ALLANGRAY

GRAYISSUE

22 March 2018 Issue 199

How to pave the way for better decisions

The decisions we make are a function of the environment that we are in, according to behavioural economists. Put in a different environment, or faced with a set of choices presented in a different way, we would make very different decisions.

Just look at a simple example such as your interaction with your mobile phone. Turn off your Facebook notifications and notice how your focus shifts to other content of interest.

If we understand how our environment shapes our behaviour, we can pave the way for better decision making.

The path of least resistance

World-renowned professor of psychology and behavioural economist Dan Ariely conducted an experiment on chronic medication users in the US who receive their medication via post. Their supplier was disappointed that an offer to switch users from expensive branded medication to much cheaper generic medication had yielded low results – despite an offer of free generic medication for the first year. The supplier had come to the conclusion that people dislike generics so severely that even making them free couldn't convince users to change.

Ariely disagreed with this conclusion, noting that the supplier had missed an important point. To action the change, users had to return a letter agreeing to it. Users had a choice: do nothing and continue to receive branded medication or send a letter and get cheaper generics. He hypothesised that people don't hate generic medication, they simply hate doing anything. If the letter had stated that the supplier was going to switch the users unless they instructed them in writing not to, Ariely suggested the outcome would have been different.

In the US it is illegal to change medication without an instruction from patients, so as a follow up exercise Ariely suggested the supplier send a letter to the users giving them the option of switching to generic medication or maintaining the status quo. Regardless they had to return the letter or the supplier would have to stop sending their medications.

While they still had to do something, the choice architecture had been changed: they could choose between branded at the regular price, generic at a cheaper price, or do nothing and receive no future medication. Around 70% switched.

In the end it wasn't about branded or generic. It was about returning the letter. Understanding behaviour and responding with different choices yielded results.

What does this have to do with investing?

The environment matters, the choice architecture we are presented with matters. We think our actions are driven by our preferences. The reality is that our brains are wired to make the easiest, rather than the best, decisions.

Ariely notes that there are two types of challenges when it comes to our behaviour:

1. Friction – resistance or limitations; essentially what gets in our way
2. Fuel – what motivates us

When it comes to investing, we may have very good intentions, but temptation in the form of spending impedes us. We know what the right behaviour is, but knowing is not enough; it does not make us spend less or save more. We need to understand our limitations and remove barriers that we put in place, or that exist due to our environment, and then we need to think about how to add fuel to motivate ourselves and remain committed.

It is hard to be motivated to spend less and to save consistently. We can make it easier for ourselves by removing the biggest barrier – the decision not to spend – and adding motivation in the form of a goal that we care about and that is achievable. Of course not everyone needs savings goals to motivate them, but research out of the UK government's National Savings and Investments arm suggests that those with specific goals save faster and more successfully than those who don't have goals.

A simple example is setting up a debit order to automate saving towards a stated goal. That way the money leaves your account each month, without having to be prioritised in a long list of obligations and temptations. Even better, add an annual escalation to your debit order to increase your saving each year.

In this example we have understood our limitations (temptation) and built around them (made it easier to save by setting up a debit order and automatically increasing it each year). We remain committed knowing what we are working towards.

Tips for making better decisions

There are other easy ways to remove friction and improve decision-making. Here are five tips:

1. **Pause**
   Give yourself time to evaluate the situation so you can make the right decisions. Be aware that the options presented to you do not always have your best interest at heart and understand that your response could mean the difference between loss or gain. Weigh up your options, become more tuned in, work on controlling your emotions.

2. **Don't always rely on your gut**
   Intuition helps us identify cues to avoid danger and survive. But avoid relying on your gut feelings when it comes to investing. Rather take the time to do your own research or invest with a reputable fund manager.

3. **Narrow your options**
   People are attracted to choice, but that does not mean that having more choice will lead to better decisions, or a better decision-making process. Research has shown that, in the face of too much choice, people often land up making worse decisions, or suffering from buyer's remorse – that is, if they are able to make any choice at all, with many suffering from 'analysis paralysis'.

4. **Sleep on it**
   Some neuroscientists believe that the best fuel for decision-making is hitting that snooze button when your alarm clock rings in the morning. They believe that spending a few moments in this half-awake zone is not self-indulgent; rather it is a place where answers lie for all sorts of problems. This light meditative state facilitates creative thinking and allows us to get clarity on important priorities and decisions.

5. **Ask for a second opinion**
   The good news is you don't need to do it on your own; improve your chances of investing successfully by making use of the services of a good, independent financial adviser. Their role is to assist with long-term financial planning. They have the objectivity and experience to help you meet the full range of challenges you might face and they help you make decisions that are right for your circumstances.

Commentary contributed by Mthobisi Mthimkhulu, Client Relationship Manager, Allan Gray

Sources: Dan Ariely, Cris Antonio, Lynda Shaw