

Behavioral Finance and
Plural Rationalities

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Behavioral Finance &
Plural Rationalities

1. BF assumes that economists have it correct
2. BF identifies and explains inefficiencies in NCE world
3. Neo classical economics (NCE) has problems.
4. PR provides a model that explains more.
5. Some findings of BF may be better explained by PR.
6. Inefficiencies exist. BF does help to explain them.
7. PR needs improving as well
8. Developing nations may not adopt NCE framework.
9. PR may help to explain the future of the world economy better than NCE

How the Economy Works

1. BF assumes that economists have it correct on how the economy works.
 - The first behavioralists were psychologists who wondered how their profession's techniques would apply to economics
 - They had no particular background in economics

Inefficiencies

2. Their findings are about inefficiencies in how people act within the NCE construct of the economy.

- Proving that the market is not efficient
- Biases
- Prospect Theory

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BIASES - Source Wikipedia

- **Bandwagon effect** — the tendency to do (or believe) things because many other people do (or believe) the same. Related to **groupthink** and **herd behavior**.
- **Base rate fallacy** — ignoring available statistical data in favor of particulars.
- **Bias blind spot** — the tendency not to compensate for one's own cognitive biases.
- **Choice-supportive bias** — the tendency to remember one's choices as better than they actually were.
- **Confirmation bias** — the tendency to search for or interpret information in a way that confirms one's preconceptions.
- **Congruence bias** — the tendency to test hypotheses exclusively through direct testing, in contrast to tests of possible alternative hypotheses.
- **Contrast effect** — the enhancement or diminishing of a weight or other measurement when compared with a recently observed contrasting object.
- **Deformation professionnelle** — the tendency to look at things according to the conventions of one's own profession, forgetting any broader point of view.
- **Denomination effect** — the tendency to spend more money when it is denominated in small amounts (e.g. coins) than large amounts (e.g. bills).^[1]
- **Distinction bias** — the tendency to view two options as more dissimilar when evaluating them simultaneously than when evaluating them separately.^[2]
- **Endowment effect** — "the fact that people often demand much more to give up an object than they would be willing to pay to acquire it".^[3]
- **Experimenter's or Expectation bias** — the tendency for experimenters to believe, certify, and publish data that agree with their expectations for the outcome of an experiment, and to

Problems with NCE

3. But neo classical economics (NCE) has fundamental problems.

- (A) does not explain actions of all of the people and
- (B) does not even explain the people that it does explain all of the time and
- (C) does not have a model for all of the phases of the economy.

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NCE Explains Rational Man

Rational Man makes all decisions by calculating expected values

- Enters into transactions only when expected value calculation tells that their expected value increases as a result of the transaction
- Any risk is acceptable if EV is positive

And markets made up of Rational Men

- Markets that are perfectly competitive
- Equilibrium seeking

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That's Not All the People

- Cannot explain altruism
 - Most families do not operate on a system that is consistent with NCE
 - In some cultures families are defined much more broadly
- Cannot explain the people who opt out of the economic system
- Cannot explain trust between individuals
- Without resorting to (cynical) judgments about those people that they would not agree with

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Not all of the time

- Markets are not always rational
 - Animal Spirits
- Some Economists approach to that fact



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Exception to the Three Monkeys approach

- Rogoff, et al This Time is Different
- Economic blowups have happened dozens and dozens of times over the past 500 years
- Usually about 17 years after a sovereign default, that government is again able to issue debt
 - And the markets are buying that debt!
 - But the countries that default tend to do so
- over and over and over again

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NCE does not have a model for all phases of the economy

- Economists will now talk about three phases to the economy
 - Normal
 - Boom
 - Bust
- But their models only apply to the “Normal” phase
 - The reason Greenspan was thought to be such a magician is that he seems to be able to keep the economy in the “normal” phase most of the time
 - But partly by denying the ability to “see” a Boom

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But they actually have been admitting to a fourth phase lately - UNCERTAIN

- The economists approach to the UNCERTAIN phase is totally confused
 - Some say stimulate
 - Some say cut back
- But the true definition of this phase is
You cannot know what to do!!

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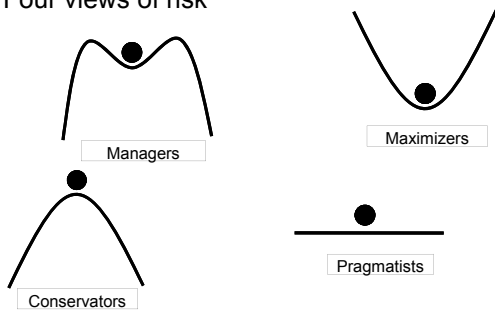
More People, More of the Time

- 4. Plural Rationalities explains more of the people more of the time.
 - The Plural Rationalities model also explains more phases of the economy than NCE.
 - Four Risk Attitudes
 - Four Environments

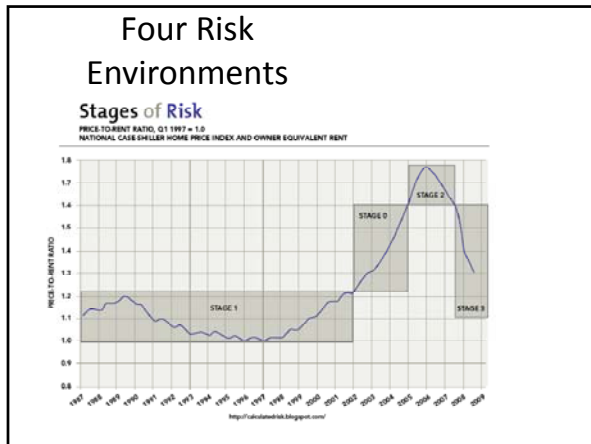
Too Complicated?

- Many believe that
 - "the simplest explanation is most likely the correct one"
- But the simple one phase explanation just does not work, except during that phase!

Plural Rationalities Four views of risk



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- ### Unique Contribution
- The unique contribution of Plural Rationalities is to name the Uncertain phase (that has been predominant for much of the past two years.) as a regular part of the cycle
 - And also identifying the strategies that would naturally fit with the stage and the people whose risk view matches that stage

Rational adaptability

	BUST	BOOM	MODERATE	UNCERTAIN
	Conservator	Maximizer	Manager	Pragmatist
	Loss Controlling	Risk Trading	Risk Steering	Diversification

Alignment of Environment – Attitude – Strategy

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ERM Differences

	LOSS CONTROLLING	RISK TRADING	RISK STEERING	DIVERSIFICATION
Risk Management Systems	Strict limits Strict authorities	Flexible Opportunities	Formal policies and standards CRO	Flexible High communication
Risk Models	Stress testing	Pricing models Rating agency	Economic capital & value	Simplified economic capital
Risk Management Reports	Limit breaches Emerging risks Extreme loss	Profit and risk weighted sales	ROE Capital budget	Risk aggregates & concentrations

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Systems Error

5. Some of the findings of BF may be better explained by PR.

- Example – Anchoring & Framing
 - BF suggests that these effects are simply evidence of less rational decision making
- Plural Rationalities
 - Would suggest that often these biases appear because people have rationally adopted different risk attitudes

People MUST filter

- There is just too much information available
 - Alternative is *Analysis Paralysis*
- Risk Attitude is a very important filter

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Surprise

- The name for the reaction to the difference between experiences and beliefs
 - Surprise Matrix (next slide)
- Reaction to Surprise will be one of:
1. Conformity
 2. Innovation
 3. Ritualism
 4. Retreat
 5. Rebellion – **Change Risk Attitude**

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A Typology of Surprises

Actual World \ Expected World	UNSETTLED	RECESSION	BOOM	NORMAL
PRAGMATIST (Fatalism)	ALIGNED No Surprises	Expected windfalls don't happen	Unexpected runs of good luck	Unexpected runs of good and bad luck
CONSERVATOR (Egalitarianism)	Caution does not work	ALIGNED No Surprises	Others prosper (especially individualistic strategists)	Others prosper (especially hierarchical strategists)
PROFIT MAXIMIZER (Individualism)	Skill is not rewarded	Total collapse (when none was expected)	ALIGNED No Surprises	Partial collapse
RISK REWARD MANAGER (Hierarchy)	Unpredictability	Total collapse (when only partial was expected)	Competition	ALIGNED No Surprises

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Inefficiencies Exist

6. Some of the inefficiencies of BF do also apply to the world as explained by PR.
 - Most BF insights are valuable
 - PR does not require perfect execution as does NCE

Not a Perfect Theory Either

7. Plural Rationalities is not perfect either.

- Few anthropologists, for example, have recognized any positive characteristics to Fatalists*.

 - That is possibly the consequence of their bias.

- Economics can only be actually explained by PR if this group is permitted to be a fully equal rationality with the others.

 - In many cases, anthropologists will talk of the three active rationalities, not realizing that Fatalists are also active and drivers of events in some situations.

*Fatalist is Anthropologists name for Pragmatists

Rational Adaptability

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The Future

8. New Economies are Developing

- China
- India
- Brazil
- Developing nations may never develop into the NCE framework of individualist capitalism .
- Actual Western business practices are a combination of Maximizer and Manager approaches
 - Managers needed to operate the large companies
- Other combinations of the four risk attitudes are possible and are being tried by the emerging economies
 - Usually much less emphasis on Maximizer approach

The New World Economy

9. PR may help to explain the future of the world economy better than NCE

- World economies will be shifting as the Western nations that have predominated the last 100 years wane due to drop in population.
- The future world may feature less growth
 - Population growth is falling in many developing nations
 - A new economic consensus will eventually arise

Plural Rationalities can help to frame the possibilities

A Conservator / Manager blend

- European model

A Pragmatist / Manager blend

- The Asian model

A Maximizer / Manager blend

- The Anglo-American Model

Pragmatist / Conservator Blends

- The Open Source Model

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