

Rational Deficit: An Interview with Dan Ariely

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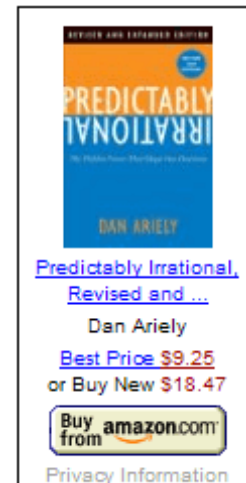
Dan Ariely

Recognizing the hidden forces that inappropriately influence our decisions is the first step toward keeping those influences at bay, says Duke behavioral economist Dan Ariely. All of which, he adds, is easier said than done.

*Having suffered third-degree burns over 70% of his body after the explosion of a large magnesium flare used by the Israeli military, an 18-year-old Dan Ariely endured years of painful rehabilitation in which, he says, "I felt partially separated from society and as a consequence started to observe the very activities that were once my daily routine as if I were an outsider." Ariely now applies his uniquely honed observational skills to the study of how people make decisions, particularly on those influences to which we are largely unaware. He last year assembled his research findings into a highly readable and informative book, *Predictably Irrational*. In the midst of a crisis set off by rampant poor decision-making, we caught up recently with Ariely for insight into how we might become a bit more predictably rational.*

*Ariely's book, *Predictably Irrational*, is available from the link above.*

In your book you write about our potential over-reliance on making decisions in relative, rather than absolute, terms. Why can that lead us astray?



It's very hard with most decisions to come up with absolute answers, such as how happy a particular activity will make us feel or how satisfactory the return on a specific investment will be. As a result we've adopted an easier method: to



come up with comparisons so we can pick one thing over another. This isn't necessarily bad, but what we choose to compare with – or what is offered as a comparison that we don't even choose – can cause us to make a different decision than we would otherwise.

One study I discussed in the book was based on an actual ad I saw for the Economist. There were three offers in the ad: an Internet-only subscription for \$59, a print-only subscription for \$125, and a combined print and Internet subscription, also for \$125. When I gave those options to students in a study, 16% chose the Internet-only subscription, none took the print-only subscription, and 84% opted for the combined subscription. Sounds reasonable, right? But what if I only offered them the Internet-only subscription for \$59 and the combined subscription for \$125? Since I took out the option no one selected, surely they'd react the same way, wouldn't they? In fact, they didn't. With only two options, 68% of the students chose the Internet-only option and only 32% took the combined offer. It's not rational that in one case 84% were willing to pay \$125 for the joint subscription and in the second case 32% were, but that's what can happen when we make relative comparisons against the wrong things.

We do something similar when we look at what our neighbors and friends have in order to judge how happy we are with what we have. At an extreme, it's possible to only care about relative value, which can cause problems. For example, male sea lions care a lot about their weight, because the heavier sea lions get all the females. They don't care about being heavy, only heavier than the other male sea lions. It turns out, though, that in this struggle to be bigger than the next sea lion they're becoming so obese that they die young from heart attacks. That's a decent analogy to what we're seeing play out today: Many people may not have really cared about how big their house or their TV or their refrigerator was, only that they were bigger than the neighbors'.

Many valuation disciplines investors use, like buying only below a certain P/E ratio or when a discount to intrinsic value exceeds a certain amount, help keep focus on absolute rather than relative value. What else might work?

Part of it is just recognizing all the relative-comparison traps and taking care to control what you use to compare. Amos Tversky and Daniel Kahneman once did a study in which they first asked people if they'd walk to another store 15 minutes away to save \$7 on a \$25 pen. Most people said they'd do it. Then they asked if they'd walk for 15 minutes to buy the same \$455 suit for \$448. In that case, most people said they wouldn't. In reality, of course, \$7 is \$7. The only question you should ask yourself is whether the 15 extra minutes of your time is worth the extra \$7 you save. Whether the amount from which the \$7 is saved is \$10 or



\$10,000 should be irrelevant. You have to force yourself sometimes to think in this kind of absolute way.

Explain the pitfalls of “anchoring” on a particular data point or experience, to the exclusion of other inputs that might lead to better decisions.

The market encourages all kinds of anchoring. The price at which you bought a stock is very vivid in your mind, but in reality you’d be much better off if immediately after the purchase you forgot the price you paid. We also ascribe importance to 52-week highs and lows, but why that? It would make as much sense to look at the highs and lows over 70 weeks, or 40 weeks.

One danger of anchoring is that it can cause regret, which usually isn’t very useful in decision-making. There was an excellent study that looked at people who forgot to mail in their frequent-flyer-program applications, who were far less likely to go ahead and join after getting back from a long trip. They missed getting credit for this big flight and thought if they joined now it would make them regret it. That’s analogous to not buying a stock at \$30 because you originally looked into it at \$20 and didn’t buy. Buying at \$30 will make you regret even more that you missed it at \$20, so you won’t buy it. That’s dumb if you really think it’s worth \$50.

With investing, focusing on what’s already happened is generally a bad strategy. The decision at any point should be only about looking forward. Just adjusting how you set up your spreadsheets and what you track on reports could help in this regard.

Describe some of the work you’ve done on honesty and the rather unfortunate results.

We set up a study in which we had students answer 50 multiple-choice questions. In the first case, they used a worksheet for their answers and then were asked to transfer the answers to a scoring sheet, called a “bubble” sheet. They handed in both the worksheet and the scoring sheet and the proctor at the front of the room graded their answers and gave them 10 cents for each correct answer.

In the second setup, we made one important change. This time the scoring bubble sheet had the correct answers pre-marked. So the participants, when transferring their worksheet answers to the bubble sheet, could lie if they’d chosen the wrong answer and put the right one on the bubble sheet. They were asked to count their right answers and write the total on the top of the scoring sheet, which they handed in along with the worksheet. The proctor then gave them 10 cents for each correct answer based on their reported total.



In the final case we pushed the participants' integrity to the limit. In this case they were told to destroy both the worksheet and the bubble sheet and just take directly from a jar of coins at the front of the room what they had earned based on their correct answers.

What happened? The first group, which had no opportunity to cheat, got an average of 32.6 of the questions right. The second group, which could cheat but might have gotten caught because they still handed in their worksheets, claimed to have solved 36.2 questions right, on average. Interestingly, the last group ended up cheating at almost exactly the same level as the second group, even though there was no chance of their getting caught.

What conclusions do you draw from this?

The first conclusion, unfortunately, is that when given the opportunity many honest people will cheat – if only a little bit – and still feel very comfortable about it. What was more counterintuitive was that the participants weren't influenced by the risk of being caught – they cheated at about the same level even when there was no risk they'd be found out.

This to me points up the critical importance of self-interest and conflicts of interest. When life will be better for you if you choose a certain direction, it's very hard not to take that direction. I believe that's at the center of what's plaguing our financial and healthcare systems. Imagine you go to a financial advisor or a physician and there are two choices, A is better for you and B is better for them. What do you think they'll recommend? If the doctor owns the equipment for a test or a procedure, they don't have to be bad people – they just have to be people – to be influenced by that.

I don't think you can overstate how careful we have to be about the incentives of people who make decisions that affect us or who give us advice. When you see conflicts of interest, it's a very good indicator that something is going to go very wrong, very soon. One of the best remedies here is transparency – but it only helps if people actually care about the conflicts of interest that might be exposed.

One chapter in the book is titled, "The High Price of Ownership." Describe what you mean by that.

The basic idea is that ownership changes our perspective, which applies to both material things as well as points of view. One principle involved is that the more work you put into something, the more ownership you begin to feel for it. For example, I can say from personal experience that pride of ownership is inversely



proportional to the ease with which I've been able to assemble furniture. We have a term for that: the "Ikea effect."

Once we take ownership of an idea – whether it's related to politics or sports or investing – a lot of changes take place. We probably fall in love with the idea more than we should. We value it for more than it's worth. And quite often, we have trouble letting go of it because we can't stand the idea of its loss. What are you left with then? A rigid and unyielding ideology that can be quite detrimental to clear thought.

Tell us about any new projects you're working on.

One interesting thing is trying to create an iPhone application to help people think better about how much money they're spending and on what. Nothing is finished yet, but our first idea is sort of an "alter-ego" application. If you are tempted to buy something, you choose some trusted friend or family member from your contact list and then are prompted to ask yourself, "What advice would this person give me?" You don't actually ask the person at this point, but the goal is to force you to think with an outside perspective. The second step is then to find out from that person what they actually would say. The first step causes you to reflect, which is important, and the second allows you to learn from others to inform longer-term decisions. We're actually looking at lots of things that allow you to use your cell phone as a time buffer between your intentions and your actual behavior.

In concluding *Predictably Irrational*, you write that, "Although irrationality is commonplace, it does not necessarily mean that we are helpless." Any final words on how to be less helpless?

There's not one magical solution, but helping people identify the various sources of mistakes should make them better prepared to fight them. Emotions like anger or fear, for example, are huge drivers of mistakes. But it turns out emotions are fleeting, so one response could be to figure out how to impose a delay between the time you feel something and the time you act on it. Other people are very helpful here – you might agree with a business partner or a friend that you have to explain why you're taking a certain action before you actually do it.

I find forcing yourself to be a devil's advocate, or assigning someone else to do it, can be very helpful. I also recommend to people that pre-committing to certain strategies and then writing them down can go a long way to keeping irrational influences from swaying you.

None of this is easy. I think about this all the time and still find myself influenced by the wrong things too often. But the response to the book has been incredibly



gratifying – people recognize themselves in the pages and want any help they can get in avoiding stupid decisions.

Do you think the financial crisis has made the book more popular?

It's hard to find comfort in this, but there's no question the financial crisis has been a good thing for behavioral economics. A few years ago people assumed markets drove out all this irrationality we were seeing. That assumption isn't nearly as prevalent today.

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