

THE ADVISOR'S DILEMMA

The Complicated Art of Making Things Simple

By Sarah Newcomb, PhD, and Samantha Lamas

Everything should be made as simple as possible, but no simpler.

—Albert Einstein

The field of behavioral economics emerged from within the broader study of decision-making. Suspecting that there were problems with the “rational agent” concept in economics, Daniel Kahneman and Amos Tversky conducted a series of experiments to test people’s decision-making processes. The result was their Nobel Prize-winning prospect theory, which explains how people view tradeoffs based on a mental reference point and give unequal weights to losses and gains (Kahneman and Tversky 1979).

The asymmetrical S-curve of prospect theory was able to more accurately model and explain actual human decisions in choice experiments, and it served as the basis of other foundational concepts of behavioral economics such as loss aversion, and the endowment effect. This work gave birth to the heuristics-and-biases approach of behavioral economics, which focuses on the ways people deviate from rational choices and how to shape their environment to aid in better decision-making.

Heuristics, Biases, and Choice Architecture

Behavioral science supports the two-system theory of psychology, which states that there are two different modes of thinking, commonly labeled as System 1 and System 2. System 1 is the automatic or unconscious form of thought and System 2 is the home of deliberate and effortful mental activities. Kahneman and Tversky’s

heuristics-and-biases approach focuses on the functions of System 1. When confronted with a choice, before making any form of effortful thought, System 1 provides the mind with “facts and suggestions,” which are then used by System 2 when making a conscious decision. For an overview of this work, see *Thinking, Fast and Slow* (Kahneman 2011).

As with all processes, garbage in equals garbage out. Biases occur when the contributions of System 1 are incorrect and lead the decision-maker to the wrong conclusion. Kahneman and Tversky’s work ignited a movement toward the investigation of these biases and their effect on our lives. Researchers have now identified close to 200 behavioral biases that we resort to when confronted with four general obstacles: too much information, the need to act fast, lack of meaning, and over-complexity (Benson 2016).

Recently, behavioral scientists have identified a way to help people avoid their decision-making biases by shaping their environments. This process is also known as choice architecture. Richard Thaler and Cass Sunstein championed this process in *Nudge*, a book aimed at utilizing the teachings of behavioral science in real-life decisions.

Choice architecture is any sort of environmental change that guides a person to the right decision. Thaler and Sunstein (2009) give the classic example of changing the location of unhealthy foods in a cafeteria. Placing the desserts or vegetables first can change the consumption of either by up to 25 percent. This gives the choice architect

(in this example, the person establishing the layout of the cafeteria) the ability to encourage diners to make healthier dietary choices; the choice architect can “nudge” people in a specific direction.

The effectiveness of nudging and choice architecture has inspired myriad changes in a wide range of processes, from small business policies to government legislation.

The implementation of automatic enrollment and escalation in 401(k) retirement accounts is arguably the most successful example of choice architecture. Saving for retirement is an essential but cumbersome and complex task for most individuals. For many, just thinking about the process of retirement saving (contacting the 401(k) provider, signing up for the service, choosing the investments, increasing the savings rate) gives way to a swarm of behavioral biases that cloud our better judgment. The onslaught of confusing information forces us to resort to biases such as inertia, status quo bias, confirmation bias, naïve diversification, and more. Behavioral economists have developed a way to avoid these behavioral biases by minimizing the amount of action the person must exercise.

Using automation and defaults, programs such as automatic enrollment in retirement plans cut down on the number of decisions a person must make and are extremely effective. Thaler and Shlomo Benartzi utilized the power of automation in their “Save More Tomorrow” program, which automatically synchronizes a person’s retirement savings rate with pay increases. Participants quadrupled their savings rates

throughout the course of the study (Thaler and Benartzi 2004).

However, not all forms of choice architecture have been accepted graciously. The Sugary Drinks Portion Cap Rule implemented in New York in 2013 drew tremendous backlash. Choice architecture presents a fine line between guidance and manipulation, and some argue that the soda ban crossed that line. The legislation attempted to ban the sale of sugar-sweetened drinks in cups larger than 16 ounces, therefore nudging people into drinking less. Critics claimed it infringed on freedom of choice, and the ban was reversed by the New York Court of Appeals in 2014 (Young 2014).

The heuristics-and-biases approach to behavioral science mainly focuses on the cognitive biases, or the negative side of decision-making shortcuts. These shortcuts can be extremely detrimental to an individual. Naïve diversification in a portfolio can cause a person to reject a risk-minimizing option, or loss aversion can prevent someone from making a profitable trade-off. Much of the work in behavioral economics has focused on mitigating the damage of these biases by designing the decision-maker's external environment in a way that makes the decision easier or altogether unnecessary.

Biases and Heuristics: Bad or Good?

Biases and heuristics are simply shortcuts, or rules of thumb. Shortcuts fail us in some contexts, but they can be very helpful in others. A second school of thought in the decision sciences believes mental shortcuts may be adaptive tools that help humans make good choices with reasonable accuracy in situations with limited information or time to decide. The mental shortcut that moves us to follow the herd might trip us up when the herd is speculating on stock prices, but the very same heuristic could save our lives when several people flee a room at once.

The researchers at the helm of this work assert, "If we want to understand how real human minds work, we must look not only

at how our reasoning is 'limited' ... but also at how our minds are adapted to real-world environments" (Gigerenzer and Todd 1999, p. 21). This body of work argues that many decisions can benefit from the use of heuristics, provided that the shortcut fits the decision environment. The trick is to find the right cognitive shortcut for the right environment, because the same rule of thumb can be a hazard or a help depending on context. "Environmentally rational" shortcuts are often referred to as "fast and frugal heuristics" in academic literature. For ease, we will refer to them simply as "smart shortcuts" from this point on.

A common example of a smart shortcut is the way ballplayers catch a fly ball. Rather than calculate trajectories and probabilities, the player uses just one criteria: Fix the ball with the gaze, then adjust running speed and direction to keep the angle of the ball constant within the gaze (Gigerenzer and Brighton 2009). This smart shortcut is fast because it does not require detailed calculations. It is frugal because it eliminates all unnecessary information. It focuses on the one thing necessary to bring about the desired result.

This may be fine for catching a ball, but what about financial decisions? One famous study of a smart shortcut in finance showed that building a portfolio based solely on whether laypeople from another country recognized the name of a stock led to outperforming the market index over a six-month period. International brand recognition may be a smart shortcut for identifying profitability (Borges et al. 1999). Other researchers tried, and failed, to replicate these findings, however (Anderson and Rakow 2007), so we do not recommend building portfolios on this heuristic. The point here is not that shortcuts can always beat the market, but that not all heuristics lead us astray.

If we widen our definition of smart shortcuts to think about rules of thumb, the practical use is more apparent. Investing at least to your company's match in your 401(k), allocating assets by the 100-minus-your-age = equity percentage, and the five-minute rule (if you can't understand

it in five minutes, don't invest in it), are all smart shortcuts that help people make good (if admittedly imperfect) decisions without overwhelming their mental or emotional capacity.

A study of small business owners showed that people who were taught basic rules of thumb for accounting did significantly better than those who took a traditional accounting course in terms of business practices and outcomes. Specifically, when people have low overall financial literacy, rules of thumb may be more beneficial than sifting through all of the information (Drexler et al. 2014).

When Small Changes Aren't Enough

Default enrollment can help people start saving. Rules of thumb, such as limiting school debt to one year's expected salary after graduation or keeping one's credit balance under 20 percent of the credit limit, can help people avoid financial crises. Yet, some financial decisions don't lend themselves easily to nudges or rules of thumb. When people routinely overspend, carry large debt balances, or repeatedly raid their stores of long-term assets for items with only short-term gains, they might not be easily moved by a rule of thumb or a nudge. In these cases, it is good to remember that behavioral economics has its roots in social psychology and look to that field for answers.

Many financial decisions are influenced by our sense of social and personal identity, our propensity to plan, and our personal relationship with money itself. In many cases, money management is less about numbers and more about the stories we tell ourselves because of those numbers. Each of us has a unique history that includes financial role models, class comparisons, gains, losses, stresses, and/or privileges that has shaped our perspective about money. This personal history is incorporated into our sense of the world and colors decisions about money itself and how we interact with it (Newcomb 2016).

We understand the world and our place in it through stories and metaphors (Lakoff

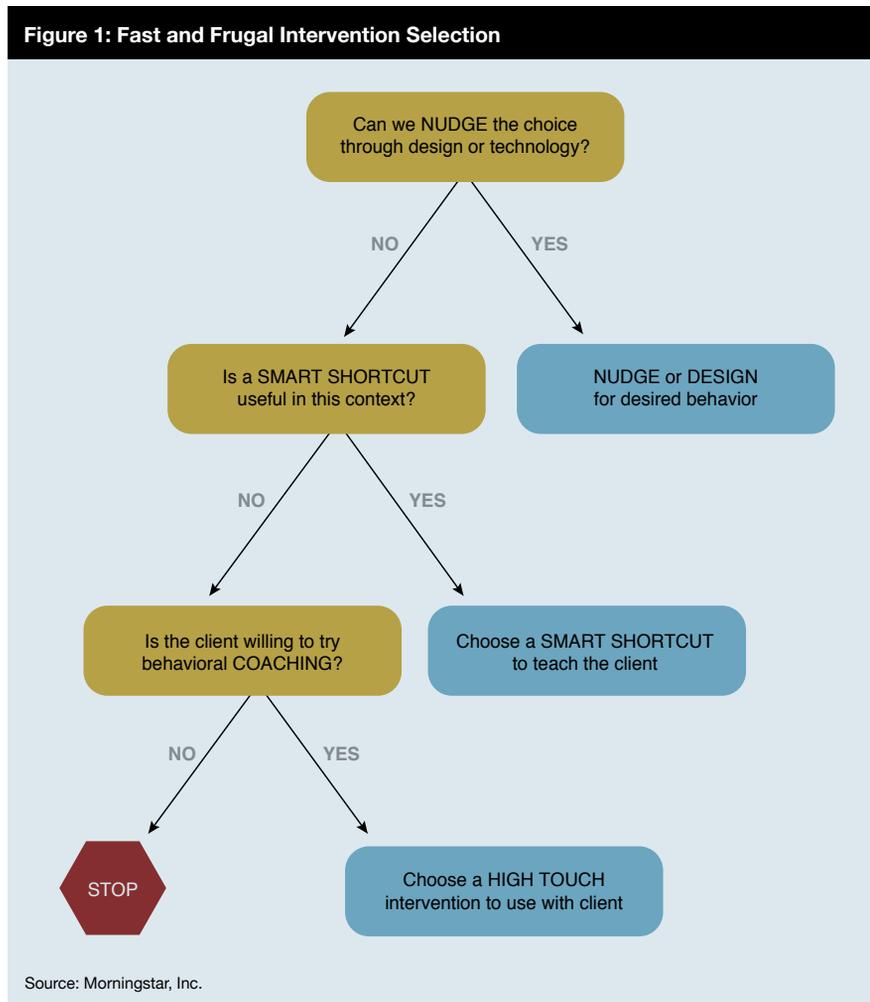
and Johnson 2003), and so the metaphors we use for money (money is power, money is the root of all evil, money makes the world go ‘round) can have a profound impact on our financial choices.

When a financial behavior does not change through nudges or rules of thumb, advisors can intervene by taking on the role of behavioral coach. If the client is willing, the advisor can use simple assessment tools to discover the possible roots of the behavior and help the client deal with the underlying issue. This is not the same as psychotherapy, but it does incorporate findings from financial psychology.

For example, many people do damage to their personal finances by prioritizing their children’s education over their own financial security. This may be due to a belief that “a good parent pays for college” or something similar. When a personal narrative leads us to poor decisions, working to rewrite that narrative may bring about change (McAdams 1993). Helping a client to rewrite the narrative above by giving examples of great parents who could not, or did not, pay for higher education (and whose children succeeded nonetheless) might help the client to reframe this belief. Replacing “a good parent pays for college” with “a good parent sets a good example of financial priorities” or “good parents help their children find ways to reach their goals” could lead to discussions about scholarships, alternative education opportunities, loans, apprenticeships, and other ways of helping children to thrive without sacrificing one’s own financial security.

In a similar vein, Morningstar’s Behavioral Insights Team has found that people who struggle to save often have a very short-term mindset. By working with your clients to extend their mental time horizons, over time they may become intrinsically motivated to save more. Other people have plenty of assets but still feel ill-at-ease with their finances, always fearing they will not have enough. These people may benefit from focusing on the power they have in their financial lives and learning to feel a

Dilemma	Dilemma Description	The Advisor’s Dilemma
Knowledge dilemma	Financial ignorance leaves clients vulnerable to predatory practices. Too much information leads to choice paralysis.	Do I keep it simple or do I give them all the facts?
Shortcut dilemma	Heuristics leave out vital information and can lead to poor decisions. Heuristics can help people make good, quick decisions.	Do I teach clients a fitting rule of thumb or do I teach them a more precise formula?
Willpower dilemma	Some changes can be made easily with good choice architecture. Some changes are difficult and take time to make.	Do I choose the path of least resistance or the path of perspective change?



stronger sense of control (Newcomb 2017). In each case, a personal narrative or a mental representation of one’s financial life needs adjustment in order to help the client make better decisions and enjoy the peace of mind that financial security can offer.

Personal narratives might not be easily nudged or subject to rules of thumb, but they can be changed, and advisors can guide that change through the use of visualization, writing tasks, and other targeted activities designed for the purpose.

The Advisor's Dilemma

Such is the state of behavioral finance: one camp teaching the dangers of heuristics and another lauding their merits. Then there are the choices that may not be suited to shortcuts or choice architecture at all—the choices that require a more hands-on approach to changing our behaviors. Advisors who wish to use behavioral techniques are left to choose the appropriate intervention for their clients' needs from a swarm of complex and conflicting ideas that overwhelm their own ability to decide, an irony that is not lost on us. The deluge of information that has come out of the behavioral sciences in recent years leads to at least three dilemmas for advisors (see table 1).

The dilemmas described in table 1 are not an artifact of faulty science or conflicting findings. They are the simple consequence of the fact that all financial decisions are not the same. Some are habitual, possibly unconscious, and can be largely influenced by the choice environment. Others require a bit of thought and can benefit from learning smart, appropriate rules of thumb. Still others are rooted in identity, society, and our personal narratives, and they may require conscious revisions to our current ways of thinking.

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Thankfully, when we examine the field as a whole, there is a smart shortcut to help us through the fog.

The decision tree shown in figure 1 assumes that less is usually more. If you can guide the client's behavior without having to resort to long conversations and high-touch interventions, all the better. Automatic savings accounts, default enrollment in 401(k)

plans, automatic increases to savings every year, etc., are examples of nudges that can eliminate the need for more time-intensive interventions. If you cannot nudge the best choice but a rule of thumb can bring about a good outcome, by all means use it. If, however, the problem persists despite these measures, or the situation is not suitable for nudges or rules of thumb, then advisors can guide willing clients through the process of perspective change. Lastly, if the behavior cannot be nudged, there is no useful rule of thumb, and the client is not interested in coaching, then stop. Without a willing participant or a tool of choice architecture, it is not a productive use of your time.

Conclusion

Decision science is a vast and complex field of research, but real-life decisions often benefit from simplicity. To date, science has not been able to prove that financial decisions benefit from utilizing all available information. Advanced modeling software has yet to be able to consistently outperform market index funds, raising questions about the usefulness of complexity in making financial decisions. Providing consumers with thick prospectuses and technical data does not necessarily improve their ability to make good investment decisions. On the other hand, nudges, smart shortcuts, and

rules of thumb have shown great promise in helping people reach their financial goals.

Advisors create value by taking the complex world of finance and making it simple and approachable for their clients. Ironically, the ongoing research in behavioral science can sometimes make this task more difficult by adding to the complexity of the financial information landscape. We have done our

best here to distill this labyrinthine field of work into a framework that is clear, practical, and useful for you and your clients. ●

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