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Irrational beings

- a user guide for behavioural finance

Contents

- Introduction
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- Irrational beings…
- Irrational consequences

Introduction

Cath Hodges

Client Partner

- Previously: Solvency II Senior Design Actuary
- Previously: Head of Modelling Centre
- Previously: Head of Actuarial Change
- Still: Hilarious

About 4most

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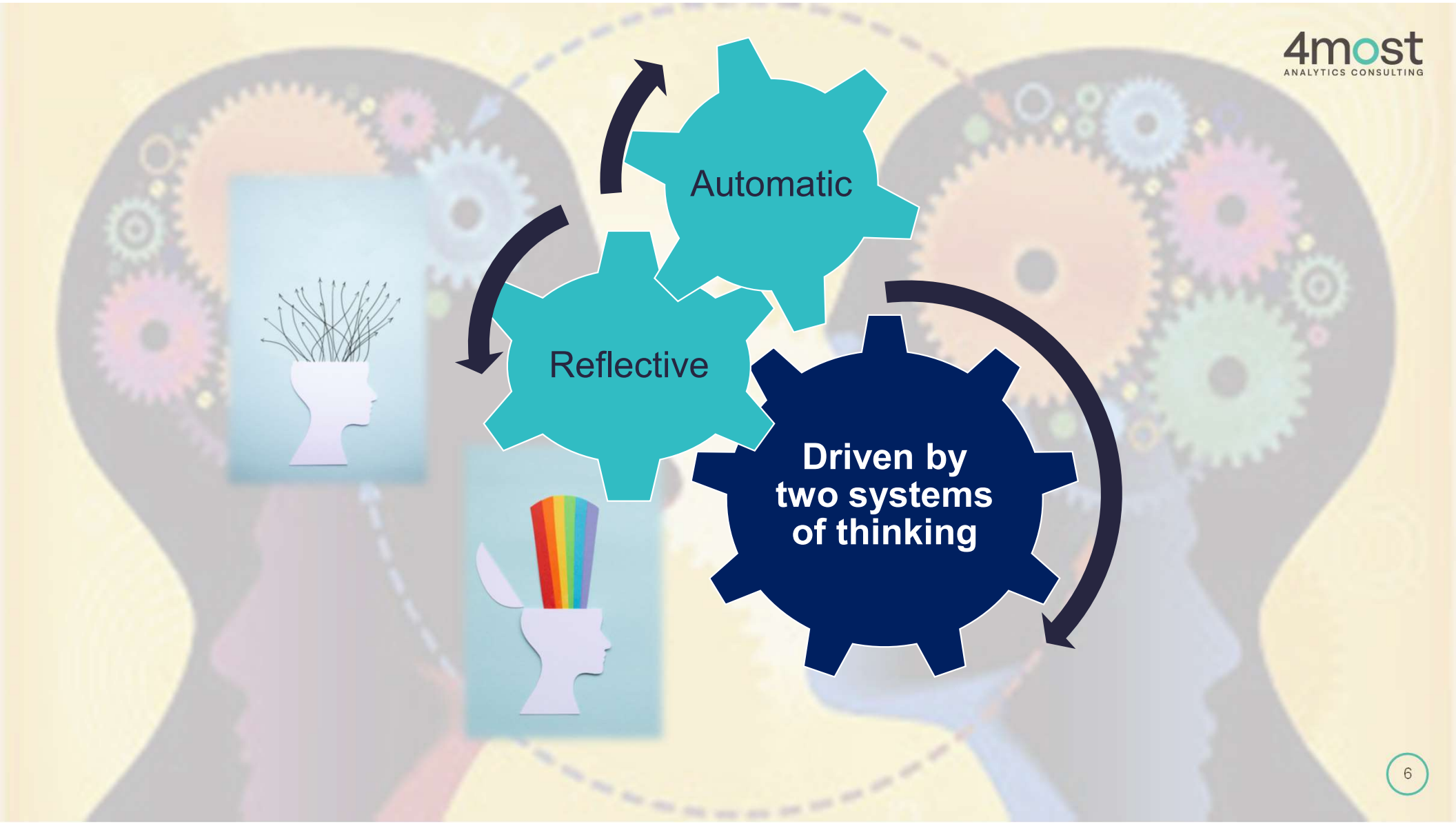
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Automatic
Reflective
Driven by two systems of thinking
6

Our brain switches between these modes

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Slower deliberate thinking

Fast automatic responses

We often use the irrational side of our brain…

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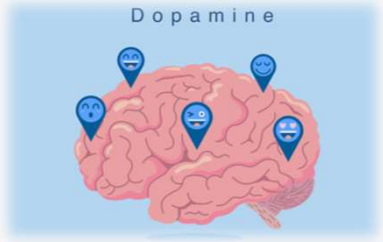
WHY?

Not enough time to think everything through



Hits of dopamine for immediate gratification….

Lack of willpower!

Even corporations are irrational…

Often bonus schemes reward upside risk, but don't penalise downside risk

Budget setting based on prior year's spending

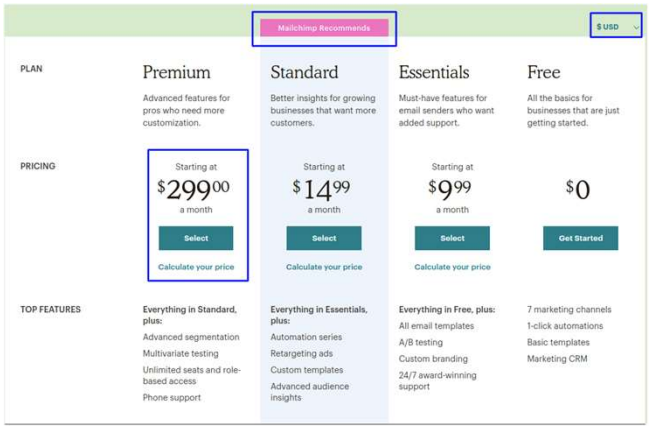
How are we irrational?

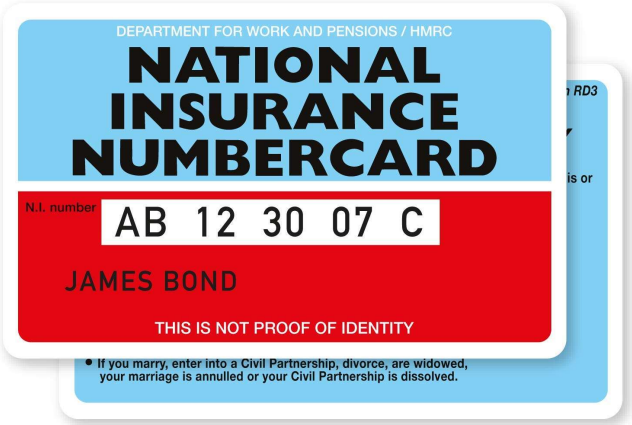
(1) We take shortcuts

We use comparisons rather than working things out from scratch

How are we irrational?

(1) We take shortcuts





Anchoring

How are we irrational?

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(2) Our brains access some things faster than others

Availability Error

How are we irrational?

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(2) Our brains access some things faster than others

Identifiable Victim Effect

How are we irrational?

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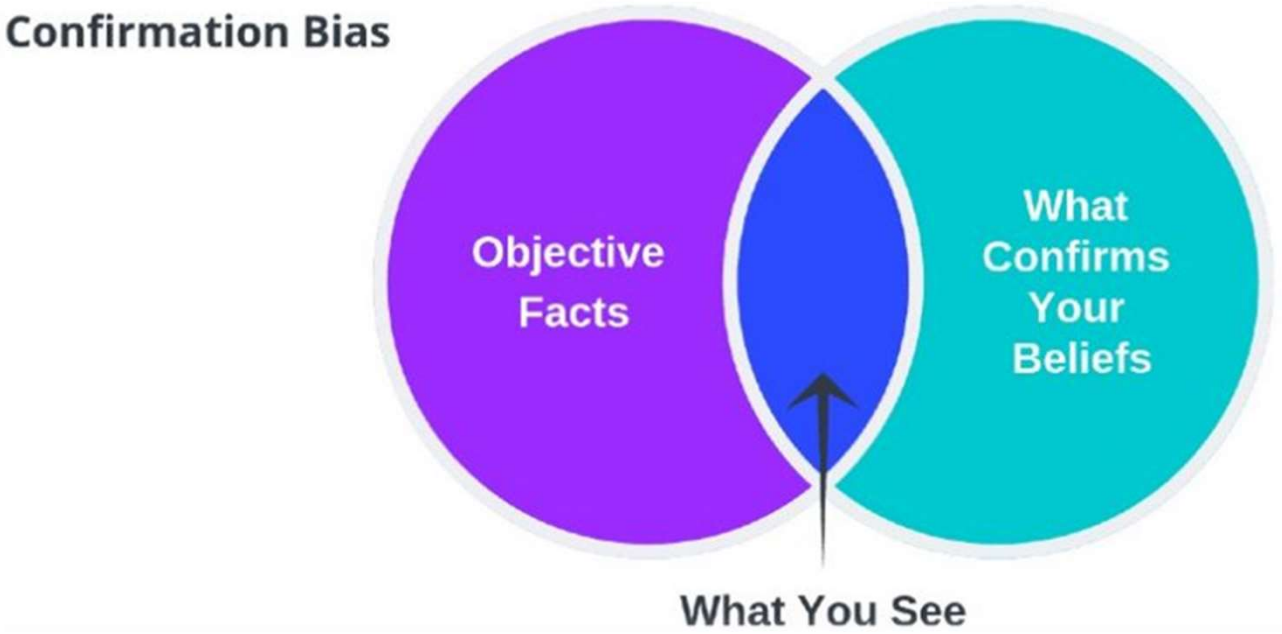
(2) Our brains access some things faster than others

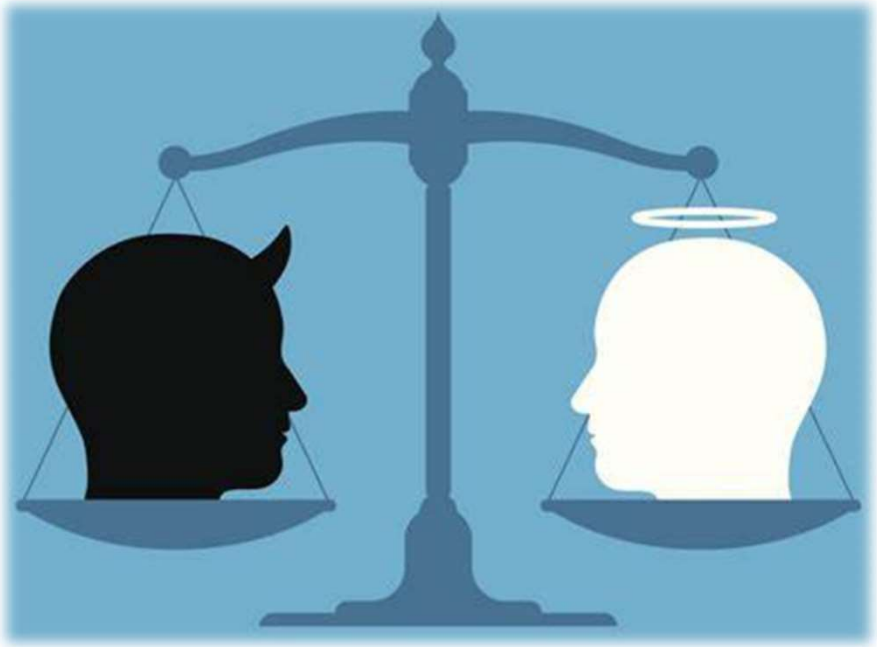


Confirmation Bias

How are we irrational?

(3) We have biases

Primacy Error and the Halo Effect



How are we irrational?

(3) We have biases

Creators Bias

How are we irrational?

(3) We have biases

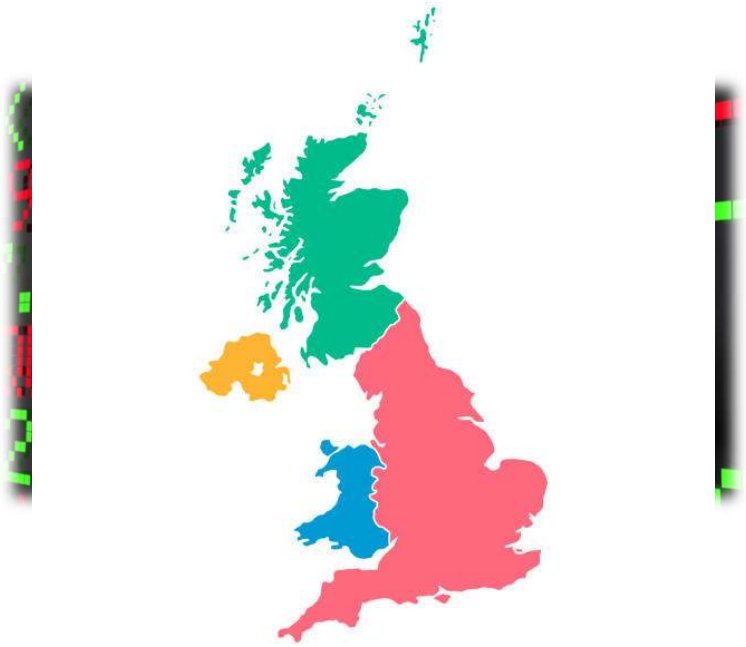
Value the familiar

April 1452 – May 1519

How are we irrational?

(3) We have biases

Value the Familiar



How are we irrational?

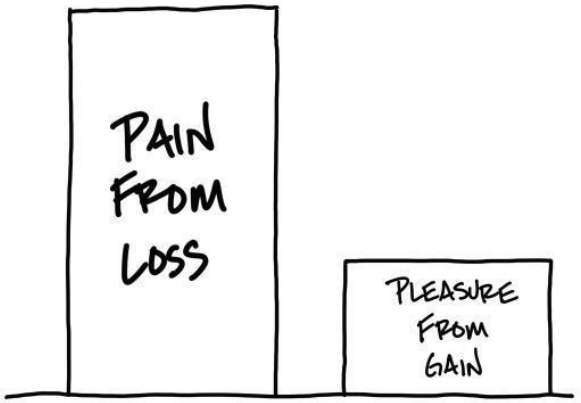
(3) We have biases

Endowment Effect

How are we irrational?

(3) We have biases

Loss aversion



BEHAVIOR GAP

How are we irrational?

(3) We have biases

Power of free

How are we irrational?

(3) We have biases

Normalcy Bias

Queues of traffic leaving before Hurricane Harvey

How are we irrational?

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(4) We form our opinions based on our own experience

e.g. assessing our likelihood of having a stroke against how many people we know who have had a stroke

How are we irrational?

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(5) We use different norms for different situations

MARKET NORMS

VS

SOCIAL NORMS

So what?

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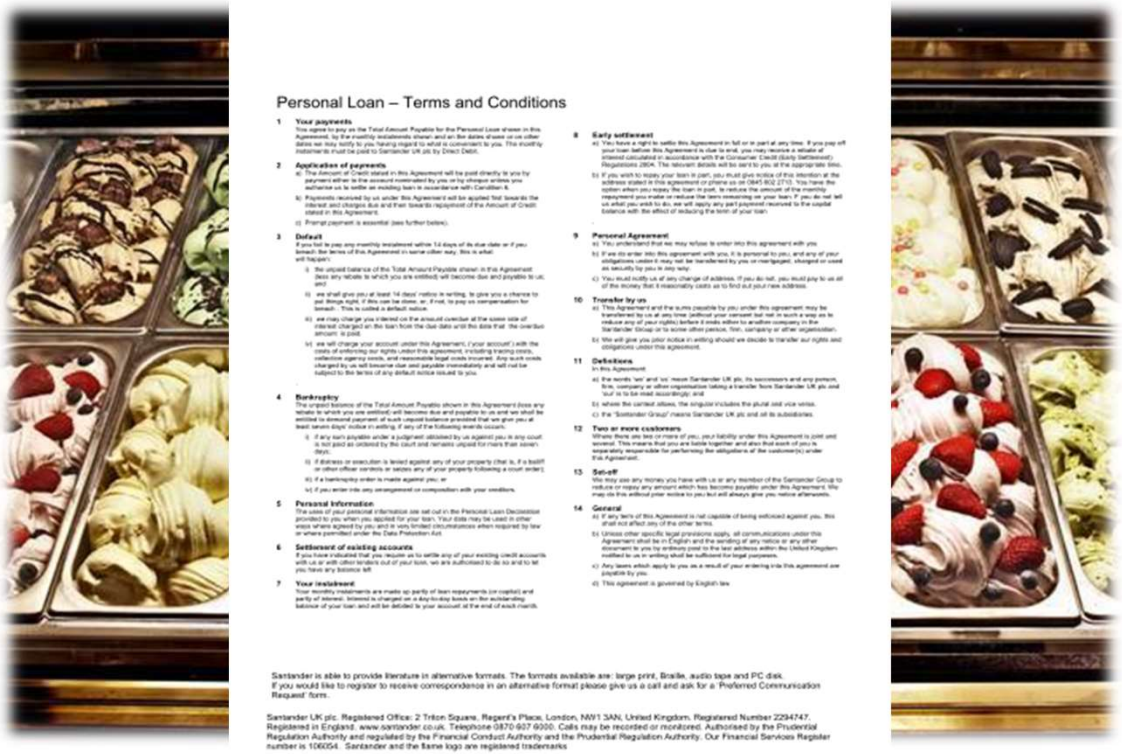
We tend to make bad decisions

… especially when trading off immediate benefit for long term payback…

And when we don’t have the right experience to interpret the information available to us.



Personal Loan – Terms and Conditions

1 **Your payments**

2 **Application of payments**

3 **Default**

4 **Bankruptcy**

5 **Personal Information**

6 **Settlement of existing accounts**

7 **Your instalment**

8 **Early settlement**

9 **Personal Agreement**

10 **Transfer by us**

11 **Definitions**

12 **Two or more customers**

13 **Set-off**

14 **General**

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Which makes us vulnerable

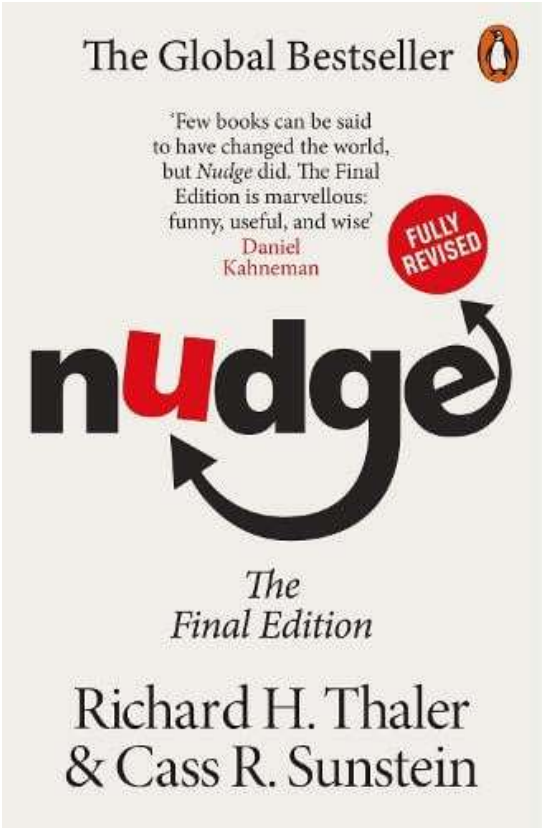
Eye level shelves in supermarkets

Free trials where you must cancel or get charged

Decoy items on the menu

XXL Sizes

Nudges



Richard Thaler: Nobel prize winner for behavioural economics

And not all ‘nudges’ are bad

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Car warning beeps (e.g. petrol, seat belts, lights, etc)

And not all ‘nudges’ are bad

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Asking companies to divulge their carbon emissions

And not all ‘nudges’ are bad

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Teen moms’ ‘dollar-a-day’ scheme

We can also help ourselves with smart nudges

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Public Weigh-Ins

Making bets with friends

Only listening to a favourite podcast when running

Cold hard thinking: listing our pros and cons, and the use of statistics

Our industry can be a force for good

FCA

"It can deliver better outcomes for all parties. It will become a standard part of an insurance company's approach to customer interactions."

Auto-enrolment

Use defaults in investment choices

Design retail finance vehicles

How we communicate with customers

Influence public policy

Conclusion

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Humans are irrational…

…extremely irrational

Corporations exploit our irrationality…

… but if we know about it, we can also use this knowledge and be a force for good

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Questions?