

**Human-Centric Investing Podcast**

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Episode 11 – The Science of Choice Architecture

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Farnoosh Torabi: How can financial advisors improve their clients' satisfaction by truly understanding the psychology through which clients make choices? Welcome to a special edition of Hartford Funds Human Centric Investing Podcast. I'm your host, personal finance expert Farnoosh Torabi of Bloomberg Media Studios.

Today, we're exploring what's called choice architecture. It's the science of structuring the way people make choices to help them arrive at better outcomes. It's been used on everything, from organ donation, to 401K plans and we're joined by one of the intellectual godfathers of behavioral economics, professor David Laibson. He chairs the economics department at Harvard University and leads the University's Foundations of Human Behavior Initiative. David, welcome to the podcast.

David Laibson: Very glad to be here.

Farnoosh Torabi: So, choice architecture. I guess a more familiar way of describing this is to nudge, perhaps?

David Laibson: Exactly. It just means setting up the environment so that people can make decisions more easily, and not just make the decision in your mind, but also execute the decision using some kind of tool.

Farnoosh Torabi: So, I'll tell you a quick story. When I was just starting out in the workforce, I remember my decision to invest in my 401K for the first time, I was (laughs) forcefully nudged by a very persistent human resources manager who basically said if I didn't invest in the company 401K, they'd offer a match at the time, that I was leaving free money on the table. And she said, just try it. If it's not for you, you can always, you can always opt out, and I opted in and thanks to Mary, I was \$30,000 richer within just a few years, and so that wasn't exact, exactly choice architecture so much as maybe persuasion.

David Laibson: Yeah.

Farnoosh Torabi: Uh ...

David Laibson: It was kinda choice architecture.

Farnoosh Torabi: Is it? Okay. But tell us what the science is, is really telling us about this.

David Laibson: So, you got it the retail way. Someone had to actually talk you into it, and that turns out to be very socially costly. The choice architecture that we're

understanding now is doing it in a way that is more scalable, more cost effective. For example, in the 401K domain, rather than having a conversation that ends with okay, I'll do it, we

automatically enroll people in the 401K plan, and that's been shown to make a night and day difference in enrollment rates in these plans, and for all the reasons that you mention, for example, matching or tax benefits, most people should be saving in these plans. Auto enrollment takes the participation rate up from about 40% to 90 or 95%. Only five or 10 percentage points of employees opt out after they're auto enrolled.

Farnoosh Torabi: What is the reason behind this? What is it that human beings we are attracted to this and this works for us?

David Laibson: So, we've done a lot of work on that with my co-authors -- John Beshears, James Choi, Brigitte Madrian -- and we find that overwhelmingly, the American public thinks they should be saving more in general for a rainy day fund, for retirement. They get it.

Farnoosh Torabi: We get it.

David Laibson: The problem is, that translating that good intention into action takes a lot of steps. You've got to open up the documents. You've got to read them. You've got to figure them out. You've got to then make a phone call. You've got to make some choices. So, all of that activity gets in the way of actually getting the job done. You'd think well, that's only an hour of time to read all the explanatory documents, make a phone call to human resources, enroll in the savings plan, but turns out, that hour of time is an enormous barrier, and some people end up procrastinating for two, three, four years before they finally get around to enrolling. So, we need to make all of that process easier or maybe even automatic.

Farnoosh Torabi: You mentioned auto-enrollment as one example of a great way to nudge someone into say a 401K plan. What are some other ways to incorporate the science and to make your clients have a better relationship with their money or just be smarter with their financial decisions?

David Laibson: So, another technique that we've studied is something called active choice, which is essentially asking people to make a decision and stop procrastinating. With auto-enrollment, you automatically enroll someone. With active choice, nothing happens automatically. What you say to the individual is, hey this is a really important decision, and we're gonna take some time right now and make the decision. This maybe a deadline or some other mechanism that generates the space for that decision to get made.

Now, it could be a no or it could be a yes, but ask the individual to take the time to dedicate the bandwidth to actually make a decision. There too, we see the people drastically accelerate their participation. We go from a let's say opt-in system, where there's only 40% participating in a 401K plan, to a 70% participation rate when we use active choice. We tell new employees, hey you've really got to make a decision. Yay or nay? Take the time, figure this out.

Farnoosh Torabi: The deadline is very helpful.

David Laibson: Exactly, the deadline. I think so often in life, it's that deadline that turns the procrastination and the good intentions from a disaster where nothing ever gets done to actually completing the task, making the decision, doing the thing that we know we should do but have been delaying for years.

Farnoosh Torabi: Part of what makes personal finance overwhelming is that like you mentioned, there's paperwork, there's fine print, a lot of us didn't the education so we feel like it's above our heads. How do you make it simple? Because that's also part of the framework that has to, it has to be there. The simplification is really key. How can advisors simplify the process for their clients?

- David Laibson: Yeah, so often there's a default option that can be created. Rather than telling people here's this choice that has 18 different dimensions, one can say hey here's what most people are doing or here's what I recommend. When you take the choice from I have to make 18 separate decisions to get this done, to it being well, I can accept the default or I can decline. Suddenly, it becomes a very simple yay or nay decision. So, simplification where we pre-populate a lot of the subtle elements and we say this is a kind of recommended path. Now, all you've got to do is think about this pre-designated option and ask, do I want it? Or do I not want it?
- That makes it easy. And of course, it's not just taking those 18 different dimensions and pre populating them. It's also taking incredibly long documents, filled with fine print and stripping them down to the essence. And so, one can imagine a world where there's the legal document that is the 50 pages of fine print, but then there's also the simplified explanation of what's going on and suddenly, those communications need to be explained in the simplest way to get people to actually pay attention. You hand someone 50 pages of fine print, they'll never read it. Maybe they'll never even participate in that program. You hand someone a page that explains it in a comprehensible way, suddenly people have the time to get that done.
- Farnoosh Torabi: I know personally for for my husband and I, you know, we knew that when we got married and wanted to have children, we had to there were certain things on our checklist we just knew as responsible human beings we had to check off. Life insurance and estate plan, a will. These aren't necessarily topics that we were bouncing up and down you know, addressing but we knew we had to do it. We got through it, I'm putting that in air quotes. We got through it, and I think that for the average person, those are mundane topics, let's be honest. You don't want to think about the what ifs.
- You don't want to think about death. You don't want to think about tragedy, uh how do you make as an advisor, how do you make these topics not only seem important but can I dare say you know, enjoyable? Let's go through life insurance policy. Let's create an estate plan. It's fun, I promise. You know, that's gotta be part of it, too. You have to, you have to make it compelling. Maybe not fun, but just compelling. How do you do that?
- David Laibson: I think it's, it's making these things simple, which makes them easier and it's creating deadlines. They can be something as simple as hey, I know you're busy right now. Why don't we get together uh, an advisor says why don't we get together in three weeks and talk about it? But actually put something on a calendar, so there's an opportunity, uh and a commitment to get something done. In my own life, when I had an advisor helping me with my estate planning, I said, "I'm so busy now. I couldn't possibly focus on this in the moment." And my advisor said, "Hey. We'll do this in two months." And um, he gave me some work to do over those two months, and I plan to do that work continuously over those two months, and of course I did all the work the night before the meeting.
- Farnoosh Torabi: Right, right.
- David Laibson: But it was great, because finally I got the job done. I filled out the forms. I came to his office, and we did all the things I knew I wanted to do and would never have done on my own or would never have gotten around to without the commitment of that appointment.
- Farnoosh Torabi: Commitment, that's the uh, the other thing I was gonna try to bring up. Part of your research is that's also an important aspect of the uh, this sort of choice architecture is to have that implemented. And the good news I suppose for the industry is that this is all free stuff they can implement. It doesn't require you know, creating some software or technology or um, increasing your you know, your worker employee staff. It's just literally um, these small tweaks, deadlines,

making it simple, uh making sure that there is some sort of level of commitment. That's good news.

David Laibson: Exactly, yeah. None of these things are rocket science. Very easy to do and very much align with the interests of the household investor. The American public knows they want to save more. They know they want to think about planning for the future. They know that there are all of these issues that hang over them. And they are looking for solutions, and are happy to make that commitment in the form of an appointment to, to actually get it done. Just don't ask me to do it this weekend.

Farnoosh Torabi: Right. Thanks for joining us today, David. This is really compelling stuff, and for listeners who want to learn more about the topics that we've discussed or about other ways in which psychology affects investors and their financial decisions, please visit [HumanCentricInvesting.com](http://HumanCentricInvesting.com). Until next time, I'm Farnoosh Torabi, and this has been the Hartford Funds Human Centric Investing Podcast.

Disclosure: Hartford Funds has engaged Farnoosh Torabi to conduct this interview. Farnoosh Torabi is not an employee of Hartford Funds. David Laibson is the chair of the Harvard University Economic Department, which is not affiliated with Hartford Funds.

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