

Pensions Convention

C04 Successful Communication using
Behavioural Finance

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Successful Communication using Behavioural Finance

- ✓ Examine the irrational decisions that people make in managing their finances
- ✓ Expose your own biases and link them to the main findings of Behavioural Finance
- ✓ Understand the differences between individual and group decision-making
- ✓ Consider the implications for how actuaries present decisions about retirement funding and investment to individuals and trustees

Behavioural Finance v Economics

- ✓ Economists are people who look at reality and wonder whether it would work in theory – Ronald Reagan
- ✓ Traditional Finance is more concerned with checking that the price of two 8oz bottles of ketchup is close to the price of one 16oz bottle of ketchup, than in understanding the price of the 16oz bottle – Larry Summers
- ✓ To make a parrot into a learned financial economist it needs to learn just one word “arbitrage” – Stephen Ross

Rational v Irrational

- ✓ The market can stay irrational longer than you can stay solvent – John Maynard Keynes
- ✓ There is nothing so dangerous as the pursuit of a rational investment policy in an irrational world – JMK

Rational is Subjective?

✓ Maths

- ✓ Axioms and proofs
- ✓ Absolute truths
- ✓ One small mistake and the whole thing is wrong

✓ Real life

- ✓ Rules are arbitrary and often cultural
- ✓ Most things relative rather than absolute
- ✓ Experiences and context shape what we see as rational

A Simple Question

Compare lines 1, 2 and 3 with Line A below. Which line is equal in length to Line A?



A



1



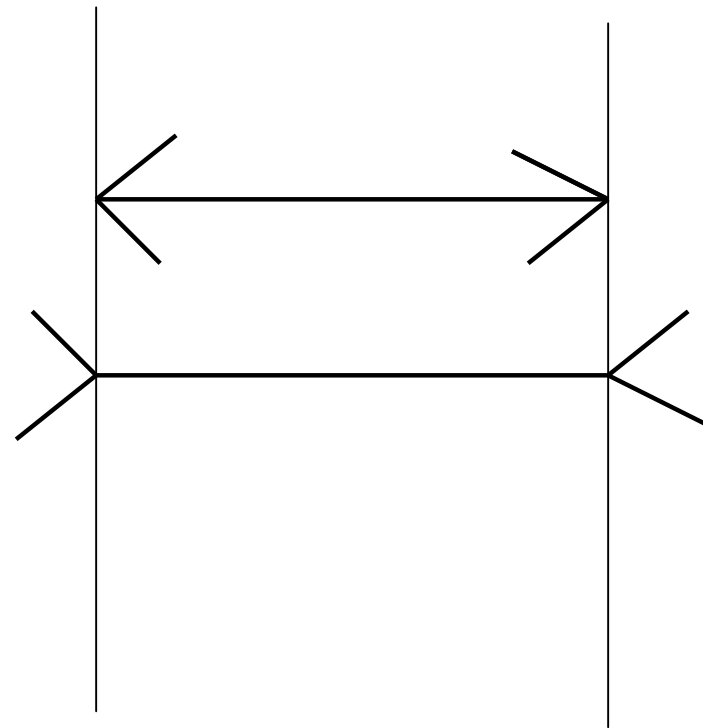
2



3

A Framed Question

- ✓ We are sensitive to Context
- ✓ Frame dependence - we can't see through how things are actually framed
- ✓ Mental accounting - separate funds for separate purposes; salary vs bonus



A Less Obvious Question

- Suppose each of the cards below has a number on one side and a letter on the other and someone tells you: "If a card has a vowel on one side, then it has an even number on the other side". Which of the cards would you need to turn over in order to decide whether the person is lying?

E

K

4

7

An Easier Question – Framed for Lie Detectors

- ✓ Suppose each card is a customer in a bar: it says their age on one side and what they are drinking on the other. Which cards do you need to turn over to check that there is no illegal underage (18) drinking going on in the club?

Beer

Coke

Age 25

Age 17

Do you Suffer from Confirmation Bias?

The correct answer to the first question is E and 7

- ✓ The rule being tested "If vowel then even number" can be falsified by finding an instance of "If vowel then odd number", so the only cards capable of disconfirming the rule are those with vowels and odd numbers. The others are not relevant
- ✓ Most people choose E and 4, or E, reflecting what's known as a "confirmation bias"
- ✓ People tend to look for supporting evidence and as a result are vulnerable to self-fulfilling prophecies. Scientists trained to disprove hypotheses may find this behaviour irrational
- ✓ Similarly for the second question, yet somehow this is more "obvious". Why?

Self Attribution Bias

- ✓ Good outcomes are a testament to your skill
- ✓ Bad outcomes are sheer bad luck

- ✓ Over-optimism
 - ✓ People tend to exaggerate their own abilities
 - ✓ Illusion of control
 - ✓ Illusion of knowledge

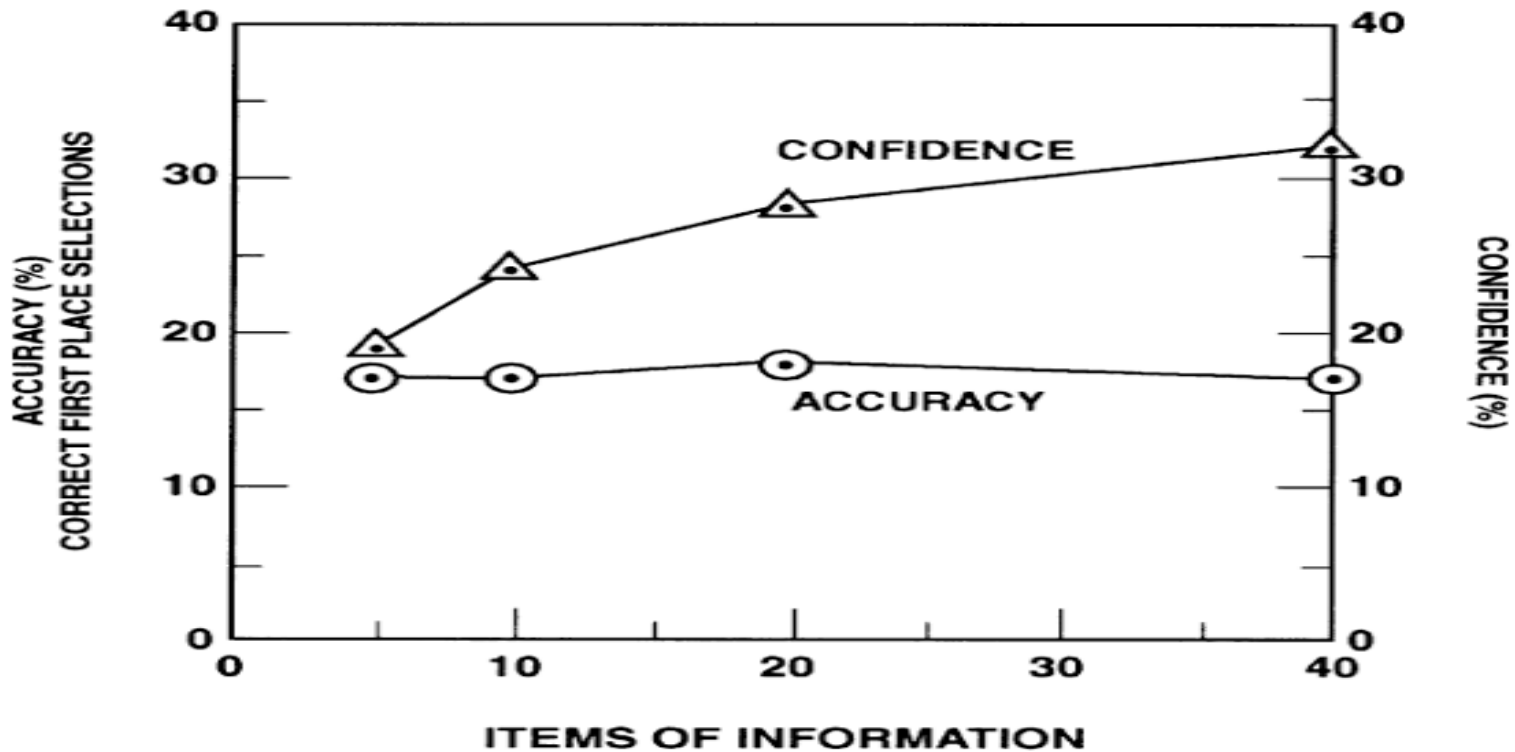
Self Deception - Over-confidence

- ✓ People are surprised more often than they expect
- ✓ Confidence intervals around a forecast which should yield 2% error, actually get a 30-40% error
- ✓ We are not well calibrated

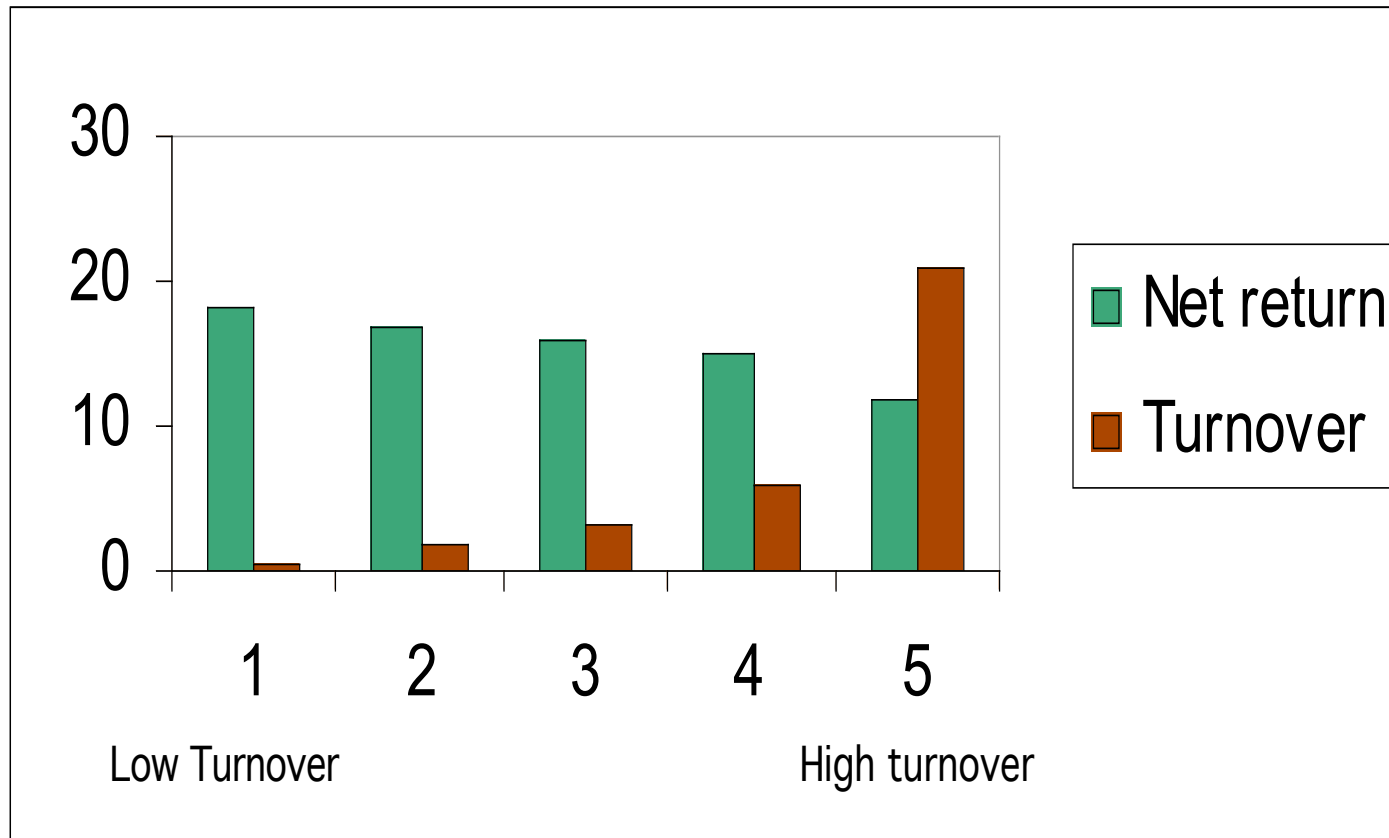
- ✓ Why?
- ✓ Are men and women different?

Does more Information improve your Accuracy?

Figure 5



Trading is Hazardous to your Wealth



Hindsight Bias

- ✓ It is a common observation that events in the past appear simple, comprehensible, and predictable in comparison to events in the future
- ✓ Hindsight bias is the tendency for people with outcome knowledge to believe falsely that they would have predicted the reported outcome of an event
- ✓ After learning of the occurrence of an event, people tend to exaggerate the extent to which they had foreseen the likelihood of its occurrence
- ✓ This self-deception feeds overconfidence

Heuristic Simplification – The New ACA

There is no such thing as context free decision making

- ✓ Affect
- ✓ Context
- ✓ Anchors

Affect - Halo Words

- ✓ Jim is intelligent, skilful, industrious, warm, determined, practical and cautious. Please pick the other traits you think Jim is most likely to have from the following pairs:

Generous — Ungenerous

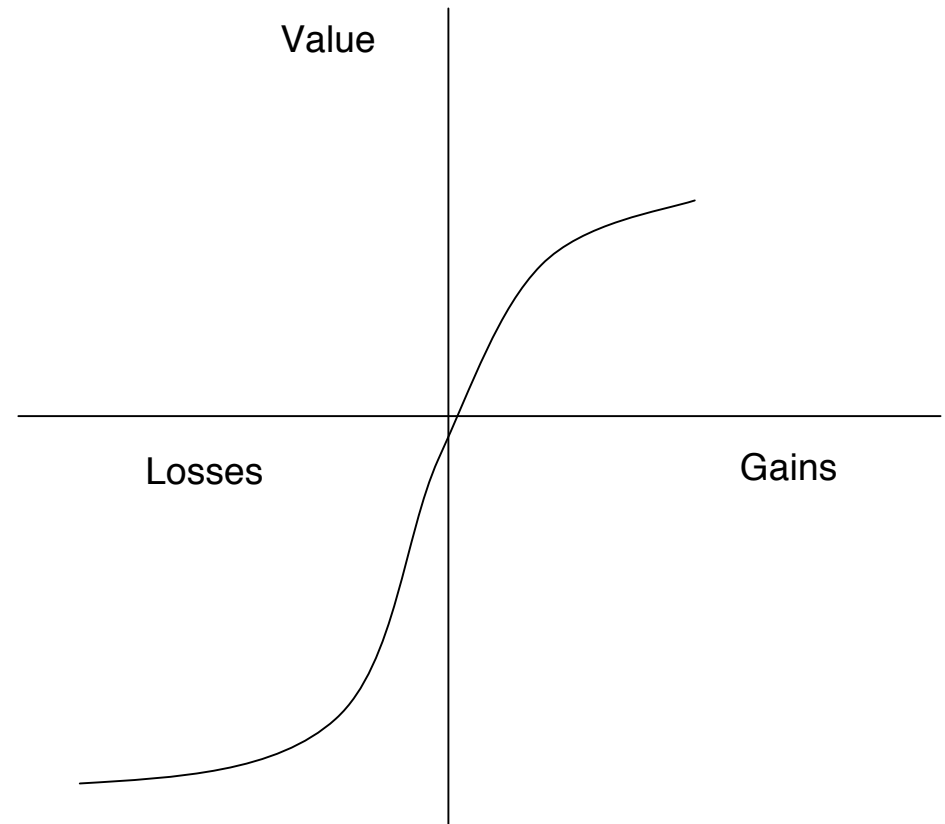
Unhappy — Happy

Irritable — Good-natured

Humorous — Humourless

Context - Prospect Theory

- ✓ Rational man tries to maximise the utility of wealth
- ✓ Real people worry far more about gains and losses than levels
- ✓ Real People worry even more about losses than gains



Anchors - Heuristic Simplification

- ✓ Conservatism Bias
 - ✓ Hard to give up a view once it has formed
- ✓ Anchoring and slow adjustment
 - ✓ Depends upon saliency of the anchor
 - ✓ Analysts will change their views from their forecasts slowly
 - ✓ Actuaries change their assumptions/methods slowly?

Group Decision-Making

- ✓ Trustees, families, colleagues, workshops ...
- ✓ Persuasion
- ✓ Provocation
- ✓ Consistent disagreement
- ✓ Seniority and other social influences

Now you Try

- ✓ On your own
 - ✓ Gather responses blind
- ✓ Four groups
 - ✓ Debate
- ✓ Gather responses again
 - ✓ Discuss process

Horsetrading

- ✓ A man bought a horse for £60 and sold it for £70. Then he bought it back for £80 and again sold it for £90. How much money did he make in the horse business?

The man ended up with a final profit of £ _____

PS If you were thinking of allowing for interest, don't bother!

Top Tips for Better Decisions (for Analysts*)

- ✓ You know less than you think you do
- ✓ Be less certain in your views, aim for timid assumptions and bold choices
- ✓ Don't get hung up on one technique tool, approach or view – flexibility and pragmatism are the order of the day
- ✓ Listen to those who don't agree with you

* and (some) Trustees?

Top Tips for Better Decisions (for Analysts*)

- ✓ You didn't know it all along, you just think you did
- ✓ Don't take information at face value, think carefully about how it was presented to you
- ✓ Vivid, easy to recall events are less likely than you think they are, subtle causes are underestimated
- ✓ Try to focus on facts, not stories

* and (some) Trustees?

Who's Overconfident about Pensions?

“In the US, we’ve spent the last 15 years educating the same 20% of our employees who ‘get’ investing for retirement, it’s the other 80% who are clueless that we’re worried about.”

*Dwight Kadar, Director of Investment Management,
Cooper Industries Inc*

Problem: The Majority of People ...

- ✓ Don't save enough for their pension
- ✓ Don't appreciate how much a pension costs or is worth
- ✓ Don't value or appreciate their employers' contribution to their retirement income
- ✓ Find percentages, probabilities and risk/return trade-offs difficult to understand
- ✓ How do we need to communicate with them?

Clues from Behavioural Finance

- ✓ Implicit advice and guidance
 - ✓ The Affect of defaults
 - ✓ Inertia
- ✓ Framing
 - ✓ Context not content
 - ✓ Different priorities for different groups
 - ✓ Myopia
- ✓ Setting the right reference points
 - ✓ Realism not aspirations
 - ✓ Create the mental accounts and Anchors

Affect

- ✓ Which words associated with pensions and investment have:
 - ✓ a positive Affect?
 - ✓ a negative Affect?

Context

- ✓ Who sets the context for the decisions trustees make about pensions and investment?
- ✓ Who sets the context for the decisions individual employees make about pensions and investment?
- ✓ What's the current context?

Anchors

- ✓ Which Anchors and reference points relevant for pensions and investment are:
 - ✓ helpful?
 - ✓ unhelpful?
- ✓ in:
 - ✓ setting a funding rate
 - ✓ setting an investment strategy

Parting thoughts

- ✓ Use reference points and framing to your advantage
- ✓ Be aware of your own biases
- ✓ Use complex calculations, computer power and advanced stochastic to communicate, not impress
- ✓ Financial economics v behavioural finance?
 - ✓ Markets can be rational even if individuals are irrational

Feedback

- ✓ Prof Warwick's reference point technique
- ✓ My feedback
- ✓ Thanks to James from Dresdner Kleinwort Wasserstein for his assistance in producing this presentation

Further Reading

- ✓ For more questions to test your biases try the Reader Survey in:
 - ✓ “The psychology of judgment and decision-making” by Scott Plous, published by McGraw-Hill in 1993
- ✓ Behavioural finance applies and develops these ideas to financial decision-making. Try:
 - ✓ “Beyond Greed and Fear” by Hersh Shefrin, published by Harvard Business Press in 2000
 - ✓ “The Winner’s Curse” by Richard Thaler, published by Russell Sage Foundation
 - ✓ “Behavioural Finance” by James Montier, published by Wiley in 2002

Please Note

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