The wrong end of the switch

Exposing the switching behaviours of members under duress during a financial crisis: what it means for retirement outcomes and the implications for Trustees.

Griffith UNIVERSITY

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Executive summary

The focus of this paper, a joint Iress and Griffith University initiative, is on understanding member behaviour during the financial downturn through COVID-19.

The ongoing research, focused on 40,000 switches during the period 1 January 2020 - 31 March 2021, has highlighted the double-edged sword of the ease with which members can switch investment options within their super, focusing on three key questions:

1. How did the COVID-19 crisis impact the volume and distribution of investment option switches within superannuation?
2. Do the characteristics of people switching vary pre- and during the pandemic?
3. Did switching during the pandemic lead to more sub-optimal outcomes?

For context, the impact of COVID-19 on the Australian financial markets was significant. While the market index had been steadily rising throughout 2019, hitting a peak closing price (ASX200) on 21 February 2020 at 7,139, the market then collapsed 36% to 4,546 over the following month to 23 March 2020.

Taken at face value, this period of market activity offered opportunities for those to invest at market lows and generate supernormal returns, with equal risk of capital destruction for those that sold at the bottom, crystallising loses and missing the recovery cycle.

In hindsight, this seems to be a typical market crisis cycle, despite the the health crisis as a cause. Interestingly, evidence from interviews with financial advisers during the first wave in Australia found that many had clients who took advantage of market lows to invest (Loy et al., 2021). To explore this further, we examine superannuation switch data to assess the impact of actual investor decisions and the impact of these over this period.

To that end, the key findings paint a picture of the challenge ahead for super funds looking to better support members' retirement outcomes, highlighting that:

- switching volumes tripled through the pandemic
- at the worst points of the downturn, over 70% of switches had a negative impact
- 'bad' switches were most prevalent in demographic groups that can least afford it.

The common thread found to be across these factors is low financial literacy and capability levels. In respect of the key findings thus far, recommendations are:

- Trustees have an obligation to better support member financial decision making through systematically increasing their financial literacy and capability.
- Consideration should be given to the use of technology to positively 'intervene' in decision making of members potentially at risk.
- Access to quality financial advice should be dramatically improved to ensure that help is available to those who need it.

Further research is being conducted, with a full report anticipated to be available from February 2022.

Research methodology

This study[1] examines the impact of superannuation switch decisions by Australian superannuation fund members during the COVID-19 crisis. The primary research question for this study is:

Did superannuation switches lead to suboptimal outcomes during (and after) the COVID-19 crisis?
More specifically, this study explores the impact of member financial literacy on these decisions by comparing the characteristics of those evidenced in the existing literature to be less likely to make effective decisions. Three specific research questions are established as follows:

RQ1 – How did the COVID-19 crisis impact the volume and distribution of investment option switches within superannuation?
Exploring this question will establish the switching activity during the crisis period and compare this across the pre-crisis period, the initial period of the outbreak of the virus relative to the market collapse and recovery and the pandemic continued.

RQ2 – Do the characteristics of people switching vary pre- and during the pandemic?
In addressing this question, we will establish the characteristics of those engaging in switches during this period of time and compare these with the characteristics of those who are likely to have higher or lower financial literacy.

RQ3 – Did switching during the pandemic lead to more sub-optimal outcomes?
Finally, we explore the outcomes of the switching decisions and if there are particular groups who were more likely to make optimal or sub-optimal switches during the crisis and how this compares to the composition of people who made optimal and sub-optimal decisions pre-crisis.

To enable analysis of the data to address the research questions, the single switch data is broken into three time-based periods relative to the development of the COVID-19 crisis:

- pre pandemic (1/1/2019 – 31/12/2019),
- early pandemic (1/1/2020 – 10/3/20) and
- during pandemic (11/3/2020 – 31/3/21).

RQ1 is examined through descriptive statistics of the 42,680 switches in the final data set. RQ2 is examined by univariate z-tests to explore the statistical significance of differences between the members between the three periods by characteristic. RQ3 is addressed by estimating the short-term financial return outcomes of the switch decision relative to the performance of the original fund (if no switch was made) over the period of the sample.

This notionally leads to an allocation of each switch as either 'good' or 'bad'. This is then used in a binary logistical regression to determine the predictive ability of the characteristics of the single switchers.

[1]The full paper is currently under review at an academic journal and a second study is currently under way.
A full report covering the entire project will be available in 2022.

Research context

Market movements during the crisis

While the ASX200 had been steadily rising throughout 2019, hitting a peak of 7,139 on 21 February 2020, it collapsed 36% to 4,546 points by 23 March.

Figure 1 illustrates that a recovery cycle then commenced, reaching the prior February peak almost 14 months later on the 10 of May 2021 (7,172 closing value). The market then continued to trend upwards to a close of 7,534 at the end of August 2021, some 5.5% higher than the prior peak.

Figure 1 – ASX 200 over the COVID-19 period

Decision making in a crisis

Source: Market Index (2021)

Individual and household experiences of a crisis differ.

These experiences impact decision making which becomes more challenging than usual with the potential for unexpected and powerful emotions to negatively impact on decision-making abilities (Anthes & Lee, 2002) and the perception of shortness of time available to make a decision (Hermann et al., 1978).
Those with more negative perceptions of their financial situation may have more discomfort, further impacting decision making. Financial illiteracy, lack of consumer competency, and lack of financial management skills may also exacerbate financial stress and distress (Keys et al., 2020; Williams, 1982). Thus, the unique responses of individuals and households and their coping strategies, including financial strategies, are crucial in mitigating the impact of the crisis.

In terms of Australian superannuation members, what decisions they made as the crisis unfolded is of interest. While better access and control is, on the face of it, a good thing, if investment switch decisions are made in a crisis with heightened emotions and with a lack of financial information and understanding, then outcomes can be poor.

We find that this very access could be putting the retirement needs of those with lower levels of financial capability at risk. The COVID-19 induced market downturn saw substantive declines in the quality of switch decisions of some members, likely resulting in significant negative impacts to retirement savings.

Financial capability and decision making

Financial capability is a complex issue that still requires much effort to counter. Although the terms financial literacy and capability are often used interchangeably, the literature has evolved to recognise that capability is essential and thus it is not only financial knowledge that is important, but the:

knowledge and understanding of financial concepts and risks, as well as the skills and attitudes to apply such knowledge and understanding in order to make effective decisions across a range of financial contexts,

Research context (cont)

to improve the financial well-being of individuals and society, and to enable participation in economic life (OECD, 2019, p. 18).

Low financial literacy is a global problem because of its impact on the wellbeing of individuals, households and economies. A wide range of factors, including gender, age, education, socioeconomic status, location, and employment, impact on financial literacy (Klapper & Lusardi, 2020). A higher level of financial literacy is associated with improved investment behaviour, stock market participation, wealth management and accumulation, portfolio choice and retirement planning (Kumar & Goyal, 2020).

Despite Australia's overall literacy rate of 65% ranking amongst the most financial literate countries in the world, individuals from vulnerable cohorts may be more likely to make poor decisions when it comes to investing (Calvet et al., 2009). The Australian Government's National Financial Capability Strategy (2018) therefore makes a commitment to ensuring our more vulnerable members of society, women, young people, older Australians and indigenous Australians are not left behind.

Thus, financial literacy and capability are of relevance to effective financial decision making in relation to changing how one's retirement savings are invested. Investors' capabilities in this regard are put to the test during a crisis which provides heightened stimulus for action and stresses the basis upon which those decisions are made.

Research findings

1. Member switching volumes grew dramatically

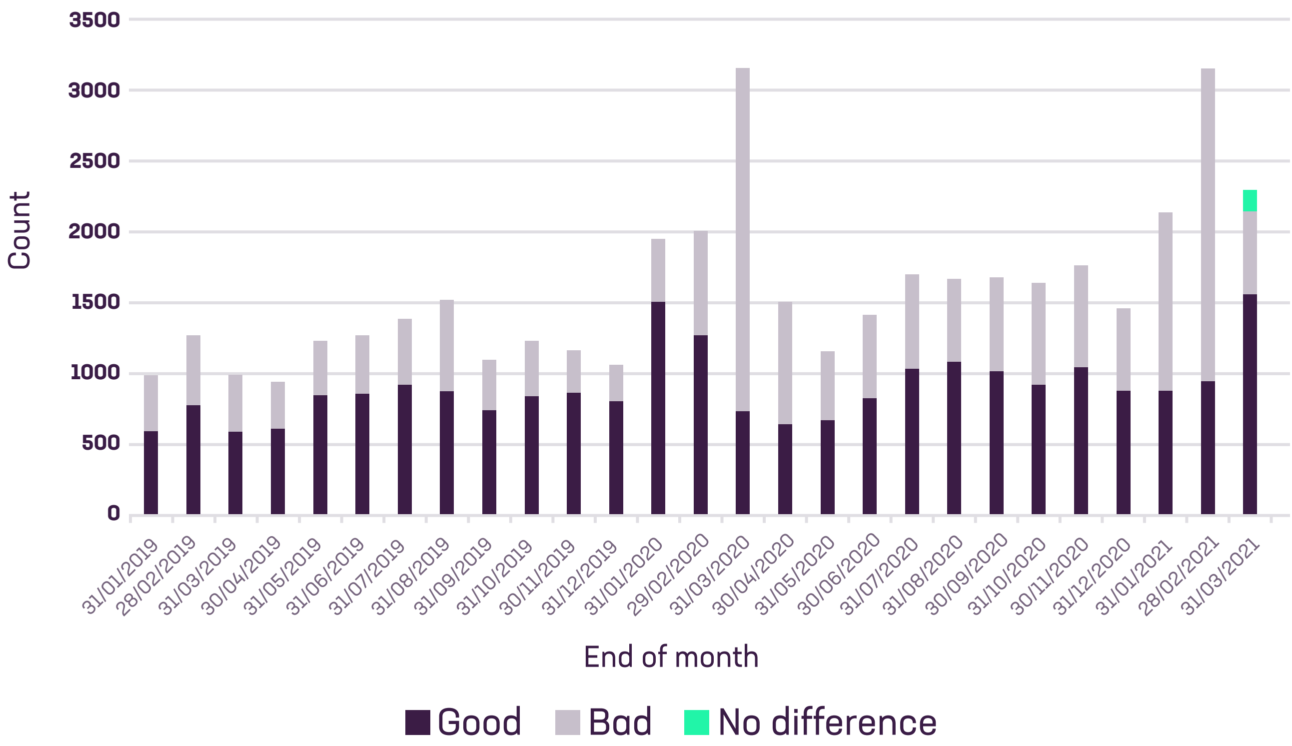
Analysis of over 42,000 single switch decisions during the period from 1 January 2019 to 31 March 2021 highlights a near 50% increase in poor switching decisions as the pandemic progressed.

'Bad' switches[2] grew significantly from 33.5% to around 50% during the pandemic (see Figure 2). This suggests that half of members who switched during the crisis period would have been better off doing nothing.

Further, it is not an isolated subset of members affected. COVID-19 saw a near tripling of members switching during this crisis, with 18% of the average member base switching compared with just 6% during the GFC (Gerrans, 2012).

In terms of the distribution of 'good' and 'bad' switches, the pre and early pandemic phases dominate the 'good' switches, while the post pandemic period contains many more 'bad' switch outcomes, signalling the heightened risk of poor outcomes during the crisis.

Figure 2 - Count of 'good' and 'bad' switches by month



[2]Defined as having a worse impact on balances over the period relative to not switching, having an average opportunity cost of -8.2% across the study.

Research findings (cont)

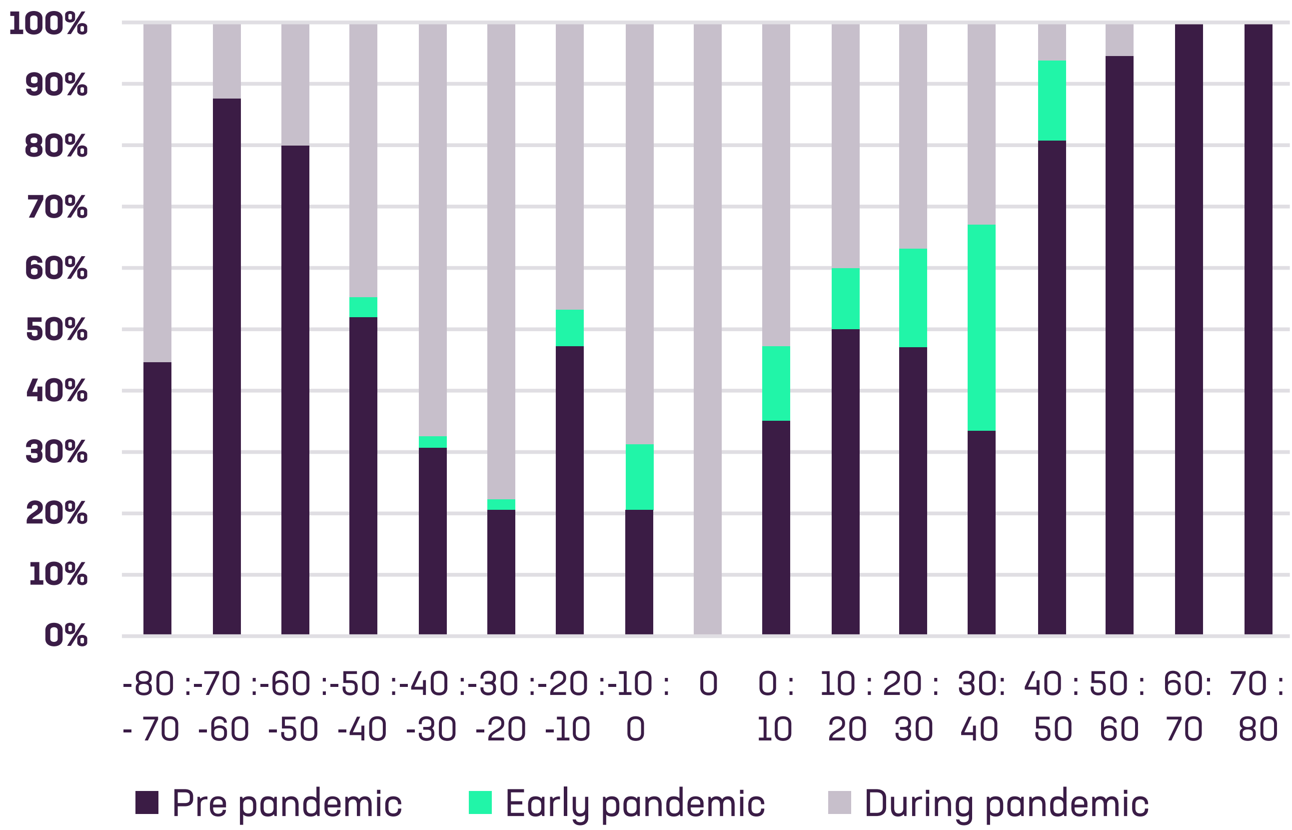
2. Convenience is a significant factor in driving behaviours

This increase in switching behaviour is posited to be directly associated with the ease of online switching access now available to the average super member, combined with heightened consumer awareness of fluctuations in financial markets, fuelled by substantive media coverage through the pandemic.

This dynamic was even further exacerbated during March and April 2020, a period of significant market downturn, when 70.4% of switches produced negative outcomes.

Compounding this escalation in proportion of bad switches, the average opportunity cost of making a 'bad' switch during March and April 2020 was -18.1%, and larger than the average opportunity cost for the period before (-9.8%) or the period after (-3.6%). This illustrates the scale and impact of switching activity during the peak of the COVID-19 induced market downturn as highlighted in the graph.

Figure 3 - Switch outcomes by share of sample



Research findings (cont)

3. Bad switches impact those who can least afford it

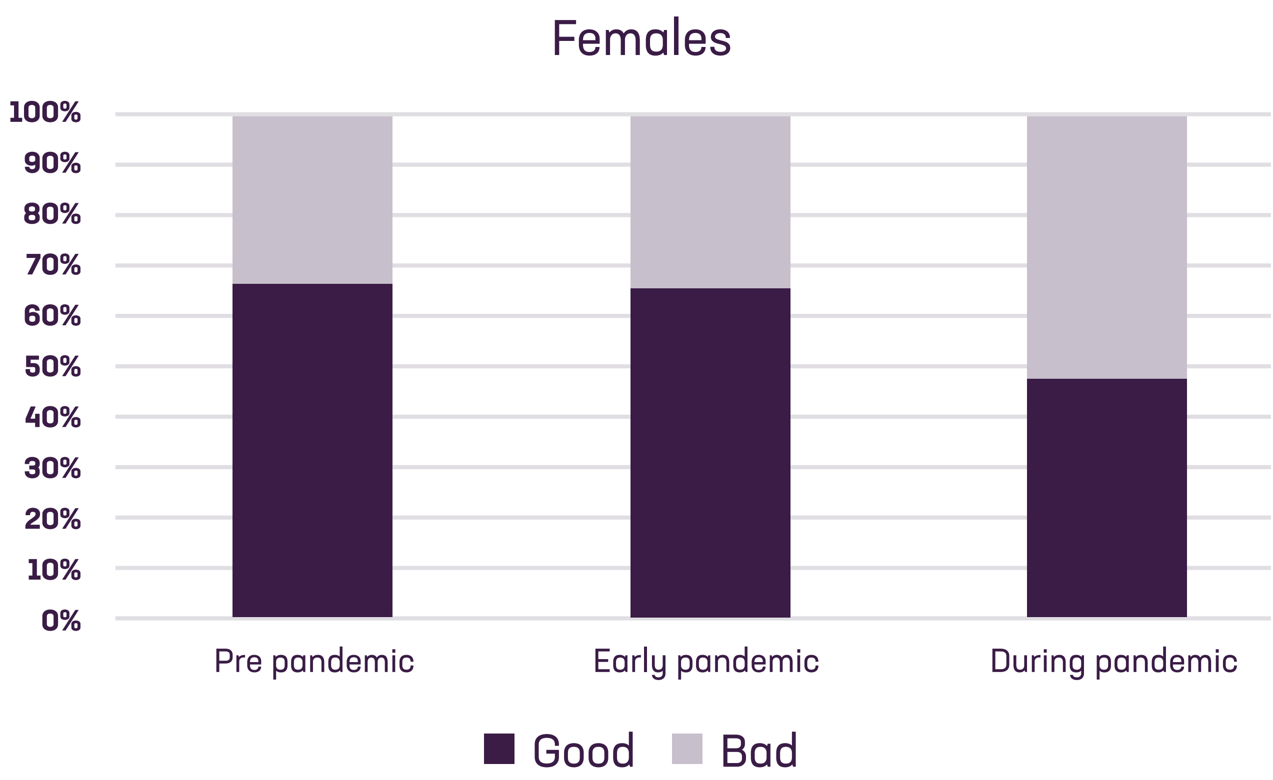
Crucially, the research identifies that those who can least afford it who are most at risk of poor switching decisions: older members with less time to make good, and women, who typically have lower balances to begin with.

Among the most dramatically affected in terms of the share of 'bad' switch decisions during the pandemic, making them worse off, were:

- **Female members** with 52.4% of switches (up 55.4% from 33.7% in 2019).
- **Mid-career (41-50 y.o.) members** with 49.8% of switches (up 90.8% from 26.1% in 2019).
- **Later career (51-60 y.o.) members** with 59.5% of switches (up 26.9% from 46.9% in 2019).
- **Pre-retiree (61+ y.o.) members** with 69.2% of switches (up 8% from an already-high base of 64.2% in 2019).

These findings reinforce prior works (see Goyal & Kumar, 2021) in highlighting that those with lower levels of financial capability are likely to have greater difficulty with financial decision making.

Figure 4 - Switch outcomes for female members



Research recommendations

Greater support required

While better superannuation switching access and financial control is a good thing, that very access could also be putting the retirement dreams of those with lower levels of financial literacy at risk. It's imperative that superannuation trustees and policymakers consider strategies to support members making more effective decisions about their superannuation.

The key recommendations emerging from this research are as follows:

1. Trustees have an obligation to **better support member financial decision making** through systematically **increasing their financial literacy and capability**
2. Consideration should be given to the **use of technology to positively 'intervene' in decision making** of members potentially at risk
3. Access to quality financial advice should be dramatically improved to **ensure that help is available to those who need it.**

As identified in foundational research *Reinvention is the New Retirement*, 2017, today, our 'lucky country' status is under real threat. The safety net is fast disappearing. The age pension today covers only a third of what is considered a 'comfortable lifestyle' in retirement.

With the maturation of the super system, with entrenched operating models, the expansion of technology as an enabler and lower levels of financial capability in some segments of the community, the financial trajectory for many is not looking good.

Calculations extrapolating out from Gen X and Y's financial position today (based on real world HILDA data), and using 5 per cent investment returns and Australia's long running inflation rate of 5.07 per cent, show that as much as 94 per cent of our population won't achieve a comfortable retirement.

This highlights even further the need for building better financial capability, protecting members at times from themselves and scaling the access to quality financial advice.

We can help

To read the full report please contact your Iress account manager or email:

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