



Financial Decision Making

The Importance of Behavioural Science

IAPF AGM

1 May, 2019



The understanding of people and their behaviour

I'm sure you have heard of and read about the science of Behavioural Economics?

We are deeply immersed in Behavioural Economics or Behavioural Science

Why?

- > Because we recognise its value in how you can better interact with people
- > How you can nudge them or encourage them to make better decisions

Influence from around the world

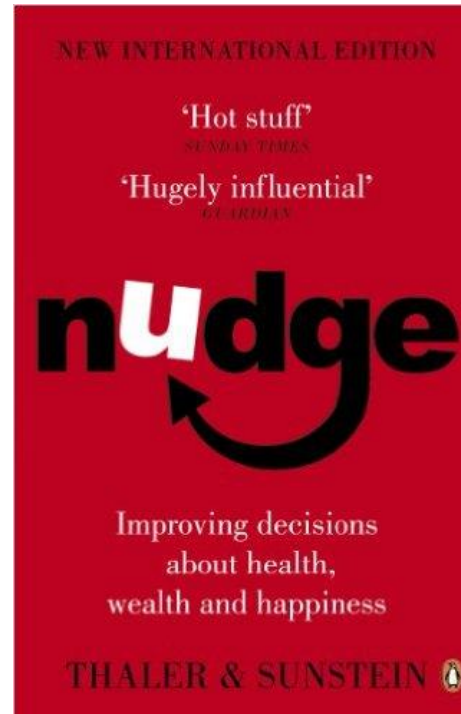


The White House
Office of the Press Secretary

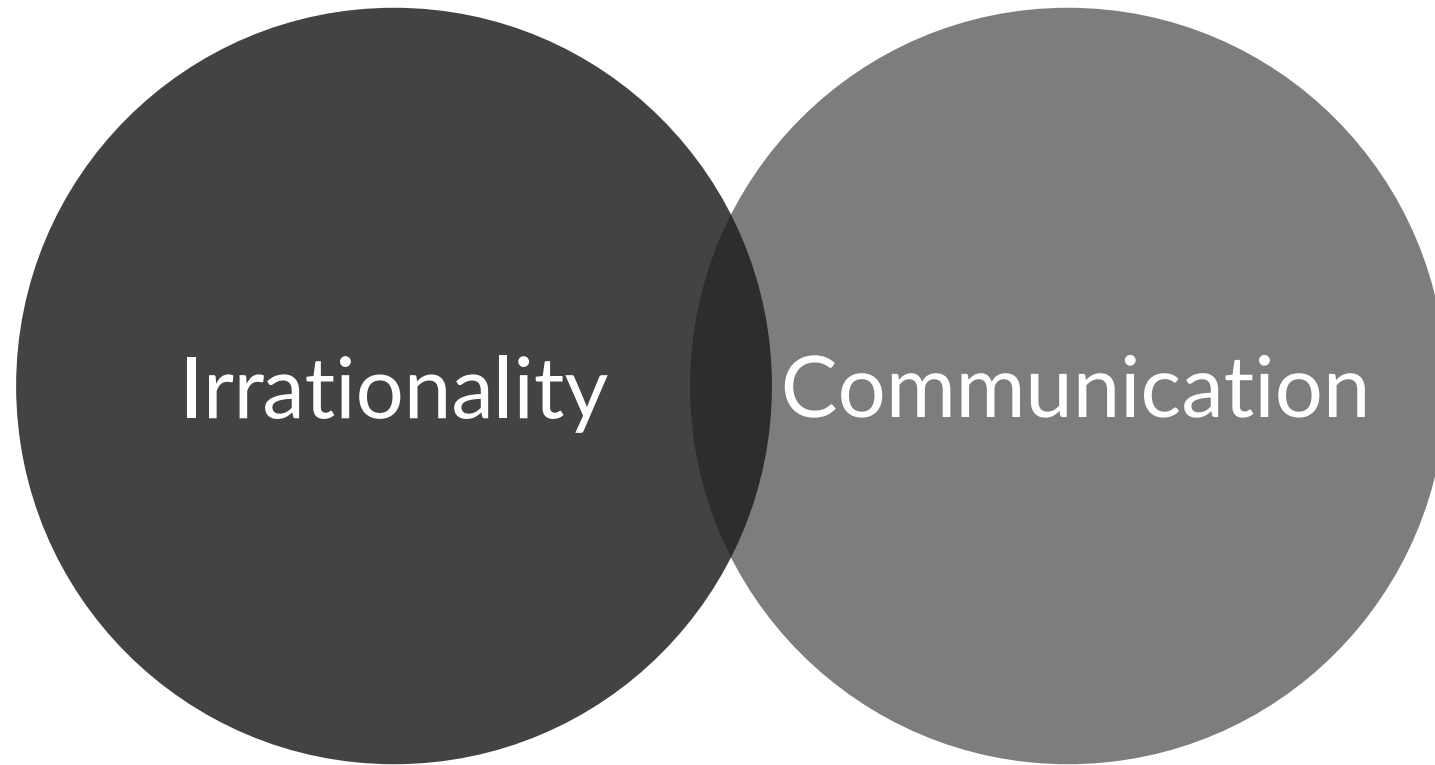
For Immediate Release

September 15, 2015

Executive Order -- Using Behavioral Science Insights to Better Serve the American People



How would they summarise it themselves?



The Transformative Power of Communication



Charlie Munger

*Vice-President of Berkshire Hathaway
Warren Buffet's partner*

"If people do not understand the science of influence then they are not at the races when it comes to communication in light of all of the changes that have been taking place"

The Transformative Power of Communication



Richard Thaler

*Recent winner of Nobel Prize in Economics
Author of Nudge*

Transformed pensions by re-framing communications

Auto - Enrolment

Auto - Escalation

The Transformative Power of Communication



The average pension contribution in Google is 10% rather than a national average of 3%



The Transformative Power of Communication

Problem

- > Reducing energy consumption

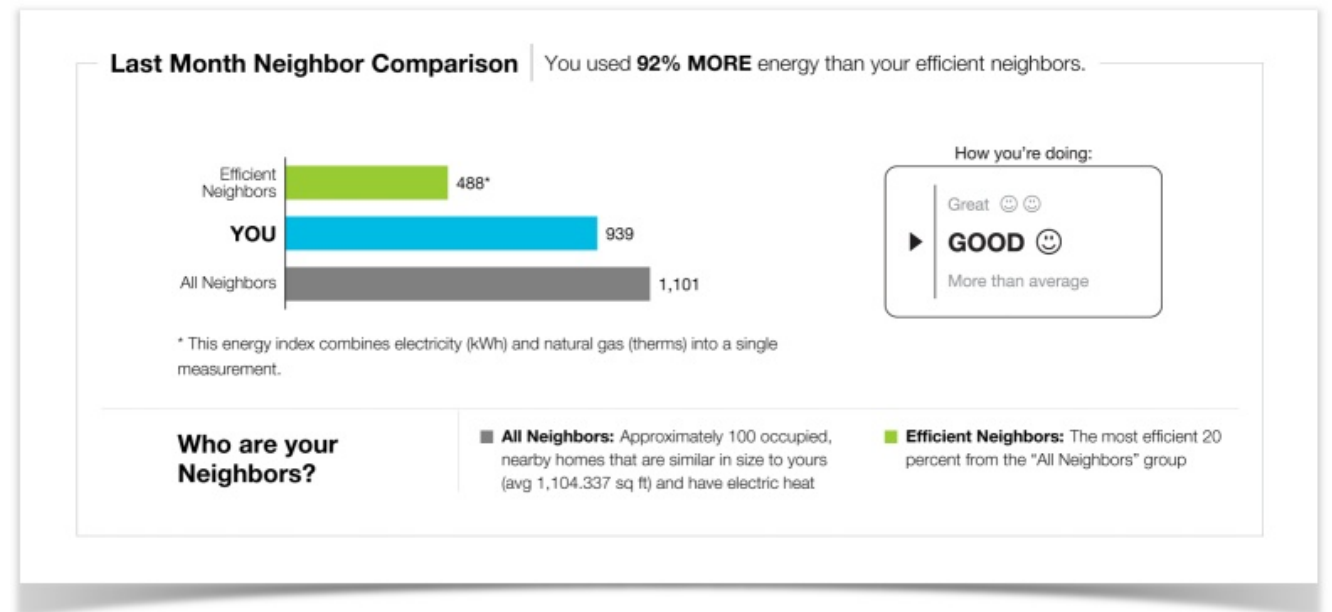
Solution

- > Reframed communications using social comparisons

Outcome

- > Reduced energy consumption by average of 2% per household
- > Saved \$75 million in energy

OP@WER



Factors at Play in your Interactions

The behavioural science research is unambiguous on these...

Too much information
Too much choice
Limits on working memory

Particular complexity
in finance
Financial illiteracy



Think (and believe) we
know more
Overconfidence

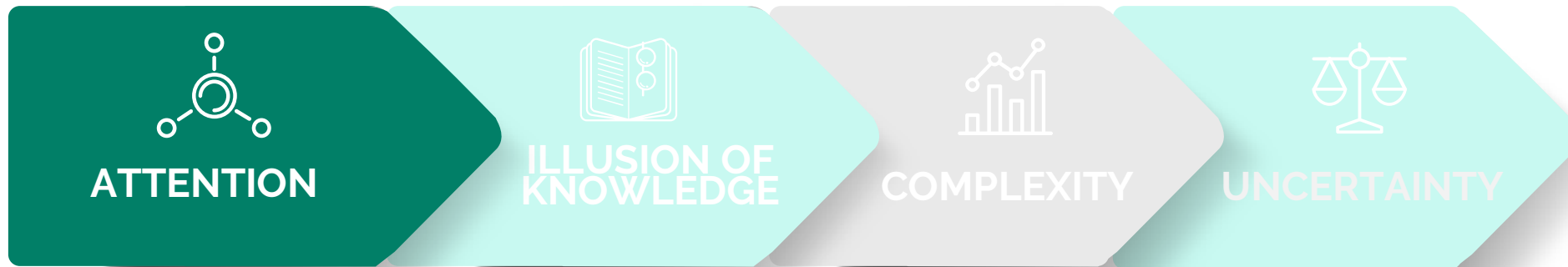
Leading to
procrastination and
stalling

Factors at Play in your Interactions

The research is unambiguous on these...

Too much information
Too much choice
Limits on working memory

Particular complexity
in finance
Financial illiteracy



Think (and believe) we
know more
Overconfidence

Leading to
procrastination and
stalling

From Dripping Tap...



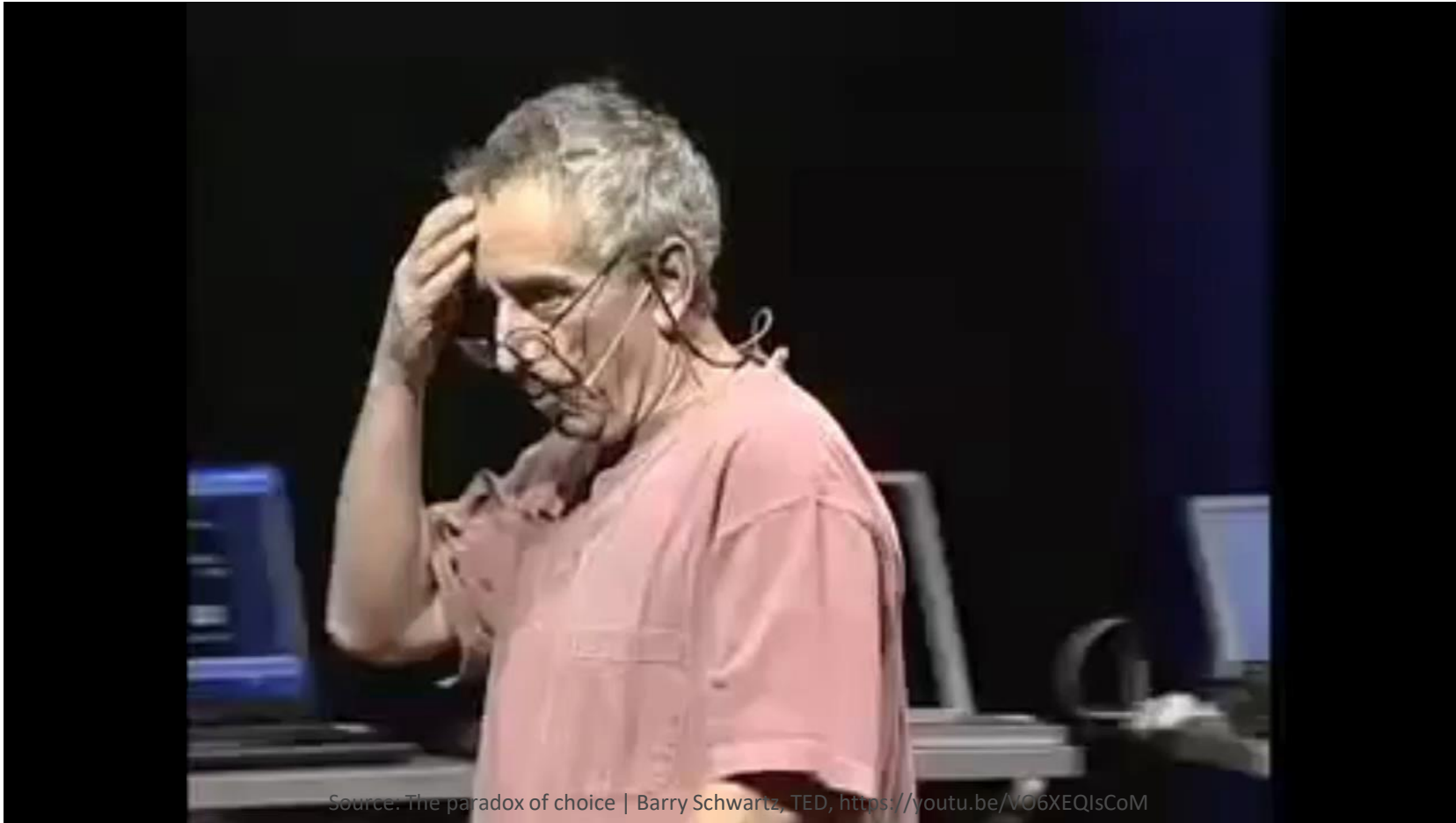
...to Fire Hose



No change in drinking capacity



The Paradox of Choice

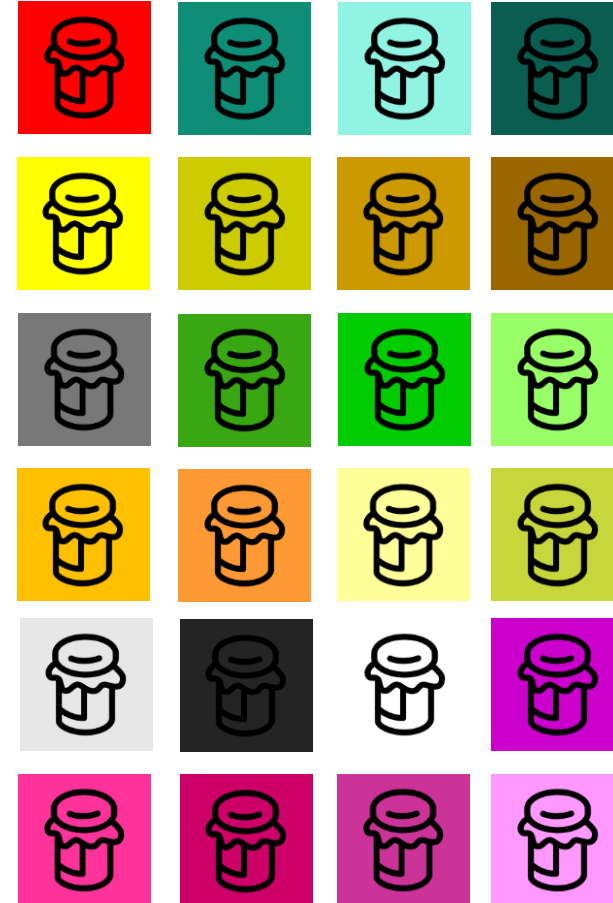


Source: The paradox of choice | Barry Schwartz, TED, <https://youtu.be/VO6XEQIsCoM>

Choice of Jam



30% purchased



3% purchased

Too much choice hinders us

We assume that more is better – more information and more choices lead us to make better choices

'While too little choice is stifling, having too many choices can be paralyzing; our bounded brain is overwhelmed, and we end up picking badly or giving up.'

Shlomo Benartzi, The Smarter Screen



Reducing the Choice Set

A large choice of mutual funds, lowered participation rates in 401(k) plans.

If there were only two funds offered, participation rates were 75%.

For every additional 10 funds, participation dropped by about 2%.



Sethi-Iyengar, S., Huberman, G. and Jiang, W., 2004. How much choice is too much? Contributions to 401 (k) retirement plans. Pension design and structure: New lessons from behavioral finance, 83, pp.84-87.

Reducing the number of decisions



“You’ll see I wear only gray or blue suits ... I’m trying to pare down decisions. I don’t want to make decisions about what I’m eating or wearing. Because I have too many other decisions to make.”

Barack Obama, in an interview with Vanity Fair

Attention and Memory

- > Professor Nelson Cowan
- > Curators Distinguished Professor of Psychology - Principal Investigator, Department of Psychological Sciences, University of Missouri-Columbia
- > World leading expert on Attention and Working Memory
- > How much can be held in working memory?



Attention and Memory

How much can be held in working memory?

Magical mystery ... **4**

'The true magical number is actually four (plus or minus one), with most tests of working memory showing that we start to miss crucial information whenever the number of bits (letters, words, numbers, colours, whatever) exceeds that amount.'

Nelson Cowan, quoted by Shlomo Benartzi, The Smarter Screen

Attention and Memory

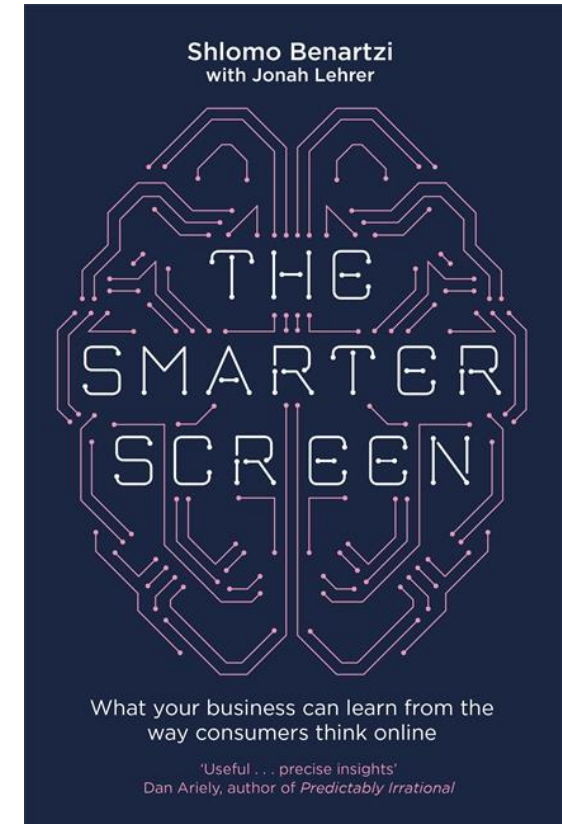
*'This is a sobering finding because we are living in a world overflowing with information, and because the mind can process only such a small amount of it, we are forced to constantly choose what to **attend** to.'*

'It doesn't matter how much data you throw up on to the screen – we can only notice about four bits of it.'

*'The rest is **noise**. Wasted pixels.'*

'The smallness of our magical number has a huge effect on how people make choices.'

Nelson Cowan, quoted by Shlomo Benartzi, The Smarter Screen



The Generation Game



Source: Bruce Forsyth's Generation Game Double Bill (2 x full shows), Snaggle Puss, <https://www.youtube.com/watch?v=us4s4Pd0abl>

Factors at Play in your Interactions

The research is unambiguous on these...

Too much information
Too much choice
Limits on working memory

Particular complexity
in finance
Financial illiteracy



Think (and believe) we
know more
Overconfidence

Leading to
procrastination and
stalling

Illusion of Knowledge



Overconfidence



People believe they **know** more



People believe they **understand** more

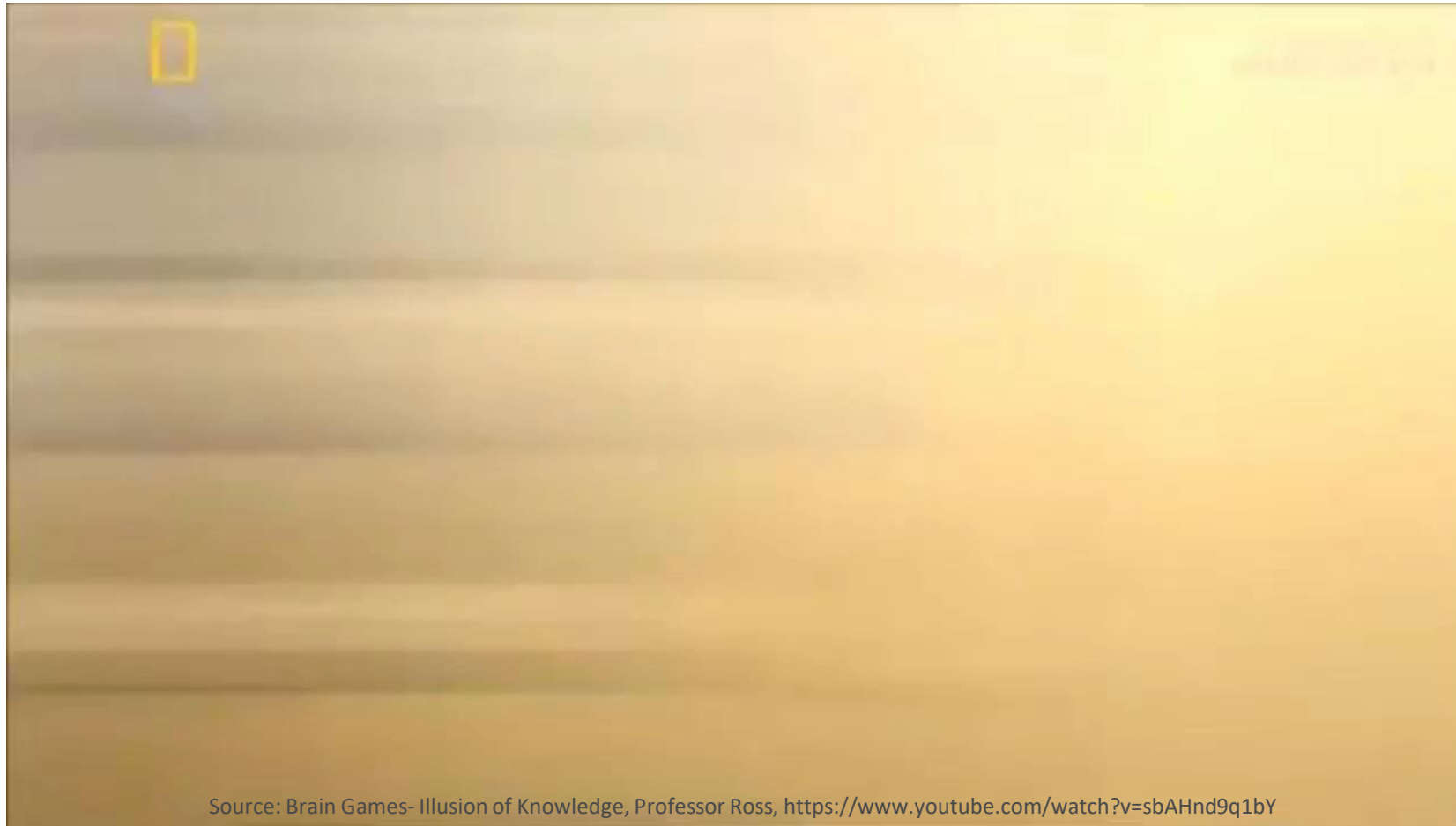


People believe they **remember** more

Bicycle Exercise



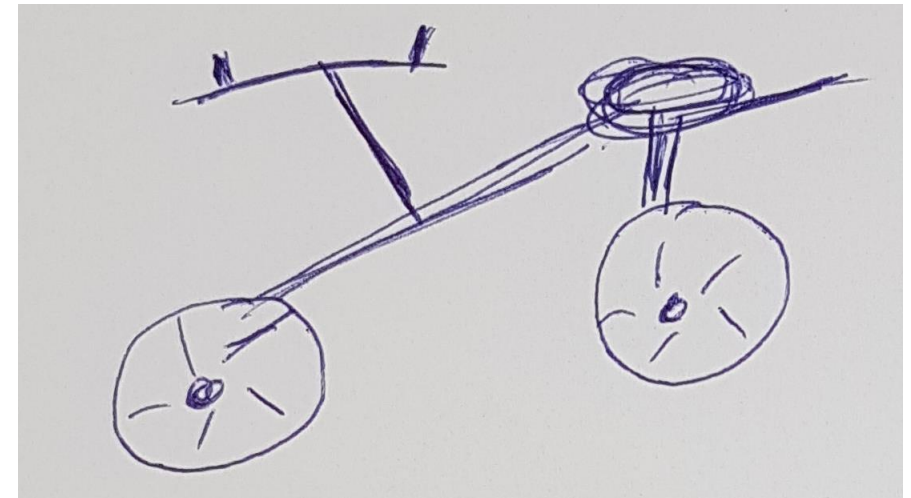
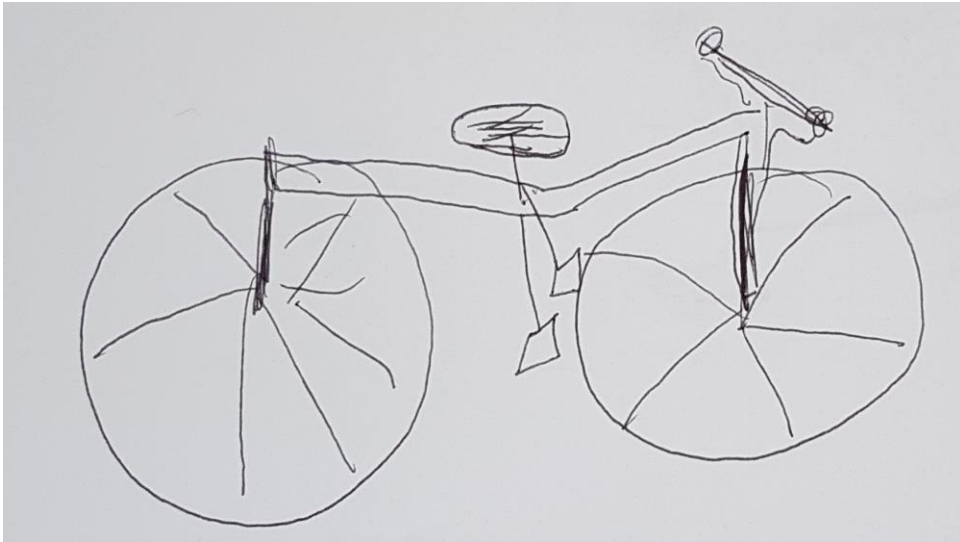
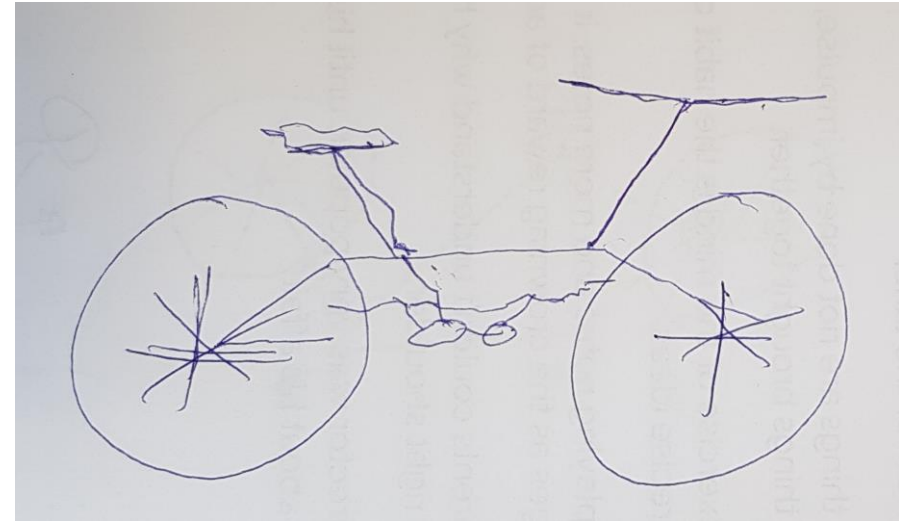
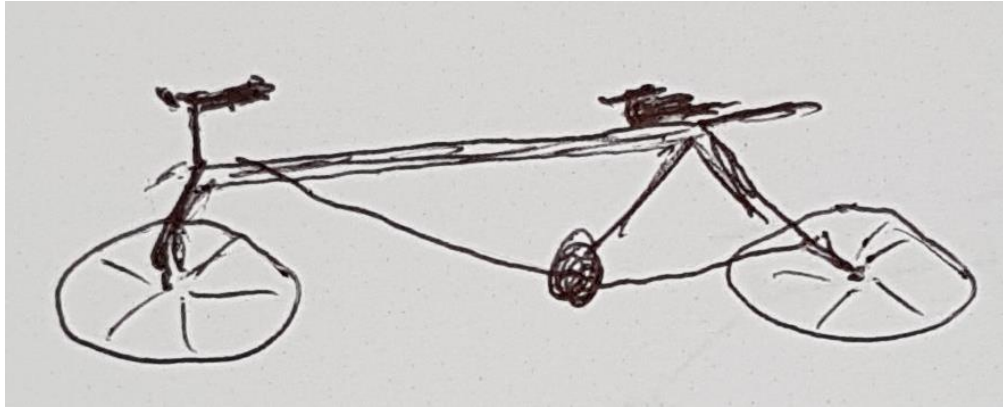
The Bicycle Test



The Bicycle Test



What others like you have drawn



Illusion of Knowledge

- > Before we even get to complex concepts
- > People don't understand simple concepts
- > They THINK they understand them
- > Until you put them to the test
- > And then they discover that they never fully understood it...

Illusion of Knowledge

'I think I know less than I thought'

Participant in the initial experiment, after completing the bicycle drawing activity

> You give clients credit for understanding more than they do, and so do they

We are overconfident in our own abilities



Overconfidence bias ... *'Perhaps the most robust finding in the psychology of judgement'*

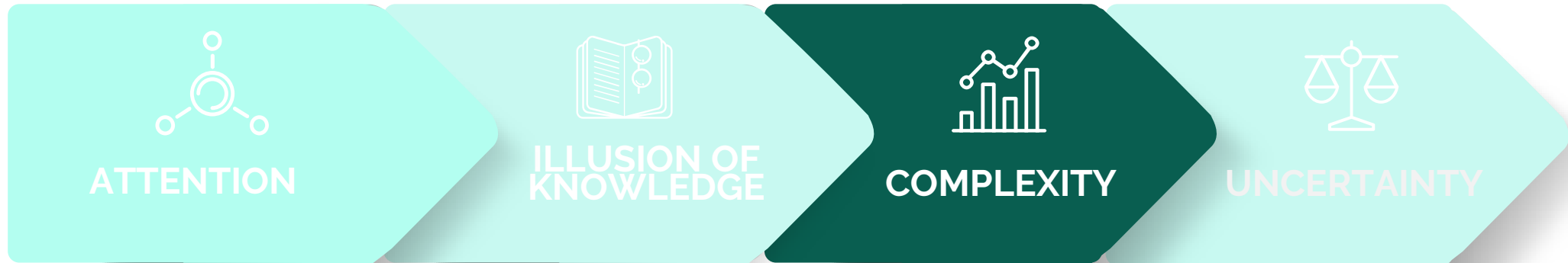
Richard Thaler

Factors at Play in your Interactions

The research is unambiguous on these...

Too much information
Too much choice
Limits on working memory

Particular complexity in
finance
Financial illiteracy



Think (and believe) we
know more
Overconfidence

Leading to
procrastination and
stalling

Financial Complexity

Research shows that all of the problems we have just described are magnified in financial decision making

*'Financial products are **abstract** and **intangible** and often have **many features** and **complex charging structures**.*

This contrasts with many ordinary products where consumers can easily understand what they are getting and the product has a single, simple price.'

FCA, 2014

Difficult Decisions

'Even hard problems become easier with practice ...

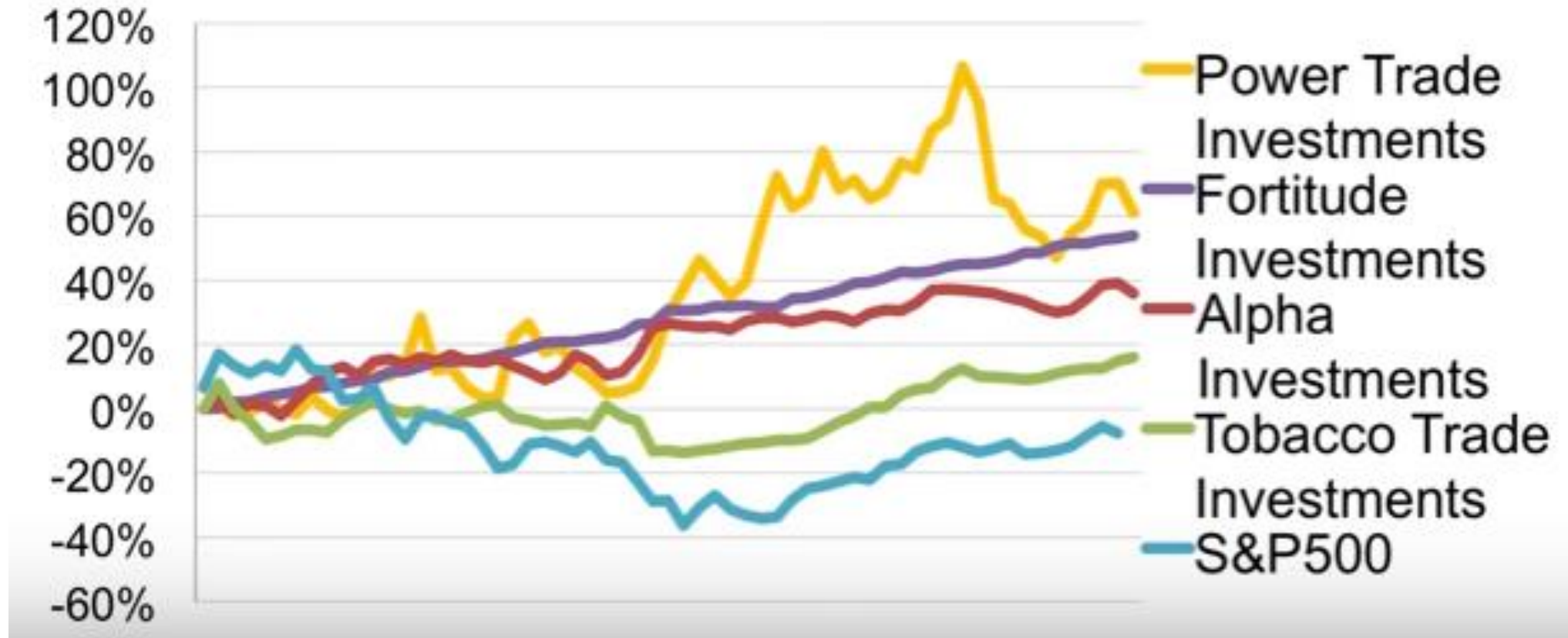
Unfortunately, some of life's most important decisions do not come with many opportunities to practise ...

'We get one chance for our retirement...'

Cass Sunstein and Richard Thaler – 'Nudge: Improving decisions about health, wealth and happiness'

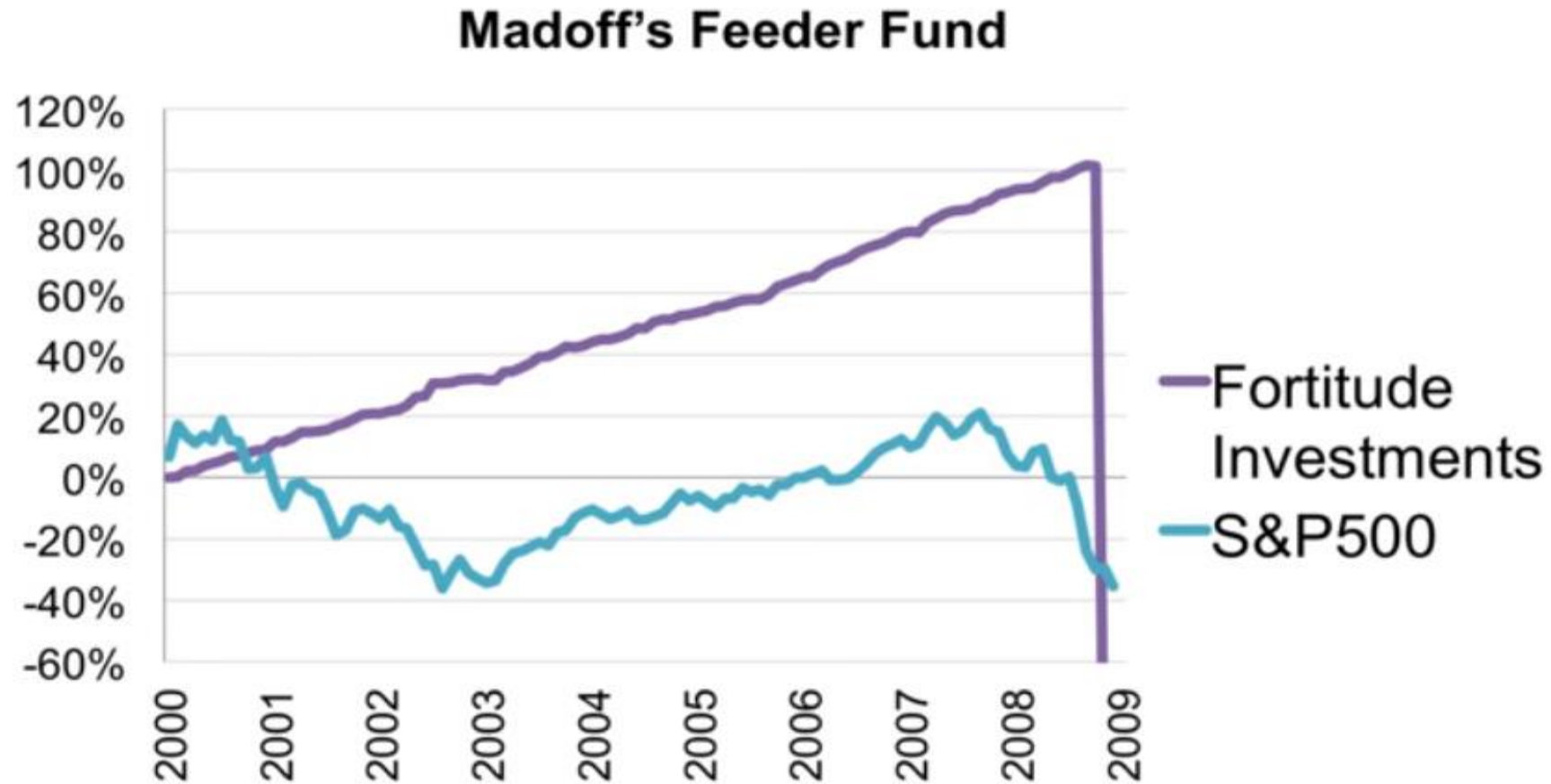


Which Fund Would You Invest In?



Behavioural Insights Team, 2015. <https://www.youtube.com/watch?v=hLkFy7etKas&t=122s>

Which Fund Would You Invest In?



Behavioural Insights Team, 2015, <https://www.youtube.com/watch?v=hLkFy7etKas&t=122s>

Which Fund Would You Invest In?

It's not that people who invested weren't smart

> Attention

- People just didn't look that closely
- People didn't take the time

> Social proof

- The number of the financial elite who signed up

Complex v Simple Concepts

- > Most people's fast thinking brain would choose Power Trade or Fortitude
- > Financial decision making is inherently complex, and even the experts get it wrong
- > Some financial concepts are more complex than others, e.g. fund selection
- > The majority don't even understand the simple concepts

Financial Literacy Questionnaire



Financial Literacy

Financial Literacy

- > These three questions are a standard test of financial literacy
- > They test understanding of three key concepts



Financial Literacy – The Big Three – Questions

- 1.** Suppose you had €100 in a savings account and the interest rate was 2% per year. After five years, how much do you think you would have in the account if you left the money to grow?
- 2.** Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After one year, how much would you be able to buy with the money in this account?
- 3.** Buying a single company's stock usually provides a safer return than a stock mutual fund.

Financial Literacy



- > These three questions are measuring the **base end** of financial literacy
 - This is the low end of understanding of your domain
- > These are not questions about different products, funds, equities and indices
- > Without these basics, they have no chance of understanding the more complex issues
- > What percentage get all three right?

Financial Literacy Statistics



Financial Literacy Statistics

*'Few people across countries can **correctly answer three** basic literacy questions.*

*In the **United States**, only **30%** can do so, with similarly low percentages in countries having well-developed financial markets (Germany, the Netherlands, Japan, Australia, and others), as well as nations where financial markets are changing rapidly (Russia and Romania).*

*In other words, low levels of financial literacy found in the United States are also **prevalent elsewhere.**'*

Lusardi and Mitchell, The Economic Importance of Financial Literacy

Financial Literacy – The Big Three – Answers

- 1.** Suppose you had €100 in a savings account and the interest rate was 2% per year. After five years, how much do you think you would have in the account if you left the money to grow?

More than €102

- 2.** Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After one year, how much would you be able to buy with the money in this account?

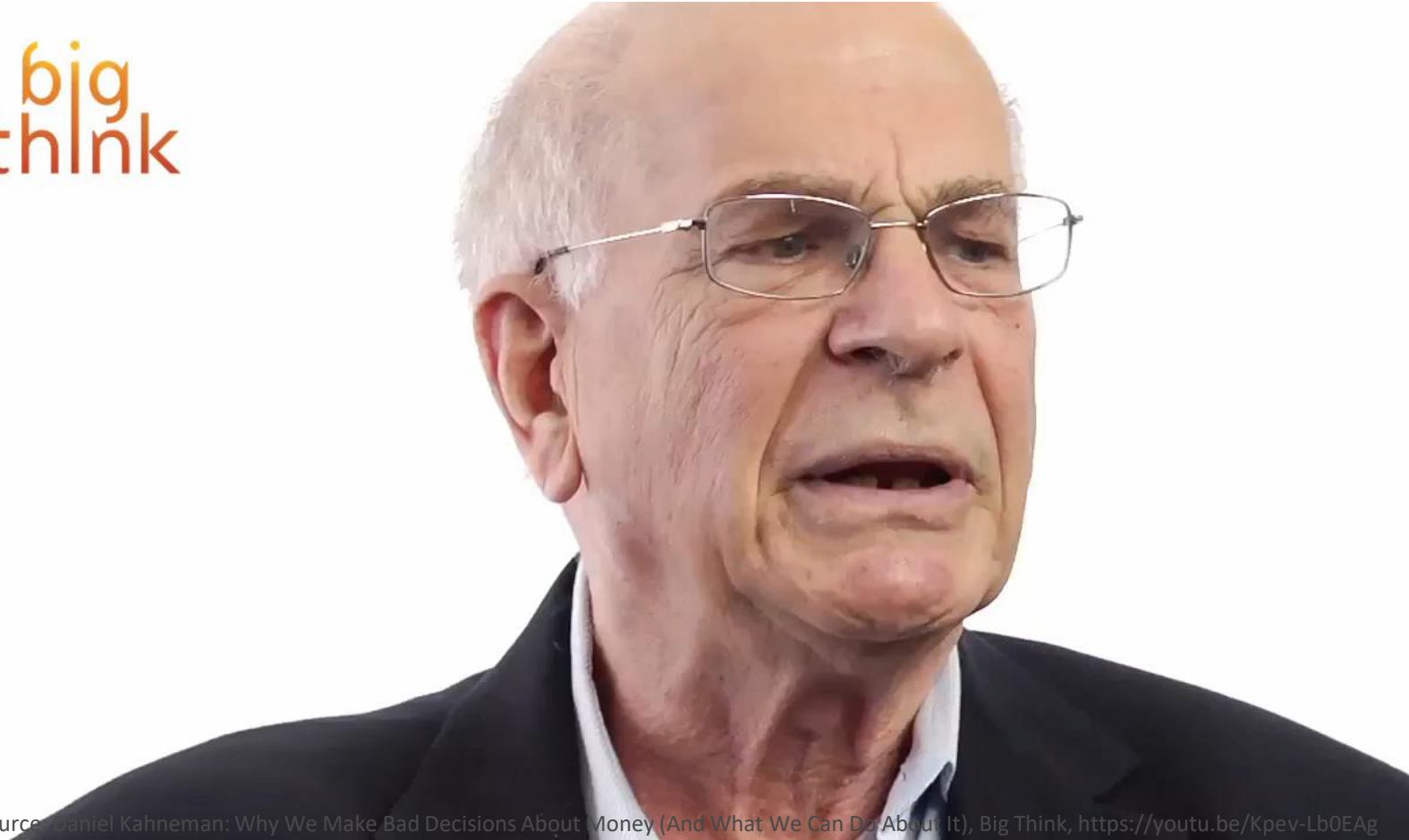
Less than today

- 3.** Buying a single company's stock usually provides a safer return than a stock mutual fund.

False

Financial concepts are inherently complex

big
think



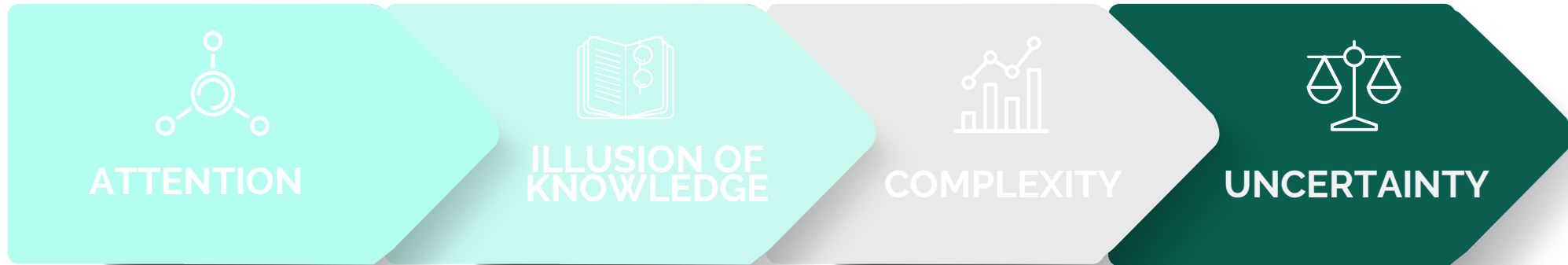
Source: Daniel Kahneman: Why We Make Bad Decisions About Money (And What We Can Do About It), Big Think, <https://youtu.be/Kpev-Lb0EAg>

Factors at Play in your Interactions

The research is unambiguous on these...

Too much information
Too much choice
Limits on working memory

Particular complexity in
finance
Financial illiteracy



Think (and believe) we
know more
Overconfidence

Leading to
procrastination and
stalling

Uncertainties Over ...

My future circumstances

What I'm committing to

What I'll get in return

The products you're outlining

That I really understand the product

The advice you're giving

What the best decision should be

“I’m not sure” – Nathan Novemsky



Source: Conquering Fear and Anticipated Regret: E*TRADE, <https://www.youtube.com/watch?v=gr13MAI1VY8&>

Factors in Communication



Core Skills for an Adviser



Ability to spot uncertainty

- Forensic listening and questioning



Ability to overcome that uncertainty

- Setting out options, with language that overcomes uncertainty and instils confidence
- Feedback and confirmation
- Following through

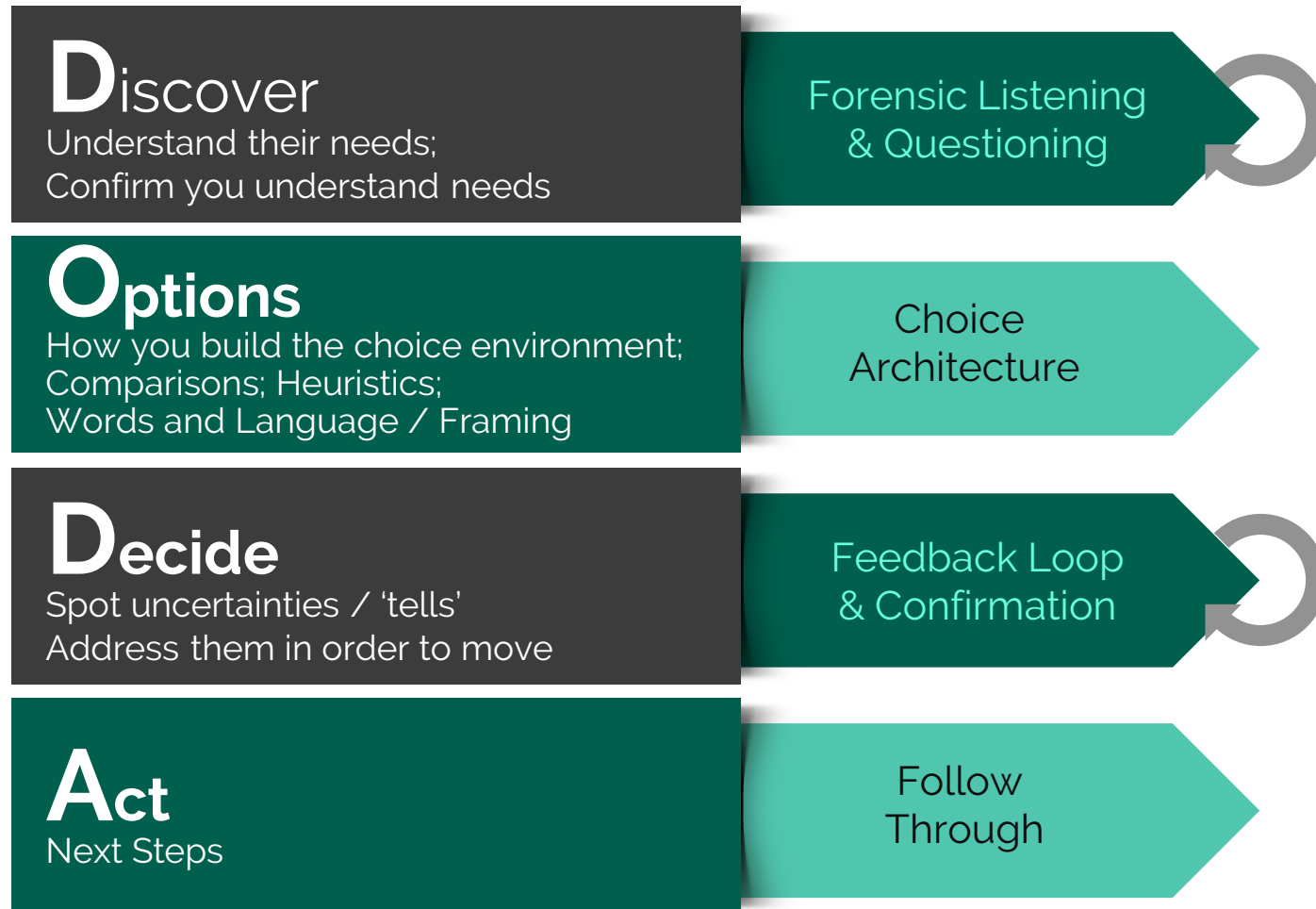


DODA[©]

Communications Model



The DODA Conversation



“A choice architect has the responsibility for organising the context in which people make decisions ...”

“Choice architects can make major improvements to the lives of others ...”

Cass Sunstein and Richard Thaler – Authors of “Nudge: Improving decisions about health, wealth and happiness”



Laying out options



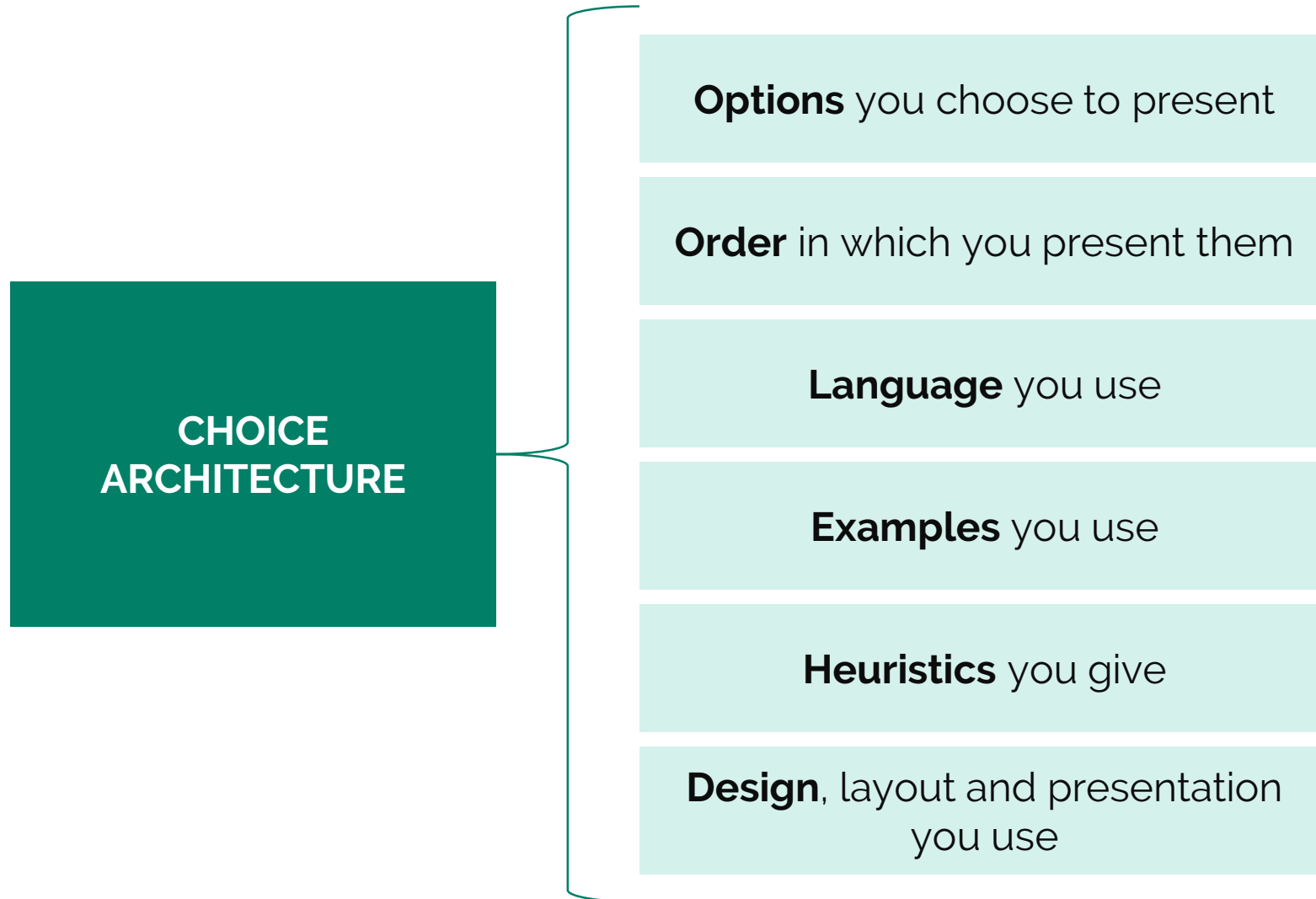
\$7



\$3

Laying out options





The future lies in Behavioural Science

What all of the research is showing is the greater than ever importance of relationships

People who can make sense of complexity

People who clearly have our best interests at heart

People who are NOT trying to sell us something

People who can 'nudge for good'

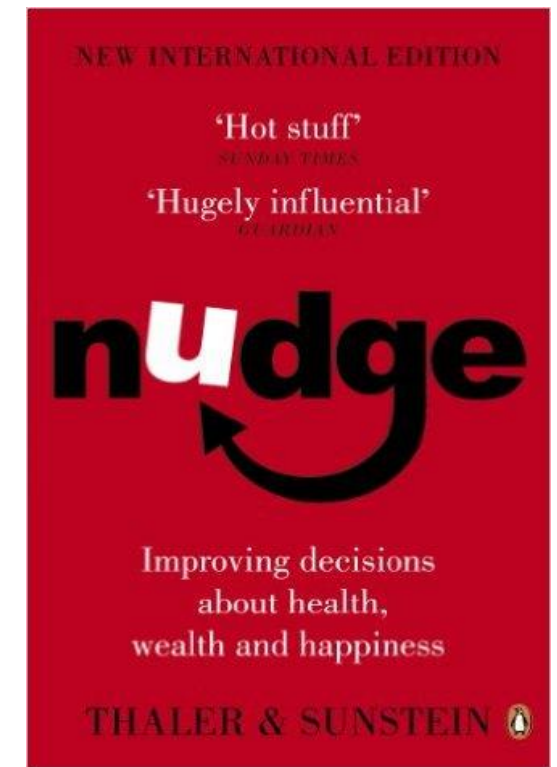
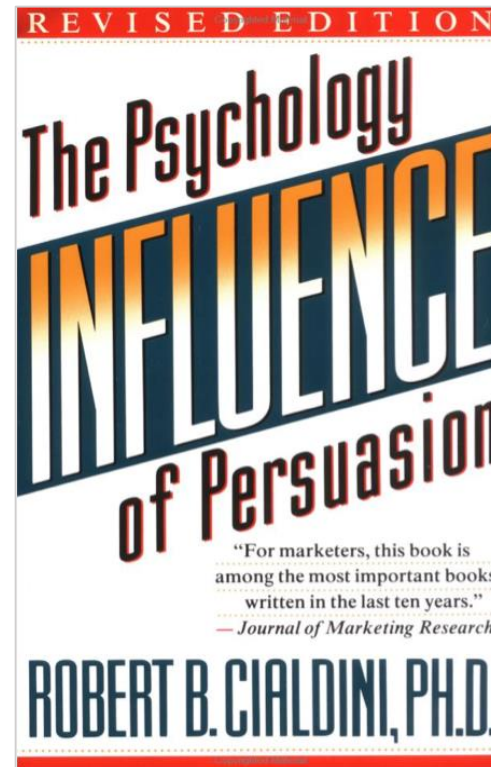
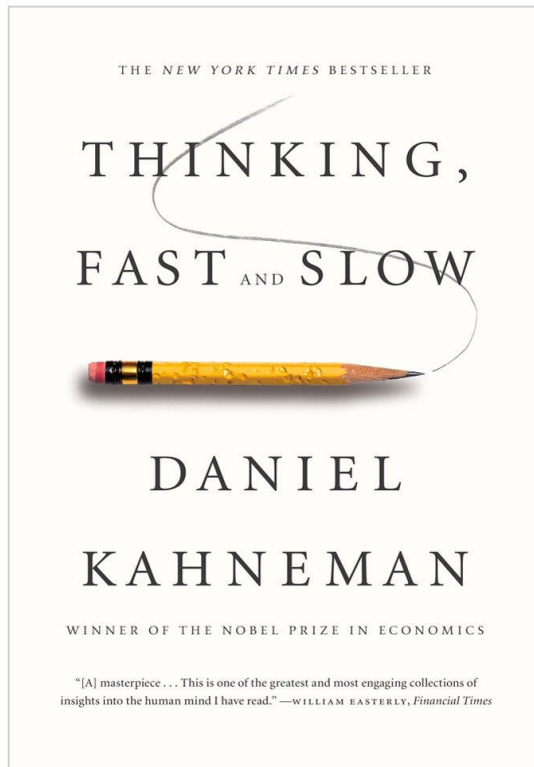
The answer, as we can now see, lies in Behavioural Science

So, what are the next steps?

How do your 'Make Conversations Count' with your customers?

- Are you asking too much of their attention?
- Are you assuming they know more than they do?
- Are you simplifying information for customers and making sense of complexity?
- Are you laying out options in such a way that leads to decisions and actions?

Some additional reading





Thank you

5 Northumberland Road
Ballsbridge
Dublin 4

(01) 772 8900
info@carrcommunications.ie
www.carrcommunications.ie