

Understanding Behavioral Finance- Rationality & Decision Making

January, 2011

Dear friends,

Behavioral Economics explains how the process of decision making functions among common people. It elaborates on the role of emotions and vision. Do you want to know how powerfully illusive our vision is and how it dominates our decisions? Refer to “We are all Predictability Irrational - Dan Ariely” on YouTube link:

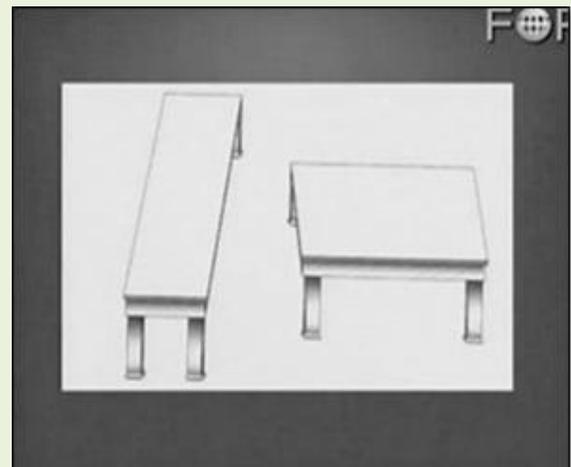
<http://www.youtube.com/watch?v=JhjUJT2i1M&feature=related>

Here, we present a short summary of the talk by Dan Ariely by extracting the important pieces of his experiments from the video. Each experiment emphasizes on important aspects of our decision making process. Please read through these pieces while answering the following questions and note the difference between your answers and answers provided.

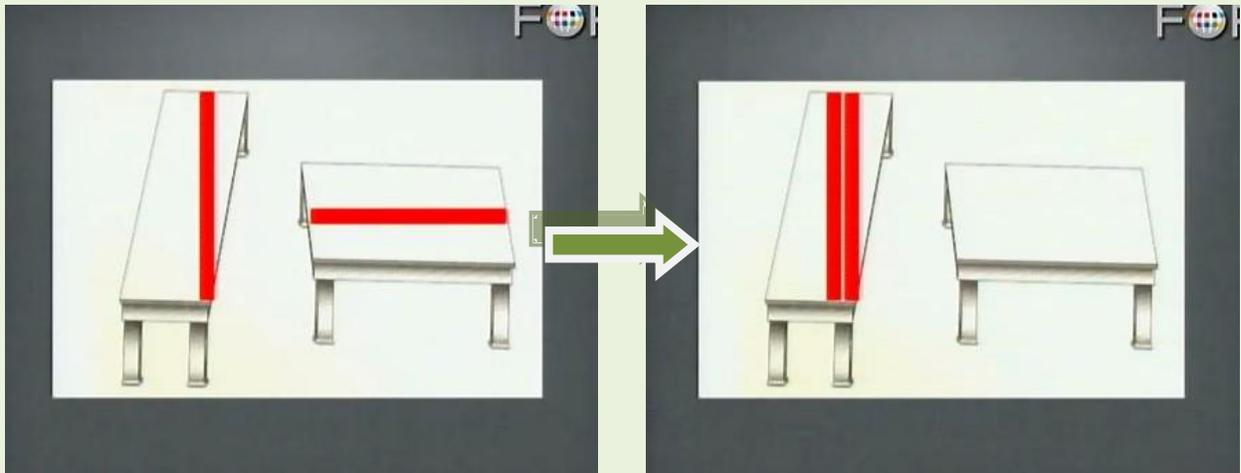
1. Visual Illusions

“Look at the two tables, try to figure out which one is longer?”

You may think that it’s obviously the left one, just based on your vision.

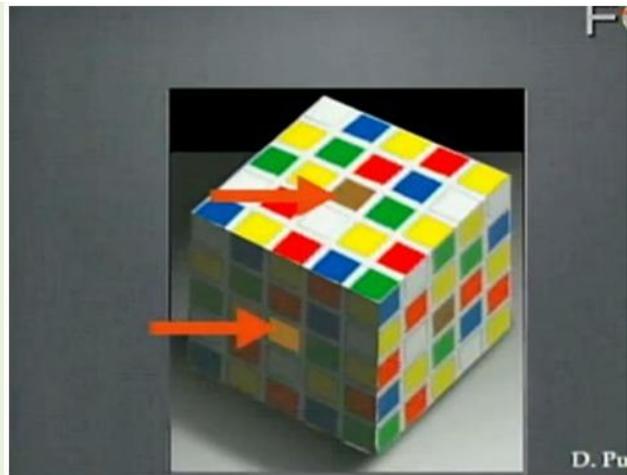


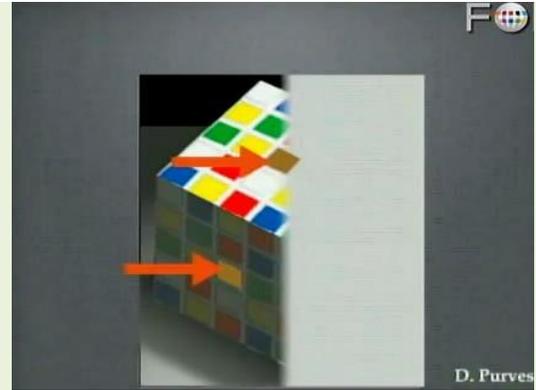
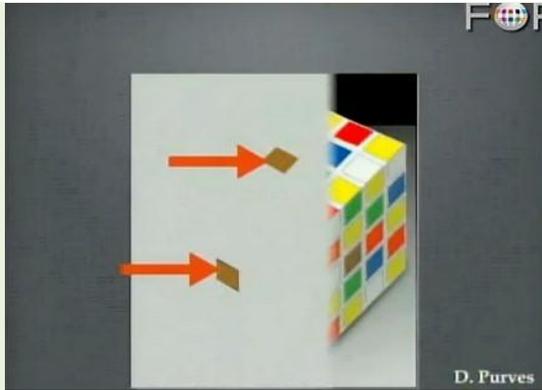
As Ariely points out in the video, it turns out that the tables are actually of the same length. It's our vision that causes the illusion and alters our judgment.



The Colored Cube:

“Have a look at the magic cube and the color which are pointed out by the red arrows. What are the colors of the two squares?”





When we cover the rest of the cube, here comes out the answer: they are the same!

We believe that they are different colors just because they look different with different backgrounds. As what the picture on the right shows, when we put away the white background, the illusion comes back.

The point is that we are dedicated to trust our vision, which we use more in a day out of all the senses of our body (*including common sense*). We believe we are good at it, but the truth is different from our belief when we take the case of two tables with the same length and the up and side centers of the magic cube with the same color.

“If we make mistakes using our vision, which we think we are good at, what is the chance we don’t make more mistakes in that we are not good at, ex. financial decision making?”

2. The Difficult Decisions

Sometimes, as Ariely points out, it becomes difficult for us to make certain difficult choices in presence of a simpler, less complex but expensive, 'default option'. Ariely proves his point by mentioning the **Organ Donation** example.

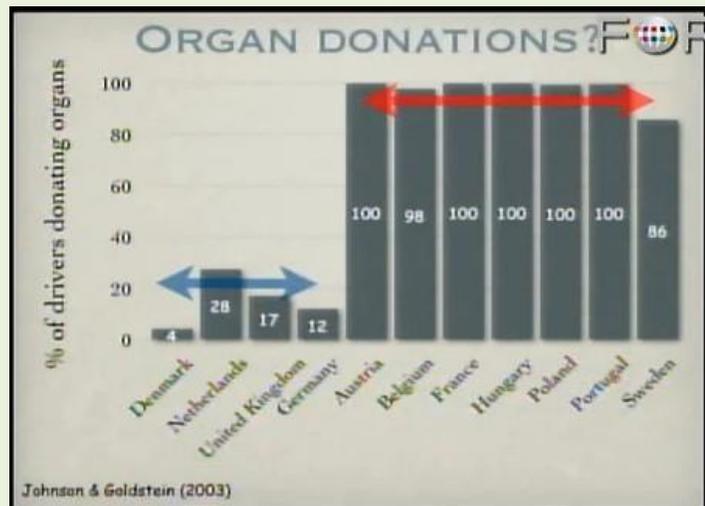
In the example he shows that the percentage population of drivers in a country, interested in donating their organs after death has less to do with the intent of the people or their culture and more to do with the default option made available to them by the person who designed the DMV form in their country.

Organ Donation:

This is the chart shows the percentage of drivers enrolled in organ donation program in different countries.

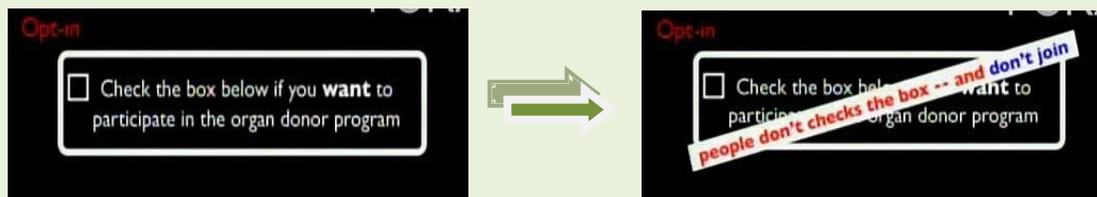
The RHS countries (marked by the red arrow) do much better than the LHS ones (marked by the blue arrow) in organ donation. Why?

It has nothing to do with culture or religion, but the design of the format DMV: Opt-in for LHS and Opt-out for RHS.

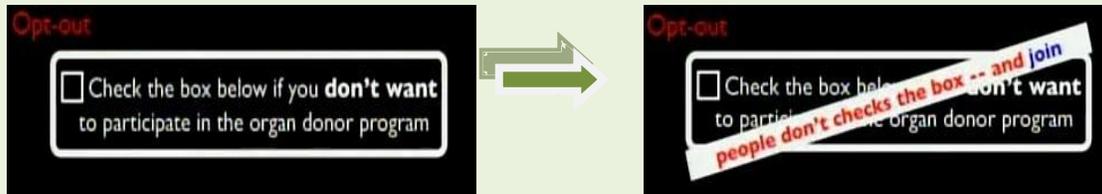


Following pictures show how the design of the DMV form influences the decision of the drivers:

The LHS countries have the "Opt-in" box on their DMV forms and often people filling up the form do not check the opt-in box.



Although the people in the RHS countries do not check the box as well, but in this case the box is has an “opt-out” option. People find it hard to make a decision about something like organ donation and end up going for the default option.



“Our decisions are not residing within us but the people who design the form! Could you believe that one form would actually change your own behavior?”

The design of the form exploits the fact that humans would inadvertently choose the default option if it eliminates the need of going through a complex decision making process. But is this phenomenon limited to common people? What about people who are professionals in certain fields? Would they make similar mistakes in their profession in a similar situation?

Professional Lapse of Judgment:

Ariely answers these questions through an experiment that deals with doctors and their decision making process. He describes a scenario where, on the way to the surgery room the physician suddenly remembers that his patient has not yet tried an alternative to surgery. Let’s take a look to find out what happens to the “professionals”?

Scenario 1:

On the way to surgery room, the physician suddenly remembered the patient had not yet tried one medicine, what will the physician do?

The Physician pulls back the patient and tries the medicine



Scenario 2:

On the way to surgery room, the physician suddenly remembered the patient had not yet tried two different types of medicine, what will the physician do in this case?

Although it may seem obvious that physician will pull back the patient, but it turns out that physician will just let his patient go through the surgery instead of facing another problem of trying to find out which medicine is the right medicine for the patient.

Professionals have a huge impact on what others end up with. If you need help from professionals make sure you find the right person!



3. Everything is Relative

Imagine that you are out of school and you are offered a job at a salary of \$70,000 per year. It turns out that you are the lowest paid employee in that company. Everybody else makes more you do.

Compare that to a situation where you are offered \$65,000 in a company where you are the highest paid employee. Which job will you take and be happy about it?

It is hard to choose the \$65,000 job if it is being offered alongside the \$70,000 job, however if \$70,000 job was not offered at all then you would be much happier working for \$65,000 a year where you would be earning more than other employees in the company at same level. Your happiness is not proportional to your salary but is proportional to your salary **relative** to other employees in the company.

Ariely describes the practical implementation of this principle of relativity by discussing an old subscription advertisement by *The Economist*.

The Subscription Trick:

The Economist has three subscription terms:

- A. \$59 for only online access
- B. \$125 for only print edition
- C. \$125 for both print edition and online edition.

The subscription forms were handed out to a group of 100 students.

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One-year subscription to the print edition of *The Economist*.
- Print & web subscription** - US \$125.00
One-year subscription to the print edition of *The Economist* and online access to all articles from *The Economist* since 1997.

Following were the results of the above experiment:

16% students chose option A

0% students chose option B

84% students chose option C

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- Print & web subscription** - US \$125.00
One-year subscription to ti
of *The Economist* and onlin
articles from *The Economis* **84%**

Then he deleted the option B and did the survey on another 100 students. The outcome changed as show below:

Following were the results after the deletion of Option B

68% students chose option A

32% students chose option C



The truth is that the second option is useless but it's presence in the advertisement makes the third option worthy and more appealing and people end up choosing option C.

Actually, we don't know our preferences that well, so we often accept all of the influences from the external forces after doing a comparative analysis that may have been pre-designed in order to influence our decision.

In the video Ariely mentions few more interesting examples, which you can see by visiting the link mentioned above. The examples include an experiment related to Dating and another experiment comparing a trip to Rome Vs. a trip to Paris. You may visit the link at your own convenience.

Our Advice

The point behind the discussion is that when we think about economics, we have this beautiful view of human nature: “What a piece of work is a man!” We know our limitations in the physical world, and we build our physical world around it step by step. However, sometimes when it comes to the mental world, such as our desire for healthcare, retirement and stock market, we somehow forget our limitations.

Before making any financial decision one must be sure of the kind of investment one is looking for. Some homework should be done before making any major decision to make it a well thought out decision.

Behavioral economics tells us where our limitations are in the mental world. It is always advised that one should be aware of one’s emotions and should explore all the practically possible and logically sound alternatives while investing.

Warm Wishes,

Patrick Bourbon, CFA

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