	\$1.32M	86%	0%
	10 Years	\$1.74M	95%	0%
Moderate	Holding Period	Average Portfolio Value	% of trials beating cash	% of trials lower than initial investment
 <ul style="list-style-type: none"> 35% Large-Cap 10% Small-Cap 15% International 35% Fixed Income 5% Cash 	3 Years	\$1.23M	70%	12%
	5 Years	\$1.42M	76%	7%
	10 Years	\$2.02M	81%	2%
Cash	Holding Period	Ending Portfolio Value		
	3 Years	\$1.11M		
	5 Years	\$1.20M		
	10 Years	\$1.43M		

Source: Schwab Center for Financial Research. Based on a Monte Carlo simulation of 1,000 trials, and a starting value of \$1 million. Each trial is 10 years in length. The holding period column identifies different time periods within each trial. The simulation used Schwab's Capital Market Expectations (CMEs), which are quantitative forecasts designed to offer reasonable expectations for risks and returns over the next 10 years. Conservative Allocation: Nominal arithmetic CME return of 5.52% with standard deviation of 3.85%, converted to monthly. Moderate Allocation: Nominal arithmetic CME return of 7.02% with standard deviation of 9.64%, converted to monthly. Cash: Nominal arithmetic CME return of 3.59% with no volatility, converted to monthly.

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The chart below shows the dramatic changes in Bitcoin prices during that time frame. Those who had exposure prior to the run-up may have benefited, but those who bought in 2021 were likely the most dramatically impacted when prices came back down. In addition, the 10 largest stocks by market cap at the beginning of 2022 averaged a drop of more than 45% of their value, so loading up on the biggest names based primarily on news or trends would have hurt significantly.

How to mitigate this bias: When you start referring to friends and family as a benchmark for investment decisions, recognize that the herd mentality bias may be behind your decisions. Consider if the decision is financially in line with your goals and limit any potential investment to money you can afford to lose without impacting retirement. And work on your own, or with an advisor or professional, to create and stick to a disciplined and diversified investment plan

Endowment effect

The endowment effect is an emotional bias that is often described as a byproduct of loss aversion; it's where investors tend to value something they own higher than its market value. For example, Bobby doesn't want to sell his concentrated stock position from company ABC because that's where he's worked for over 20 years, and he feels very loyal to the company. His feeling is understandable, but it can affect what may be the best way to manage risk in his portfolio. While it's important to recognize that Bobby's strong loyalty to the company

is normal, we also suggest that it's helpful to remember that the company offered him stock as payment for his services and as a tool to help him reach his financial goals – not as a keepsake. The question to ask is: Will exposure to one or a handful of stocks continue to keep and preserve your wealth in retirement? If not, then perhaps consider alternatives that may.

How to mitigate this bias: Remember that money is fungible and that investments are a means to help families achieve life and financial goals. You can still remain loyal to a company by [holding no more than 10%](#) of an investment portfolio's value, but diversify the rest tax-efficiently based on your risk capacity and tolerance.

Overcome common biases with a plan

A large part of overcoming these biases is being aware of when and how you may be susceptible to them. An effective way to do this is to prepare for uncertainty. We believe everyone should have a financial plan, regardless of their age or amount of assets. When faced with uncertainty, individuals can fall back on their plan instead of reverting to biases or using mental shortcuts.

For investors transitioning to retirement, a financial plan can help determine an appropriate mix of assets that depends primarily on goals, time horizon, retirement income sources, and investment preferences to mitigate the different risks in retirement. Then, secondarily the asset mix depends on the investor's risk

Bitcoin Volatility During the Crypto Craze



Source: Schwab Center for Financial Research with data provided by Bloomberg. Daily data for Bitcoin/USD (value of 1 Bitcoin in USD) from January 1, 2020–December 31, 2022 were used in the chart.

tolerance (or how much investment risk they are willing to take). This helps prevent investors from succumbing to a bias that can hurt them.

Bottom line

All investors are susceptible to common behavioral biases – it's part of being human. But, when faced with a milestone as significant as retirement, and the complex decisions surrounding it, investors can be much more vulnerable to making suboptimal decisions. The biases mentioned here are especially common as investors transition to retirement. By recognizing them and having a financial plan to help prepare for uncertainty, these common biases can be mitigated.

Endnotes

1. "[How the Aging Brain Affects Thinking](#)," by the National Institute on Aging. Content reviewed June 27, 2023.
2. "[Old Age and the Decline in Financial Literacy](#)," by Michael S. Finke, John S. Howe, and Sandra J. Huston. Published Jan. 21, 2016 in *Management Science* 63 (1): 213–230. Also available at [SSRN](#).
3. "[Risk Taking in Financial Decisions as a Function of Age, Gender: Mediating Role of Loss Aversion and Regret](#)," by Muskaan Arora and Santha Kumari. Published 2015 in the *International Journal of Applied Psychology* 5 (4): 83–89.
4. "[An Empirical Investigation of COVID-19 Effects on Herding Behaviour in USA and UK Stock Markets Using a Quantile Regression Approach](#)," by Richard T. Ampofo, Eric N. Aidoo, Bernard O. Ntiamoah, Ophelia Frimpong, and Daniel Sasu. Published Jan. 6, 2023 in the *Journal of Economics and Finance* 47: 517–540.

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Common Behavioral Biases When Transitioning to Retirement

Bias	Description	How it applies to retirement transition	Example	Action to mitigate bias
Overconfidence	Cognitive bias that overestimates one's knowledge and abilities to make sound financial decisions.	Financial literacy declines with age, but confidence in financial knowledge doesn't.	You feel that your knowledge and years of trading stocks can easily translate to choosing investments that can beat the markets and sustain your retirement.	Name a trusted contact for investment accounts, assign a power of attorney consistent with your estate plan, and use the help of an advisor.
Loss aversion	Emotional bias that prioritizes avoiding losses over earning equivalent gains.	Market volatility leads to investment portfolios that are too conservative or, potentially, not invested at all, running counter to the timeline of your life and financial goals.	You did not like seeing your investments take a nosedive in the last market dip and you feel you can't afford to lose any money as you transition to retirement. You want to take it all into cash.	Consider building a short-term reserve of 2 to 4 years of stable, liquid assets (cash, cash equivalents, CDs, or short-term bonds) to mitigate sequence risk, or consider adding an income annuity that can bolster lifetime income to mitigate longevity risk.*
Anchoring	Cognitive bias to use a certain piece of information (the anchor) as a baseline to make decisions.	Investors commonly cite retirement age of 62 or 65, due to popular social programs without understanding the implications of retirement age based on personal financial resources.	You want to retire at age 62 because that's when you can start collecting Social Security.	Use do-it-yourself tools to review a plan based on your personal life and financial goals or get help from an advisor.
Availability	Cognitive bias to make decisions using information that is easily recalled or easily accessible.	Investors use easily recalled numbers, like the 4% rule, to support major retirement decisions without taking steps to personalize a plan.	You want to retire early at age 55 and you've heard about the 4% rule for retirement. Based on your portfolio balance, you think retirement is doable.	Use do-it-yourself tools to review a plan based on your personal life and financial goals or get help from an advisor.
Herd mentality	Emotional bias to copy the behaviors of other investors or follow what the masses are doing.	Following the herd during a transition can be very precarious. Timing market turning points – down as well as up – is nearly impossible.	You've seen XYZ stock triple over the past year and all your friends are talking about how much they are making. If you could double your money like them, you could retire sooner rather than later.	Consider if the decision is financially in line with your goals and limit any potential investment to money you can afford to lose without impacting retirement.
Endowment effect	Emotional bias to value something you own higher than the asset's market value.	These feelings are natural, but they can also affect what may be in the best interest to manage risk in the portfolio.	You have accumulated XYZ stock since you joined the firm 25 years ago, and with its growth, your investment portfolio has skyrocketed. You're on the verge of retiring but can't imagine letting the stock go.	Hold no more than 10% of an individual investment and diversify the rest tax-efficiently based on your risk capacity and tolerance.

Source: Schwab Center for Financial Research. * Annuity guarantees are subject to the financial strength and claims-paying ability of the issuing insurance company.

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