Tendency to select targeted retirement fund ending in zero may impact wealth

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New research shows that selecting a targeted retirement fund that ends in a zero could negatively impact your retirement savings.

The study, published online in the *Journal of Consumer Research*, identified a "zero" bias or tendency for individuals to select retirement funds ending in zero as compared to funds ending in five. This zero bias affects the amount people contribute to retirement savings and leads to an investment portfolio with an incompatible level of risk, which can significantly lower total wealth at retirement, the findings show.

Wei Zhang, Kingland Faculty Fellow in Business Analytics and associate professor of marketing in Iowa State University's Ivy College of Business, and co-authors Ajay Kalra, Rice University; and Xiao Liu, New York University, analyzed data from a global financial investment firm that included 84,600 individual accounts—nearly half of the sample invested in targeted funds. The researchers found investors born in years ending in eight or nine tend to select targeted funds that mature earlier than they intend to retire.

According to the results, approximately 34% of people born in years ending with eight or nine select early retirement funds and all of them end up worse off financially. About 29% of people born in years ending in zero through two select fund dates that are later than they plan to retire and end up better off, except for those who are risk-averse.

One benefit of a targeted retirement fund is that it automatically rebalances the portfolio over time, decreasing the percentage invested in stocks and increasing the percentage invested in bonds. This reduces the risk as the investor nears retirement.

"Targeted funds offer a 'set it and forget it' approach to investing, which is popular for consumers who don't want to navigate financial decision-making," Zhang said. "However, that initial decision of selecting a targeted plan has implications."

The researchers also looked at several demographic factors where the likelihood of "zero bias" was stronger. They found men, older people and those with higher incomes are more likely to demonstrate the bias. Investors who participated in a 30-minute financial planning program were less likely to exhibit the zero bias tendency, Zhang said.

Wealth implications

In the paper, the researchers explained how the zero bias affects accumulated wealth:

- Investors contribute less if they select a later-date retirement fund compared to the matching targeted fund.
- Zero bias exposes investors to different risk-return trade-offs: Selecting a non-matching targeted fund exposes investors to risk that may be incompatible with their stage of life.
- The extent of losses incurred by not choosing a matching targeted fund can be quite large depending on birth year.

Mitigating the bias

The findings indicate that the bias is a result of imprecise math, specifically rounding up or down to estimate retirement age. By understanding this bias and how it relates to birth years, financial advisers can better inform investors of their choices.

"Given that many individuals are choosing targeted retirement funds for their retirement portfolio, the insights from our paper will help financial service companies and consumers to improve investors' financial well-being," Zhang said.

More information: Ajay Kalra et al. The Zero Bias in Target Retirement Fund Choice, *Journal of Consumer Research* (2020). DOI: 10.1093/jcr/ucaa035

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