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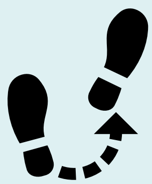

A Nudge (Libertarian Paternalism) is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any option or significantly changing their economic incentives - Richard Thaler

Libertarian Paternalism (or just 'NUDGE')

"When an economist says the evidence is 'mixed', he or she means that the theory says one thing and the data says the opposite"

- Richard Thaler

This is the 25th article of 'The Stoic Investor' and marks the six months of write-ups about behavioral finance, improving investment decision-making and implementing sound investment strategy and process. Excited about the silver jubilee edition, I decided to pick up a topic related to Richard Thaler, the founding father of behavioral economics (and a personal inspiration for me).

Richard Thaler won a Nobel Prize in Economics in 2017 for his contributions to the field of behavioral economics. His most cited papers are regarding: The Endowment effect, the overreaction in the stock markets and the concept of Nudge. In this article we will explore the concept of Nudge. It is a simple yet extremely powerful concept which has wide applicability in improving decision-making.

WHAT IS NUDGE (IN PSYCHOLOGY)?

Richard Thaler and Cass Sunstein (American scholar in Constitutional Law) worked on the concept of Libertarian Paternalism. It involved applying the techniques of psychology and behavioral economics to improve decision-making without limiting the choices. The Libertarian part of the concept means people should have the freedom to choose. Paternalism involves being concerned about the choices people are making and hence influence those decisions with the intention to make their lives better. In Libertarian Paternalism, one is not forcing people to make a particular choice but 'nudging' them towards making a choice that is good for them. *"A Nudge (Libertarian Paternalism) is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any option or significantly changing their economic incentives"* - Richard Thaler.

Let's look at an example here: A lot of people have trouble sticking to a healthy diet. A few years back, the US government made it mandatory for restaurants to display the calorie value of the food they serve, along with other information on the menu. This had a positive impact on the eating habits. The customers have the freedom to pick up any dish they want to have but the calorie number acts as a nudge to choose a healthy meal. The additional information influences the consumer to make a healthy choice without changing the options or the economic value.

In investing, most people want to buy low and sell high but end up doing the opposite. When I get an opportunity to present during crisis times, I make sure that I present data about the previous crises and discuss how markets behave and how investors can take advantage of certain conditions. Though the people in the audience have the choice to make their own assessments and decisions, understanding history and behavior of markets will nudge people towards better investment decisions.

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WHY DO WE REQUIRE NUDGES?

Psychologists classify our thinking into two types: System 1 referred to as the Automatic system and System 2 called the Reflective system. The automatic system is the rapid, intuitive and uncontrolled system. It is in action when you duck because a ball is thrown at you unexpectedly. It is sometimes referred to as 'Gut Feeling'. The Reflective system is analytical, deliberate and rational. When you are asked, what is 67 x 113?, system 2 is in play. System 2 is slow and requires lot of effort and energy. Because we are living a busy life, the mind develops short cuts through experiences and available knowledge to take decisions without much effort. These short-cuts are rules of thumb or heuristics. They serve us well and help us in many day-to-day activities. Unfortunately, because they are not accurate, sometimes they are also the source of biases coming into decision-making. The mind can use the right nudges during these times to identify and eliminate the biases or de-bias.

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CHOICE ARCHITECTS AND INVESTMENT NUDGES

Problems arise when people have to make decisions that test their capacity of self-control. Investing, like exercise and diet, is an area where people have to sacrifice or incur costs upfront and receive benefits later. It tests people's discipline and commitment. Also, the complexity involved in decision-making regarding investments makes people vulnerable to errors. Hence, this is an area where people need the right nudge.

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The context in which people make choices is called the choice architecture and the person who designs the context is the choice architect. For example, for individual investors, a financial advisor can be a choice architect, if they are his/her clients. For an investment firm, the person designing the investment process (say a Research Head) is the choice architect for the team. Even government (through its finance ministry and financial institutions) acts as a choice architect for encouraging and guiding savings and investments for the citizens.

Richard Thaler has provided a framework for creating a good choice architecture. Based on this framework I have suggested some nudges below, which can help improve investment outcomes. For this article, I have classified the nudges into two broad areas: One, for financial advisors guiding their clients. Two, for a Research Head designing the process for the team.

- **Using Model Portfolios and Defaults:**

  Model portfolios and defaults can help anchor investors to the right mindset for long term investing. Some people prefer to go with the default options without much changes; others are influenced by the model portfolio and the rationale behind it even if they don't go by it exactly.

FAs can make the investors aware of the long-term investment returns and the risk-return trade off to be taken under various options. Whether investors go with the model allocation or choose to customize, the numbers will nudge them towards making informed decisions

- **Financial Advisors (FAs):** FAs can create asset allocation model portfolios for investors based on long term asset returns (asset profile) combined with investment horizons (age profile). Model portfolios can be divided into aggressive, moderate and conservative to suit different risk profile of investors. Through this exercise, FAs can make the investors aware of the long-term investment returns and the risk-return trade off to be taken under various options. Whether investors go with the model allocation or choose to customize, the numbers will nudge them towards making informed decisions. Portfolio statements should ideally carry return calculations only of long-term timelines (at least 1 year). Resisting the temptation to look at short term returns will help reduce noise and unnecessary churn.

- **Research Head (RH):** RH can have analysts create a model portfolio of their top ideas. A model portfolio can also be created by using risk-return estimates processed by a quant model (like Kelly's Criterion). These should be shared with portfolio managers to compare with their portfolio allocations and difference in opinions discussed. This will help identify any bias in security selection or allocation.

- ***Expect errors and prepare for them:***

To err is human. The most common error made by investors is increasing allocation to a stock or an asset class at its peak and selling it at the lows. The choice architecture should expect such situations and prepare for them.

- **Financial Advisors (FAs):** Clients need to be told that it is profitable to be greedy when others are fearful and fearful when others are greedy. A pre-commitment can be taken to increase allocation when valuations are attractive in a particular asset and reduce when something is overpriced. Of course, clients need to be given the freedom to change the plan whenever they want. However, experience says, people who opt-in for in a plan don't quickly opt-out. Inertia or status-quo bias can keep clients on the right investment plan.

- **Research Head (RH):** Thaler and DeBondt published a paper on overreaction of the stock markets where they showed how the underperformers and outperformer of the previous 5 years change roles in the subsequent years. They show how contrarian investing delivers better returns than the index over the long term. If the team regularly discusses such screeners, it can help nudge towards better stocks selection, reducing the temptation to chase overvalued investments.

Nudges can be developed for specific situations by understanding what drives particular behavior and what can de-bias or introduce an opposite bias

➢ **Mapping and feedback:**

Mapping is like helping someone visualize the impact of the choice. Feedback is about reviewing what's working and what's not.

- **Financial Advisors (FAs):** Rather than showing statistics about expected rate of return under various plans, FAs can use pictures of houses that a client would retire in if a certain allocation is followed. And how by increasing contribution at the right time, the client returns can afford him a bigger house or in a better location. Mapping aids people to take decisions that make them better off. Reviews should be focused on how the client portfolio is moving towards the long-term goals. Ideally, an investment journal should be maintained to record all the decisions taken from time to time. This helps understand the outcomes and improve future choices.

- **Research Head (RH):** For mapping, Factor Analysis (Value, Quality, Growth, Momentum) can be conducted to understand portfolio leaning and what can be expected under certain conditions (Scenario Analysis). This can be compared with predetermined Portfolio strategy. Investment decisions should be recorded in a journal and discussed along with attribution reports. This feedback will help improve decision-making.

I have discussed nudges for some common issues faced by investors. Nudges can be developed for specific situations by understanding what drives a particular behavior and what can de-bias or introduce an opposite bias. Smart investors try to understand their own biases and weaknesses and design their own environment in a way that makes it easier to take the right decision. They can 'self-nudge' (behaviorally).

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ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).