

The Upside of Irrationality

The discoveries by Duke's Dan Ariely on how investors make decisions may transform your wealth management practice

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"We are all far less rational in our decision-making than standard economic theory assumes. Our irrational behaviors are neither random nor senseless: they are systematic and predictable. We all make the same types of mistakes over and over, because of the basic wiring of our brains."

That's the financial world as Dan Ariely sees it. A professor of psychology and behavioral economics at Duke University, Dr. Ariely has wondered for years why people often don't act in their own best interest. In 2008 he wrote about his research in *Predictably Irrational: The Hidden Forces That Shape Our Decisions*, which he updated last year with observations on the financial crisis.

As a clinician in private practice for more than 30 years, I focus on irrationality, too--specifically, on helping individuals and couples explore irrationalities around money and move toward a more balanced state of mind that I call money harmony. After reading Ariely's thought-provoking book, I wanted to know what this enlightened researcher might have to say to advisors today.

After all, we have just emerged from a period when investors were whipsawed by market crises precipitated partly by individuals who took risks with other people's money to everyone's detriment. Bernie Madoff didn't take risks; he just took the money. How did that happen, and why were so many otherwise sophisticated investors duped? Finally, what are the implications for advisors, since your clients will often not act in their own self-interest?

Here are answers to some of those questions from the *Predictably Irrational* findings.

Other People's Money

Ariely disagrees with the assumption that people who deal with large amounts of money usually make more rational decisions about it. **From investment bankers to mortgage brokers, he says, "a big part of the cause of the financial meltdown was conflict of interest."**

While Ariely believes that most people are honest, he says that bad things can happen when you place good people into conflict-of-interest situations. "Imagine that I gave you \$10 million a year if you were able to view mortgage-backed securities as a good product," he suggests. "Wouldn't you be able to see them as better than they are? Of course you would."

What's more, he adds, "when things like complex financial instruments are difficult to evaluate, it's easier for us to rationalize unethical behavior and the effects of conflicts of interest become larger. Finally, when other people around us behave similarly, conflicts of interest rule even more." In other words, if everybody else is

making no-doc loans, why shouldn't I? Ariely concludes, "I think it's inhumane to put people in strong conflict-of-interest situations and expect them to behave well."

Although we're used to hearing about shady accounting practices, backdated stock options, junkets for politicians, and drug company perks for physicians, today's dishonesty isn't just business-based. We're all vulnerable to this weakness in our own small ways, from fudging expense reports to inflating losses on an insurance claim. Interestingly, Ariely's research finds that cheating is a lot more prevalent when it's a step removed from cash. In *Predictably Irrational*, he recounts an experiment in which he first placed six cans of Coke in a refrigerator accessible to college students. All six cans were soon pilfered. He then placed six \$1 bills on a plate in the same refrigerator. By the time he ended the experiment 72 hours later, none of the cash had been taken.

Ariely concludes, "When we deal with cash, we are primed to think about our actions as if we had just signed an honor code." Think of the dollar bill, with "In God We Trust" right next to that pyramid with its unblinking eye. If we're dealing with a string of electrons instead, it's much easier to rationalize actions that aren't totally honest. "When cash is taken away--and that's what's happening to our economic system," Ariely warns, "we will cheat by a factor bigger than we could ever imagine." Talk about a wake-up call.

Escaping Conflict-of-Interest Risks

"This is a very hard time to have trust in financial advisors," Ariely says. He elaborates, "There are two kinds of trust: one is real trust, and the other is sticking a camera on someone to make sure they don't behave badly." Today, we often opt for surveillance rather than trust. For example, we put devices in our children's cars to track how fast they are going, and legislate extra supervision and regulation when people or institutions act improperly.

"Real trust is wonderful," Ariely says. But after this financial crisis, he feels that the time-consuming process of regaining it has to begin with a high degree of transparency. Unfortunately, Ariely told me, our government, legislators, and banks don't seem to recognize what it will take to regain people's confidence and trust. He keeps hoping some bank will break away from the herd to eliminate conflicts of interest and model full transparency--not just because it's the moral thing to do, but because they understand that engendering trust is the best way to solve the liquidity problem. Without such bold actions, he fears we will not escape "this economic mess."

What can investment advisors do? Moving to fee-only compensation helps reduce conflict-of-interest perceptions, Ariely says, but it doesn't solve everything. "Even with fee-only, they only get to keep the fee if they keep the client, so even if they really think at the moment that they're doing the right thing, they're biased to make the client happy." All advisors need to be transparent about how they get paid, and admit to themselves (and, if they are bold enough, to their clients) when their own vested interests are getting in the way of making an unbiased recommendation or giving honest feedback.

'Hot States' and Risk Tolerance

In these turbulent times, investing in the stock market is not for the faint of heart. "The real issue for advisors is to protect people against themselves," Ariely says. He believes advisors can do more to help their clients

truly understand how a loss would impact their life. "Imagine you come to me as your financial advisor," he suggests. "I ask how much are you willing to lose, and you say 20%. A little later I call you and say, 'You lost 20%; do you want to change your risk tolerance?'"

Perceptions of any kind of risk can change dramatically when people go from a cold state, where they tend to make sound and rational decisions, to an emotional, hot state where they're more likely to behave impulsively and irrationally. The problem is that when people get to a hot state due to losses, they act very differently than they do in a cold state, when things are more hypothetical. "Good advisors should work hard to prevent this," he emphasizes.

Ariely agrees with me that risk tolerance should be calibrated for a client's cold state, while taking their hot (more emotional and risk-averse) state into account. In one experiment, he asked male college students whether they would engage in unsafe, kinky, or morally questionable sexual behavior. Most of the men responded negatively. Before questioning them again, he showed them erotic pictures. Thus aroused, the men were about twice as likely to say they would have unsafe sex or try to get an attractive woman drunk to seduce her. In short, they themselves failed to predict how they would feel when aroused. Other passions--rage, hunger, jealousy--may similarly make us strangers to ourselves.

This story reminds me how crucial it is for advisors to help clients move from an emotionally charged state to a calm and rational one in which they can make more solid decisions. When I suggested that this transformational process can take a much longer time than merely following a client's orders would, Ariely concurred. "If advisors want to provide value, they have to earn their keep by ascertaining the part that is so difficult to figure out: how financial decisions map onto the things we want out of life," he said.

Procrastination and Self-Control

When emotions grab hold of us, we view the world from a different perspective. In a cold state, as Ariely calls it, we promise to save money, exercise, diet, and so on. But when we are in a hot state or aroused in some way, we feel that we have to have that new car, designer shoes, e-reader, etc. To help people start saving more money, Ariely came up with a creative idea: a "self-control" credit card that allows users to restrict their own spending behavior. Cardholders would set spending limits for clothes, entertainment, food, whatever. The card could be programmed to reject attempted over-the-limit purchases, or to "tax" the cardholder an amount that would be sent to an IRA, a charity, or some other beneficiary.

When Ariely presented this innovative concept to one of the major banks a few years ago, its executives could relate to everything he said about the terrible human costs of impulsive overspending. But when he went on to describe his idea, they seemed dumbfounded. Ariely argued that if one bank had the courage to offer consumers a card that helped them control debt and accumulate retirement savings, people would cut up their other cards and flock to this bank.

Despite the bankers' promise to follow up on the idea, nothing ever happened. Ariely wonders if this was due to procrastination or to a conflict of interest: i.e., the potential loss of up to \$17 billion in interest charges. He still hopes someone will pick up on it. Ariely comes back to the problem of not saving enough for retirement in *Predictably Irrational*. He blames "good old procrastination," as well as people's inability to understand "the real cost of not saving as well as the benefits of saving." Along with the self-control credit card, he favors the

Save More Tomorrow plan devised by Richard Thaler and Shlomo Benartzi. In the plan's first implementation, a company's new employees were asked to commit in advance to investing a portion of future raises in retirement savings. Since promising to change one's behavior in the future is relatively painless, 78% of those eligible took part, increasing their average savings rate from 3.5% to 11.6% over the following 28 months. Ariely calls ideas like these "free lunches" that benefit all the parties involved.

Creating Loyalty: Money vs. Mutual Aid

Another aspect of our predictable irrationality around money relates to loyalty toward others. In a purely social environment, people often make generous and altruistic choices. But the moment money is introduced; we lose our altruistic impulses and want to get the best possible deal for ourselves. This can become a problem for a business that insists it cares about its customers and/or employees. For example, when a customer is charged a fee for a bounced check, he may become furious that the "caring" company didn't help him out. If the business simply presented itself as a business, the customer would probably accept the fee as "nothing personal." A company can't have it both ways, Ariely says. "If you want a social relationship, go for it, but remember that you have to maintain it under all circumstances."

Years ago, businesses were run more on the market model: you worked 40 hours and picked up a paycheck on Friday. The exchange of labor for pay was understood by everyone, and it worked fairly well.

But as Ariely points out in *Predictably Irrational*, money is an expensive way to motivate people. Companies have discovered lately that it costs less to offer more of a social exchange. "In a market where employees' loyalty to their employers is often wilting, social norms are one of the best ways to make workers loyal, as well as motivated," he argues. Treating employees like "family" or members of a team tends to make them more "passionate, hard-working, flexible, and concerned." However, companies that model a social exchange must remember that they can't expect employees to take on more work, put in longer hours, and travel at the drop of a hat without providing loyalty in return. This means helping them when they're sick and keeping them employed when a market slump threatens their jobs.

I'm reminded of companies struggling through the present crisis who got everyone together to figure out how the "work family" could survive. Employees voluntarily cut their hours and their pay (bosses did, too) so no one would have to be let go. Think what this successful blending of social and market norms must have done for company morale!

If you have a business of your own, what balance of social norms and market norms do you offer employees and clients? Is it effective in building and sustaining loyalty?

The Paradox of Big Paychecks

After experimenting with different levels of salary and job performance, Ariely concludes that financial rewards can be a double-edged sword: "They motivate people to work well, but when these financial rewards get very large they can become counterproductive and actually hurt performance." When people start making tremendously high compensation, he explains, they are driven by the amount of the bonus, the stress involved in attaining it, and the fear of not getting it, instead of doing the best job they can.

Ariely understands the pressure banks and brokerage houses feel to continue paying huge salaries and bonuses--no one wants to be the first to cut back. He hopes for the emergence of new banks and bankers "with more idealistic underpinnings and a more realistic, more transparent salary structure" who can compete and win against older banks with overpaid executives.

Asking the Right Question

Sometimes we're so intent on acting rationally that we don't realize we've veered off into irrationality. For example, Ariely points out that during the mortgage market bubble, home buyers accepted that the key question was "How much house can I afford?" Many who believed the answer (and borrowed the maximum) have ended up defaulting. No one asked the right question: "Given our financial situation, how much should we spend on a house?" or its corollary: "How much should we borrow on a 30-year mortgage?"

Ariely says this is a lesson in human decision-making. When we can't determine the right answer to the question facing us, we often figure out the answer to a slightly different question and apply this to the original problem. If a lender says you can afford a mortgage payment of up to 38% of your income, most people accept it as an implicit recommendation that they should spend that much. In my view, this was a missed opportunity for investment advisors to proactively remind the public of the right question, and to offer their help in determining the answer.

Why Can't We Plan Better?

"Rational economics is useful, but it offers just one type of input into our understanding of human behavior," Ariely writes in *Predictably Irrational*. "Relying on it alone is unlikely to help us maximize our long-term welfare." He cites several ways our emotions can hinder us from doing what's in our best interest:

1. Relativity Error. We often think we're making enough money until we hear of someone in a similar job who earns more. Then, all of a sudden, we're dissatisfied. The only cure for this vicious cycle of "the more we have, the more we want," Ariely says, is to stop comparing oneself to others. When clients are stuck in contrasting their income, possessions, or achievements with the Joneses', I think advisors can help them see that this is a very human frailty, and that constantly trying to outdo one's peers is a losing battle. It's better to compare ourselves to more attainable people and goods, learn to be satisfied with "enough," and choose wisdom and inner fulfillment instead.

2. The "Free" Fancy. Ariely's research shows that once something is offered for free, people will stampede to get it, even if it winds up costing them money at a later date. This makes me wonder whether offering an initial session free of charge leads to a significant increase in an investment advisor's business. Ariely's experiments suggest that it does.

3. Ownership Bias. Simply put, we think what we own is worth more than it really is. Ariely finds that decisions to sell something (a car, a house) and buy a replacement are influenced by three human quirks: we fall in love with what we already have, focus on what we may lose instead of what we may gain, and assume other people will see things from our perspective. He counsels himself (and us) to "try to view all transactions (particularly large ones) as if I were a non-owner, putting some distance between myself and the item of interest." Buddhist detachment: a state of mind devoutly to be wished!

4. The "Price Equals Value" Perception. Ariely phrases this as "why a 50-cent aspirin can do what a penny aspirin can't." In the world of financial advice, this may translate into a perception that those who charge more must, ipso facto, be offering something better. Is it true? If you've been afraid to raise your rates even a little, you might try testing this irrational belief that more expensive goods and services are better.

5. The Planning Fallacy. I believe Americans' tendency to overspend instead of saving is a sign of a young, adolescent nation, unable to defer gratification in order to enjoy pleasure and security later. Ariely adds that we often can't plan well because we underestimate how long it will take to complete a task. This trips us up in deciding what we can and can't afford, and what we should and shouldn't buy. As a result, many of us don't have a cushion when the unexpected happens.

Using Predictable Irrationality for Good

As predictably irrational beings, Ariely says, "we are pawns in a game whose forces we largely fail to comprehend." We think of ourselves as sitting in the driver's seat, but in reality our decisions are limited by the tools nature has given us. If we rely too heavily on the expectation that people will act rationally, we can end up making mistakes when we design policies and institutions.

On a personal level, it's good to be vigilant about a tendency to act emotionally. "Trust your intuition only after you have evidence that it's useful," Ariely counsels. "Intuition is based on emotions, which are all about the short term; investment decisions are not."

Avoid snap decisions, and slow down the process of eliminating people or choices from consideration. Ariely suggests that when you're facing a hiring decision or deciding who to date, try testing your intuition by doing the opposite and seeing if it works out. Otherwise, you'll never know whether or not your instinct is right.

Don't be discouraged by mistakes; they're very educational. "Everybody should be divorced once," says Ariely, wryly. (He's in his second marriage.)

He also advises combining "immediate, powerful, and positive reinforcements with the not-so-pleasant steps we have to take toward our long-term objectives." An example might be watching a favorite TV show while exercising on a treadmill.

On a larger scale, businesses and policymakers could develop products and procedures that help us overcome our inability to act in our best interests, so we can make better decisions and improve our lives. In *Predictably Irrational*, Ariely quotes a Duke University colleague, Ralph Keeney, as saying that "our inability to make smart choices and overcome our own self-destructive behaviors" leads nearly half of us to early graves.

But we are not helpless. Ariely, who is already at work on a new book titled *The Upside of Irrationality*, urges us to "learn to embrace the Homer Simpson within us, with all our flaws and inabilities." By taking our predictable irrationality into account when we design schools, health plans, and other strategies, tools, and systems, we can create a better world. "This," he says, "is the real promise of behavioral economics."

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