

Dishonesty, Choices and Investing

An Interview With Dan Ariely

Article Highlights

- The conflicts of interest faced by financial advisers can lead them to make decisions that are costly for investors.
- Mandated disclosure is not effective at reducing dishonesty. Rather, investors should ask their advisers questions.
- Investors can improve their decision-making by thinking about what they would buy now, versus what they bought in the past.

Dan Ariely is a professor of psychology and behavioral economics at Duke University. I spoke with him recently about how advisers and investors rationalize actions that are not in the investors' best interests.

—Charles Rotblut

Charles Rotblut (CR): In your new book, *"The (Honest) Truth About Dishonesty"* (Harper Collins, 2012) you seem to imply that people rationalize their dishonesty and that people only cheat up to a certain point. Could you elaborate?

Dan Ariely (DA): The standard view is that people who cheat do a cost/benefit analysis. They weigh the cost, the benefit, what they stand to gain, what they stand to lose. And they work within that framework.

First of all, we don't find evidence of that. But also, if you think about it, even if you look at the cheating you see around you, you will probably come to the conclusion that you have lots of opportunities to cheat every day that you don't take. And it is the same for everybody. It turns out that there's this construct that we call morality, which keeps us more honest than we would be if we were perfect cost/benefit analysts.

What's very interesting is that there are basically two psychological mechanisms at work. One of them is rationalization. Rationalization works as long as people cheat but still think of themselves as honest individuals. And the second thing is the slippery slope, which is that once people take a step in the wrong direction, the next steps are going to be more and more and more likely. We have found both of these



mechanisms in lab experiments.

I've also had the chance to interview all kinds of white-collar criminals, who have committed insider trading, accounting fraud, and other kinds of white collar crimes. In every one of their stories these mechanisms have been at work.

If we think about investors who have a financial adviser holding their money somewhere or getting tips from somewhere, there's this sense among investors that as long as we

don't have bad people, as long as we trust these people, everything will be okay. But the truth is, lots of good people can start making small deviations. And because they make them a lot, it ends up costing us a lot of money.

CR: Do you think that herding behavior plays a role? I know you talk about the fudge factor in your book, the idea that some analysts are more favorable in their recommendations than they should be.

DA: Herding behavior is something very important. The moment people think that everybody behaves this way, it's easier to justify.

Take, for example, a very bad practice called soft dollars. Imagine that I'm your financial adviser, and I charge you 1% of assets under management. Now, somebody else trades stocks for me. That person is charging me, let's say, one penny per share. Now, the first thing I do is, instead of using my 1% to cover that cost, I ask the broker to include it in the stock price. So if a stock was \$80.34, it becomes \$80.35. It increases the cost of the stock a little bit. That, usually, financial advisers don't tell the client. But that's not

immoral yet.

What happens is, if I'm your financial adviser, I can go to the broker, and I can say, "Instead of charging me one penny per share, why don't you charge me two pennies per share, include it in the price of the stock, and in return, why don't you buy me the Bloomberg system for my office?"

Now what's happened is, your transaction price is slightly higher, you still pay me 1%, and on the books it looks like you're not paying more, but in fact, I'm getting more money out of you. And it turns out that this is a common practice. Of course, it's illegal, and it's immoral, there's no question about it, but because it's so pervasive, many of the financial advisers I've met basically say, that's what everybody is doing! They're using that as a justification for why this practice is okay.

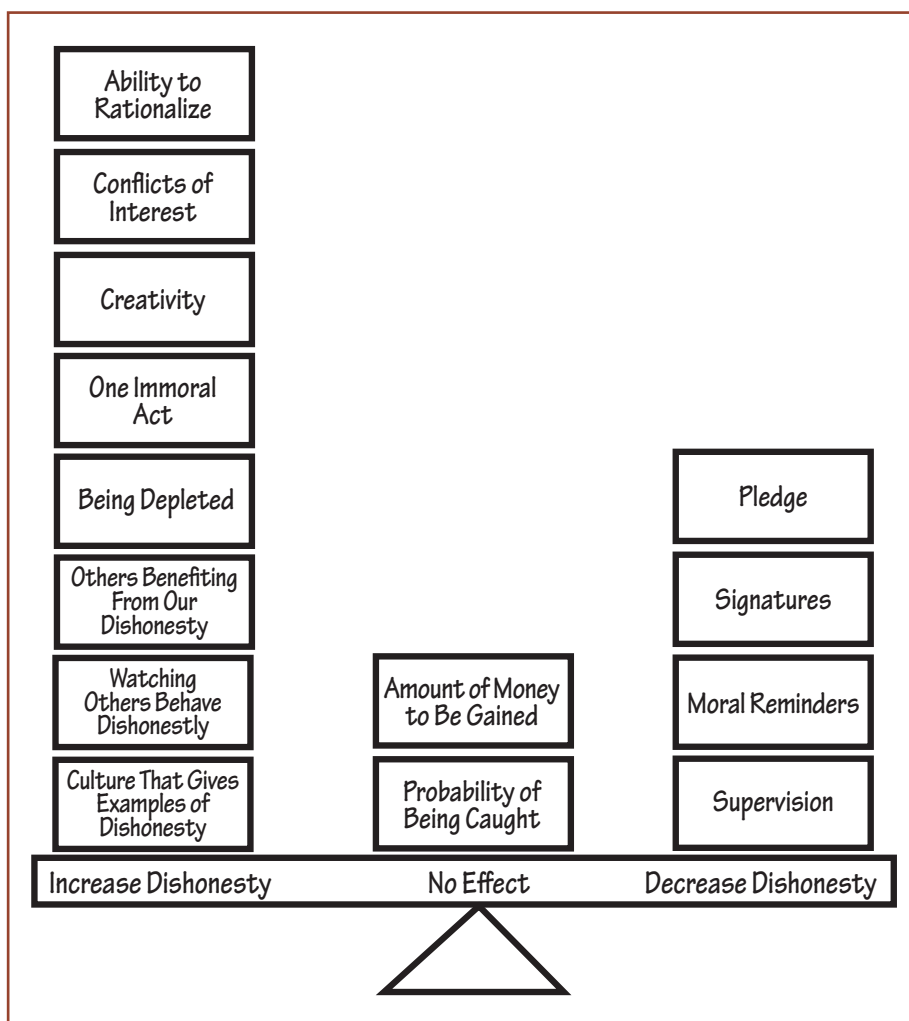
CR: You describe in your book a situation where a dentist bought a new piece of equipment. Because the equipment was there and the dentist had spent a lot of money on it, he started to recommend more costly procedures involving the use of the equipment. Do you think financial advisers are basically passing on these costs because they feel that they now have to rationalize having the Bloomberg terminal in their office?

DA: I think a lot of things like that happen.

By the way, the main point of this book is that there are a few bad people who cheat, but there are also a ton of good people who cheat. So I don't want to say that financial advisers are bad people. I think they're really nice people—almost all of them, the vast, vast majority.

However, they face tremendous conflicts of interest, because the way they make money is not the same, exactly, as the way their clients make money. And every time this happens, there's a situation where there are conflicts of interest. And I think that conflicts of interest and the fee system are the main villains here, not individuals. If we took all the people who invest and who we try to educate, and we took all the financial advisers, and we reversed their roles—

Figure 1. Forces That Shape Dishonesty



the financial advisers would become the investors and the investors would become the financial advisers—the shenanigans going on would probably be the same. So I don't think we need to think about financial advisers as bad people; we need to think about them as people with a really bad incentive structure. We need to be very thoughtful about what happens when we have a bad incentive structure.

It is really nice to think that we can trust people. But if somebody has a really bad incentive structure, it's not that they will do something intentionally, necessarily, but it will grind them, it will basically influence every one of their decisions. They will probably never do anything big against us, but lots of small decisions will be influenced by

those conflicts of interest.

CR: And you don't think that disclosing that these conflicts of interest exist solves the problem, correct?

DA: Right. Disclosure tends to be the recommended solution. Sadly, the experiments done so far on these disclosures don't show that they are effective. And in fact, there are some reverse effects.

Now, think about disclosure: What kind of behavior could disclosure prevent? Disclosure could prevent the behavior that I would exhibit under the cost/benefit analysis: I would be afraid that somebody is watching me and that I would be caught; what's preventing me from being bad is this idea that somebody's watching me. But the kind of

dishonesty we find is rarely this type. It's mostly dishonesty on the rationalization side. And the moment it's about rationalization, whether somebody's observing us or not doesn't make any difference. So having conflicts of interest and then disclosing them is not effective. The right approach is to figure out how we can eliminate, or at least vastly reduce, conflicts of interest.

CR: *From the standpoint of individual investors, where they don't have a lot of control over the pay structure, what can they do?*

DA: First of all, I think there are choices. There are some advisers who are charging a fixed amount a year. We as investors can be very explicit about asking the financial advisers to show us the financial statements, so we can figure out who is paying for the Bloomberg terminal. We can actually ask advisers what happens if they invest in a mutual fund that gives them a kickback. So I think if we ask questions directly, the financial adviser is not going to lie. But without being asked all these questions about the practices and so on, advisers will keep all kinds of things kind of shady.

So think about something like a kickback. A financial adviser can invest in mutual fund X, and mutual fund X gives him back a quarter of a percent on the amount invested. The financial adviser can say to himself, "I would have invested in this company anyway! I'm getting back a quarter of a percent, but my client is not suffering." And that kind of rationalization becomes incredibly harmful. So we want to ask the financial adviser what he does with that money: Is it going back to the client, or is it fueling some further conflicts of interest? Or we can ask advisers to consult with us specifically every time they're going to buy a fund that has a kickback. I think we just need to be worried about conflicts of interest, aware of them, and try to eliminate them to the extent that we can.

CR: *In terms of dishonesty, do you think it also is an issue for how people view their own performance and view their own ability to pick stocks and bonds?*

DA: I think that's not so much a

matter of dishonesty. But I do think financial advisers often claim all kinds of performance figures that are kind of shady. For example, when advisers show performance over the last few years, they often don't take the management fee out of that. Say I show you my performance over the last year, and it's 1% better than that of the S&P 500 index, but I don't show you that I take a 1% fee. Then you don't see that I'm actually not doing much better.

CR: *What about individuals? When you've done studies, do you see that people themselves are overstating their own abilities? If we look at it from the standpoint of, say, how an individual who is managing his own money is actually doing?*

DA: In terms of individuals, I think there are cases of kind of delusional returns that people think that they're getting, but I think the bigger issues with individuals are more standard and go back to the issues of sunk costs and anchoring.

So, of course, if you buy a stock at whatever price, \$60 or \$100, and today this stock is \$80, it shouldn't matter whether you bought it at \$100 or whether you bought it at \$60. The only thing you should care about is whether you think it's going up or going down in the future. But the truth is that people have an incredibly hard time looking at stocks like this. If you bought the stock at \$60 and now it is \$80, you feel really good about it, and you're willing to sell. If you bought it at \$100 and now it is \$80, you feel very bad about it, and you hope to keep it on a little bit further, a little bit more, hoping it will increase in price. Now, that basically means that we look at the past in order to evaluate our performance. But any investment in the stock market should always be forward-looking. Everything in the past isn't relevant; it doesn't matter. And we should just ignore it. In fact, the strategy I like best for thinking about investments is to imagine that somebody sold all your assets during the night and then the next morning it's tabula rasa, it's nothing. So the question becomes, what should you buy and what should you sell, based

on the portfolio that you have now? Every time I've presented this exercise to somebody, they say that they would stay with that portfolio. And I think that tells us that we are basically married to what we had in the past—to what we purchased—to too high of a degree.

Now of course, it is an expensive exercise to sell and buy everything, and a time-consuming one, so I'm not recommending it. But as a thought process, it's incredibly important.

CR: *To change subjects, I remember that at the 2010 CFA Institute Conference you talked about how people become paralyzed by choice. They don't make any decisions when confronted with too many decisions.*

DA: Yes, that's right. Having a lot of choices is a very paralyzing thing, because we don't know what to do. And because we don't know what to do, we do nothing. That's actually very terrible, because, especially in the financial market, if we think about it, we have lots of things to decide. It's about our current state: If too much information paralyzes you, it's hard to make exchanges with confidence.

And the same problem occurs to quite a high degree now, since the financial crisis. My understanding is that lots of money is held on what's called the sidelines: People had taken money out, and they are waiting to decide what to do. And of course there are so many options, and we have seen so many fluctuations, that it's hard to figure out what to do, and the delay is very long. So this idea of paralysis, I think, shows itself both in terms of standing on the sidelines not committing to something and also in terms of not changing the strategy that we use.

CR: *So how do investors stop being paralyzed when they find themselves overwhelmed?*

DA: One suggestion is to create a default option. Imagine the following: If you basically say to yourself, "I have all my money in money market accounts getting 0%, and I'm going to wait until I find a great option." That means that you're going to search and search and search and look for something, and it might take you forever to find anything.

However, what if you took a different approach? What if you said, “I’m going to spend the next two months deciding what to do, and if I don’t find anything better, I’m going to buy X.” Or you could say, “While I wait for something better to do, I’m going to do Y.”

If we understand that there’s a tremendous role for a default option, for the path of least resistance, then we want to think very carefully about what this default is. And, in particular, we want to think if we want to let the default be the choice of having the money in a money market, basically, or checking. That’s a very bad default option.

So the complexity of choices actually has two components: complexity and default. As the complexity increases, our reliance on the default option increases—which means that at some point we don’t make decisions. As the amount of choices increases, we actually make fewer and fewer active decisions, and we make more and more passive decisions. So if we understand it, then we want to say, “If that is the case, let

me control my passive decisions. I don’t want them to be left to chance.” So that would be my main suggestion.

CR: *And would that also hold true for someone who sees choices but maybe is distrustful of their advisers and Wall Street? Would you suggest that they have a default option?*

DA: Yes. We can never know for sure, right? The next financial crisis could come very quickly, and a money market account might be the best thing to do with our money. I mean, it’s possible. But in principle, the problem is that we get out of the market and we miss some of the market increases, and these are things that are incredibly hard to recuperate from. So there are people, I think, who left the market in a bad situation and basically have lost their ability to retire. It’s incredibly, incredibly sad.

CR: *Lastly, do you have suggestions on how investors can prevent the most common behavioral errors?*

DA: There are two ways to overcome these problems. The first one is

that when we think about our money, and when we think about changes, what we don’t want to do is to look at our portfolio and then make the decision. If that’s what we do, then we will be inherently focusing on the past. All of the websites that we see, that give us information, they basically focus on the past. They try to overwhelm us with information and to make us feel that we’re getting some value, but they show us all this information about the past, which is mostly irrelevant. So the thing to do is to make decisions without looking at how our individual portfolio has done compared to the past. So that’s one thing: Not to be reactive to the movement of the stock market, but instead be thoughtful.

The second thing to do is the exercise I described earlier, which is to periodically imagine that somebody came at night and sold everything you own. And then think about what you would want to own if you had nothing. And that would help liberate you from those thoughts. ▲

Dan Ariely is the James B. Duke Professor of Psychology and Behavioral Economics at Duke University and a founding member of the Center for Advanced Hindsight. His new book is called “The (Honest) Truth About Dishonesty” (Harper Collins, 2012). For more information, go to www.aaii.com/authors/dan-ariely. Charles Rotblut, CFA, is a vice president at AAI and editor of the AAI Journal. Find out more about Charles at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/charlesrotblut.

Portfolio Strategies

Table 4. Summary of Results

	Annual Income 2012 – 2041 (\$)	Annual Cash First Year – Last Year (\$)	Total Cost (\$)	Possible Legacy (\$)
Plan A	40,000 – 40,000	483 – 1,184	987,352	41,022
Plan B	40,000 – 40,000	3,045 – 7,177	920,304	258,483
Plan C	40,000 – 40,000	4,121 – 9,711	855,770	467,795

(continued from page 29)

The transaction costs may necessitate the reduction of the maturity value of each STRIPS and the residual

amounts of cash and or equities (perhaps not significantly), depending upon the purchase venue, such as Fidelity Investments or Wells Fargo Advisors. With

the former, the investor would have to do all the calculations to ensure the best utilization of the money. With the latter, the adviser would determine all the purchases.

This analysis shows that investors have several alternatives for guaranteeing acceptable, and known, retirement income for 35 years—essentially a pseudo-life annuity for those investors aged 55 and older.

Additional options for Plans B and C are included as an appendix to the online version of this article. ▲

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