Dollars and Sense

Insights from the Dan Ariely, Mastermind Series with Duke University

Dan Ariely is the Professor of Psychology and Behavioural Economics at Duke University and is the founding member of the Centre for Advanced Hindsight. These delightful contradictions are littered throughout Ariely's work, as he explores interventions that help make people happy, healthier and wealthier. To promote his new book, co-written by Jeff Kreisler, Dollars and Sense, he recently conducted a Mastermind Series with Duke University in South Africa.

The topic of discussion was money mishaps and how they can be avoided. Ariely began his discussion exploring the reasons people are predictably irrational when dealing with matters of the purse. The short answer is rooted in complexity and relativity. The barter system helped create a simple life, with equally simple decisions. If apples were farmed but oranges were in demand, one could be traded for the other at a market where relatively few goods were available. You knew the opportunity cost of eating the apple was an orange or perhaps a fur coat or slice of venison on the dinner table. Depending on your preference, this was an easy decision to make. Enter 'money' – a fungible store of value and unit of exchange, which creates infinite possibility. Trading apples for money added the complexity of intertemporal choice (when to consume it) and the related problem of providing for future periods where crops may be destroyed (saving). It also vastly increased the opportunity cost set, because anything could be bought, even happiness, although arguably temporarily. To solve this complex problem, people needed relativity or some form of value from something else (a comparison). Unfortunately, this cognitive shortcut often leads to flawed decision making, for example, Ron Johnson (former JC Penny CEO), who decided to stop sale items and give customers an everyday low price. This sounds rational, but it turns out, when people don't have a marked-up 'standard' price to compare a sale price to, they stop buying the goods altogether. It also takes away the transaction utility that makes people feel smart for spotting and taking advantage of the sale. Ariely argues that, if Albert Einstein was an economist, his famous theory of relativity would not be stated as E=MC2 but rather \$100 > 50% off \$200.

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The million dollar question is how can Momentum 'nudge' clients through financial planners, or directly, to make better decisions? According to Ariely, providing simple and user-friendly visual toolsets are desperately needed to get clients invested in their financial decision making. The two simple rules of friction and fuel provide further valuable insight into the motives behind making decision. People don't like any friction or complexity when making choices. Food at eye level in the refrigerator is eaten first because looking up or down causes friction and complexity. The problem of insufficient organ donors is likely more of a problem with the friction in becoming an organ donor than a moral opposition. Would people still have the problem if, by default, they were all donors and opting out required a registration process? Fuel alludes to the reward mechanisms in place to validate the new behaviour required.

A quick example should tie this all up neatly. Investment planning is a complex activity. Think of a financial planner with 1600 portfolios to choose from, varying investment managers and styles, different benchmarks, varying risk-and-return metrics, etc., and then the complexity itself of guiding clients into doing the right things to deliver on their specific needs. Complicating the matter further is these metrics and measures won't necessarily point to one single or optimised solution. In the complexity theory, for example, relativity is needed and, inevitably, this adds to investment returns being looked at as the ultimate measures of relativity (a higher return means portfolio A is better than portfolio B, without necessarily understanding the concept of risk and, more importantly, understanding risk, as it relates to the needs of the client).

These insights are well aligned to some of the initiatives that are underway with the client experience interfaces that encapsulate elements of this model of thinking in the underlying advice engine. As a business, Momentum needs to steer the focus away from returns, by removing friction and adding fuel to support the desired behaviour, which may arrive in the form of higher practice valuations or greater resale values for the planner's book when outcome-based investments have been used for client investment outcomes. In this manner, the work done on an outcome-based investing 'score' rolls up the metrics that in general are aligned to clients' outcomes into a single measure of relative value in the form of a single number relating to the investment journey, relevant client risks and final hit rate or probability of reaching a target (this score is in the process of being integrated and rolled out in Momentum's advice systems that engage financial planners and intermediaries as well as end clients). Linking this to an online switch capability with straight-through processing further removes friction and, together with the fuel discussed, will change behaviour. After all, financial planners as well as clients are human and, understanding complexity and relativity together with fuel and friction will drive business growth through sustainable and repeatable investment outcomes.