Your Own Worst Enemy I - Framing and Nudges

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Your own worst enemy I - Asking the Right Questions

We know from a behavioral perspective that the framing of questions can radically alter the answers given and that it is incredibly hard to remove people' biases. In this paper, we explore how framing, nudges and re-biasing and nudges can influence answers to questions, and how at the philosophical heart of Nebo is a focus on the importance of asking the right questions.

"Your own worst enemy"

"Your own worst enemy" is a series focused on helping advisors deal with the challenges associated with the fact that their clients, like all of us, are fallible and subject to behavioral biases. Investing is hard, and these behavioral biases add another layer of complexity. The series will also explore how the Nebo platform (www.nebo-gmo.com) is particularly well-suited to helping advisors better understand, visualize, and mitigate these issues.

James Montier, Editor

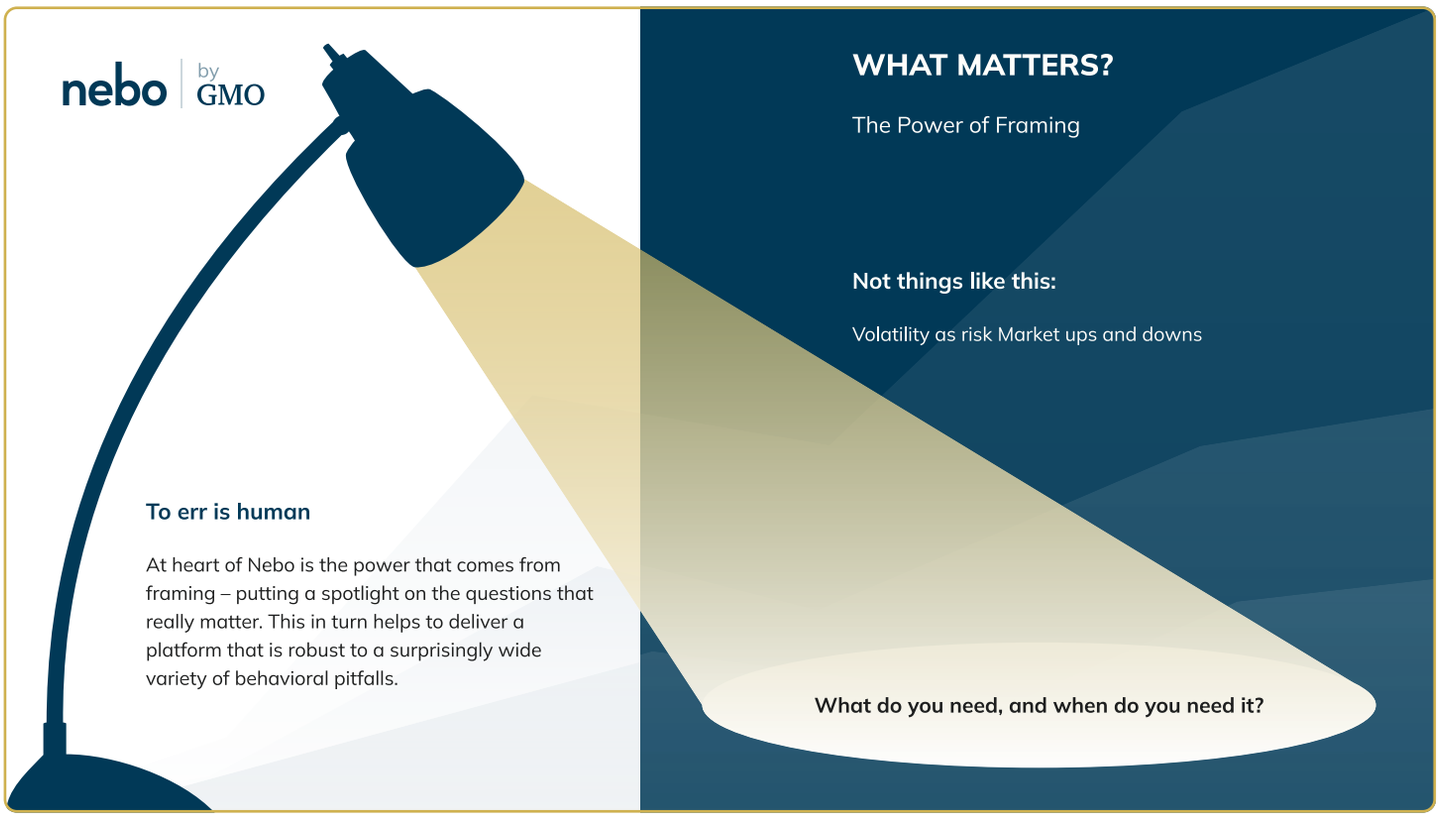
At the philosophical heart of Nebo is a focus on the importance of asking the right questions. In the case of financial planning this amounts to asking what do you need and when do you need it[1]? Once this is understood then everything else begins to fall into place. For instance, real risk becomes falling short of what you need or running out of money during the retirement phase. From this we can build a portfolio that seeks to mitigate these risks - but it all starts with asking the right questions.

Contrast this with the standard approach of asking what is the goal you trying to accomplish with your portfolio? In some sense the portfolio is the answer, but it isn't terribly clear what the real question is that the portfolio is the answer to. The questions posed to investors are framed in terms of a client's risk tolerance and/or risk capacity. This "risk tolerance" is then generally translated into a volatility limit (at odds of course, with the idea that risk isn't a number (one of the most important edicts in finance)).

As Martin is fond of saying "The answer depends up on the question". A point beautifully illustrated by the late great Douglas Adams in his Hitchhikers Guide to the Galaxy:

> Some time ago a group of hyper-intelligent pan dimensional beings decided to finally answer the great question of Life, The Universe and Everything. To this end they built an incredibly powerful computer,

1 We frame risk here as 'not having what you need, when you need it' but it equally applies to 'not having what you want, when you want it.' The needs-based allocation framework is agnostic to either concept. Our 2022 Fall Conference presentation takes you through an example of an individual who has a very small chance of ever running out of money, but we show how Nebo applies to high-net worth or ultra-high net worth individuals as well Nebo Fall Conference 2022.



> Deep Thought. After the great computer program had run (a very quick seven and half million years) the Answer was announced. The Ultimate answer to Life, the Universe and Everything is… *You're not going to like it…. Is….. 42 which suggests that what you really need to know is "What was the Question"

Framing

We also know from a behavioral perspective that the framing of questions can radically alter the answers given, like this except from an old British comedy *Yes, Prime Minister.* In this particular example Sir Humphrey demonstrates the power of leading questions in order to generate completely opposing answers (in this case on the topic of National Service).

In his first run, Sir Humphrey asks his hapless minion (Bernard) the following set of questions:

- *Are you worried about the number of young people without a job?*
- *Are you worried about the rise in crime among teenagers?*
- *Do you think there is a lack of discipline in our comprehensive schools?*
- *Do you think young people welcome some authority and leadership in their lives?*
- *Do you think they'll respond to a challenge?*
- *Would you be in favor of reintroducing National Service?*

When presented with these questions, Bernard replies in the affirmative to each question, leading

to the final question, to which he says yes.

Then Sir Humphrey poses a second set of questions:

- *Are you worried about the danger of war?*
- *Are you worried about the growth of armaments?*
- *Do you think there's a danger in giving young people guns and teaching them how to*
- *Do you think it's wrong to force people to take up arms against their will?*
- *Would you oppose the reintroduction of National Service?*

Once again poor Bernard finds himself answering in the affirmative, and of course, providing a completely opposite conclusion to his answer from the first set of questions. Such is the power of framing.

People are very poor at seeing through the way that information is presented to them. For instance, it is much better from a marketing perspective to label something as 97% fat free, rather than 3% fat. Yet the two statements are obviously equivalent.

The classic example comes from the work of Kahneman and Tversky. In their study, a group of participants all read the following description:

> The Scenario:
>
> *Imagine that the US is preparing for an outbreak of an unusual Asian disease, which is expected to kill 600 people. Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimate of the consequences of the programs are as follows…*
>
> Then the participants then had to choose between two options:
>
> **Program A:** *200 people will be saved.*
>
> **Program B:** *There is 1/3 probability that all 600 people will be saved, and 2/3 probability that no people will be saved.*

When given this choice, 78% of the participants chose Program A. They would rather take a sure bet that 200 people would be saved than gamble on the possibility of losing all of the people.

So far so good. But when Kahneman and Tversky gave another group of participants the exact same scenario and the exact same decision but they framed the decision differently, something very different occurred:

> **Program C:** *400 people will die.*
>
> **Program D:** *There is 1/3 probability that all no people will die, and 2/3 probability that*

600 people will die.

This time the results were different. In fact, they were the exact opposite. Now 78% chose the **second** option. They would rather risk losing everyone than take the option that involved 400 people dying.

In both circumstances the situation is exactly the same. The options are just **framed** differently. For the first group of participants the options were framed as a *gain* and for the second group they were framed as a *loss*. And depending on the way these choices were framed people made completely different decisions. Learning how to frame the discussion you are having with clients is truly vital.

Nudging

In the field of psychology there is an expression "If you can't debias then re-bias". We know it is incredibly hard to remove people' biases. We certainly can't just wave a magic wand and transform people into Vulcans (a humanoid species that that relies exclusive on logic to govern their actions, just in case you are the last person alive who has never encountered Star Trek.... In which case stop reading this immediately and go and indulge in the wonders of a going boldly where no man has gone before).

Often it is easier to recognize that people will suffer biases and try to turn those biases to their own advantage.

Opt out vs opt in default options when it comes to organ donations, and auto enrollment in retirement plans are just two of the many possible examples where people's behavior can be "nudged" to borrow Thaler and Sunstein's expression.

Nebo

As we stated at the outset, Nebo attempts to frame the discussion between an advisor and their client in terms of highly relevant 'what do you need and when do you need it' questions. These are very salient and accessible questions which give rise to a natural view of risk as falling short of your needs. Thus, Nebo nudges us towards portfolios that are better aligned with the things that a client should truly care about.

What we hear from advisors is that Nebo helps increase their confidence that they have clients in the right portfolio. Nebo bridges the gap between a client's financial plan and a portfolio personalized to the success of that plan. Nebo can do this by asking the critical question related to the portfolio and the plan: how do we define risk? By redefining risk more sensibly around the client's desired outcomes, we can create a portfolio specifically designed to minimize the risk of falling short of a client's goals (both in the probability of falling short and the magnitude of falling short – missing by $1,000 is very different than missing by $1,000,000).

Part of this confidence also arises from having more robust and real-life Monte Carlo simulations.

We find that most 'out of the box' Monte Carlo simulations are stuck using 'Random Walk' assumptions for returns (popular in the 1970s – fifty years ago). Nebo uses next-generation Monte Carlo simulations which account for real-world effects related to the mean reversion of stocks and bonds as well as a volatility term structure based on how stocks and bonds actually behave. We believe the result is a more correct and robust analysis, a narrower distribution of outcomes and avoiding the critical error of bond-heavy and stock light portfolios propagated by most financial planning software [2].

Nebo is an asset management platform built on pillars of behavioral finance. Our mission for Nebo is to improve client outcomes. Understanding the importance of framing questions around client outcomes and building portfolios directly linked to those outcomes gives clients a much better chance of achieving their goals. Nebo provides the tools for advisors to nudge (or a proverbial shove as well) clients in this direction.

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2 See reference to White Paper, hyperlink to webinar.

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