FT ADVISER

Investments June 15, 2015

Being in the limelight inhibits risk-taking

Investment ADVISER

A major corollary of the global financial crisis was that the general public became aware of both the financial sector's importance to the economy and how little it knew about its inner workings.

Not surprisingly this resulted in calls for more transparency.

Transparency unquestionably has its merits. Above all, a degree of transparency is necessary to prevent misconduct and potential fraud. But it also creates more bureaucracy and thus increases costs.

In addition, financial professionals and corporate managers may adjust their levels of risk-taking when faced with greater scrutiny, which could affect long-term profits. Given that it involves the psychology of decision-making and potentially serious financial repercussions, this possibility is of considerable interest to behavioural economists.

In recent research, we carried out a series of incentivised experiments to investigate the effect that being in the limelight has on financial choices. We used as the basis of our study the TV game show Deal or No Deal, which has become every bit as popular in behavioural economics circles as it has with viewers.

It's not the programme's innate drama that makes us so fond of it. Neither are we die-hard fans of Noel Edmonds' shirts.

Regardless of whether its creators intended as much, Deal or No Deal is extraordinarily well suited to analysing how people choose between probabilistic alternatives that involve risk. As it turns out, behaviour in the game deviates sharply from traditional accounts of risky choice and is well captured by ‘prospect theory’, a description of decision-making co-developed by Nobel Prize winner Daniel Kahneman.

In keeping with the established format of the series, we invited our contestants – all students – to accept a cash offer or hold out for a mystery amount hidden in a box pre-selected at random. They either played the game on private computer terminals in a laboratory environment or in a simulated game-show setting with an audience, a host and cameras.

Simply put, our key findings were as follows:

n Players in the limelight setting demanded a considerably lower offer before agreeing to deal.

n This result arises because players in the limelight have a greater fear of losing, relative to earlier expectations, if the risky gamble does not pay off.

In essence, what this means is that our subjects found the limelight constraining and anonymity liberating. Contrary to the widely held notion of ‘playing to the crowd’, being forced to make decisions in public did not promote a devil-may-care, audience-pleasing attitude. Rather, it heightened the fear of losing after going out on a limb.

Studies by other research teams focusing on investor behaviour corroborate our findings. It has been found, for example, that investors trade more frequently and more speculatively after switching from phone-based to online trading, and that they tend to keep their core investments with traditional brokers and use only a small fraction of their wealth to speculate online.

In short, then, more scrutiny means more cautious decisions, as people try extra hard to avoid losses. Those who believe the financial industry has been taking too much risk may see this as desirable, but it is also vital to remember there is no profit without risk.

Overall, even when they are anonymous, people show a tendency to place too much importance on potential losses when evaluating risky prospects.

Indeed, subjects playing the Deal or No Deal game in the laboratory also place too much importance on potential losses relative to potential gains. In order to improve the quality of decision-making, this tendency should be resisted rather than encouraged.

Calls for more transparency remain entirely understandable, not least at a time when wider awareness of the industry's complexity and importance is growing – but the economy does not benefit from an overly bureaucratic and timid financial sector.

Too much transparency may lead to overcautious decisions being made by financial professionals, which in the long run will cost clients and shareholders money.

Dr Dennie van Dolder is a research fellow at the Nottingham School of Economics' Centre for Decision Research and Experimental Economics (CeDEx). He is also an affiliate of the Network for Integrated Behavioural Sciences (Nibs). The study referenced here is 'Risky Choice in the Limelight', co-authored with Martijn van den Assem of VU University Amsterdam and Guido Baltussen of Erasmus University Rotterdam

DEAL OR NO DEAL: AN EXPERIMENT

The experiment followed a similar format to the TV show where:

In each of a maximum of nine game rounds, subjects choose a given number of cases to be opened. After the prizes in the chosen cases are revealed, an imaginary banker offers to buy the subjects' own cases. If the subjects accept the offer ('deal'), they receive the amount offered and the game ends. If the subjects reject the offer ('no deal'), play continues and they enter the next round. If the subjects decide 'no deal' in the ninth round, they receive the prize in their own cases.

The experiment was conducted in two settings:

Subjects either played the game in a standard economic laboratory or in a limelight environment, where subjects played the game in a setting mimicking a TV studio with a live audience.

Also in this guide

Sponsored by

Your Industry June 15, 2015

Summer Investment Monitor - June 2015

CPD 60min

1 The outlook for currencies

2 Being in the limelight inhibits risk-taking

Finished reading all (6) articles in this special report?

Bank CPD