Winter 2015: The Not-So Rational Consumer

The Not-So Rational Consumer

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Not many professors of economics would pride themselves on being irrational. Even fewer would desire to write a kitchen guide entitled Dining without Crumbs – The Art of Eating over the Kitchen Sink. But Dan Ariely, who teaches at Duke University, is hardly the traditional economist. When I was introduced to Ariely, he was in Boston speaking to 500 members of the nation's leading organization of professional investors, the CFA Institute. His presentation asked a simple question: Is traditional economics applicable in the real world? Since most professional investors use traditional economics at some level, the audience was captivated. For those not in the investment world, the question may seem academic and with limited implications, until one realizes that Ariely's aim is to point out that regardless of how rational we think we are in our decisions, people are actually predictably irrational.

At the heart of Ariely's work is challenging one of the cornerstones of traditional economics called the theory of consumer behavior. This theory states that consumers act rationally in order to maximize the value derived from the amount of money spent. It assumes that man calculates and is able to weigh the cost-benefit of every decision in order to optimize the outcome. If man is rational, he would be able to easily navigate the free-market and therefore make the best choice for himself at all times.

Ariely believes that far from being rational, people are often irrational and make decisions with a shortsightedness that works against their own interests. To prove his point, Ariely has conducted hundreds of tests, capturing many of them in his entertaining book, Predictably Irrational: The Hidden Forces That Shape Our Decisions.

While traditional economics is based on the premise of a rational consumer, Ariely's discipline is behavioral economics, which integrates psychology. Behavioral economics is rooted in the 1970's with the work of Israeli-American psychologists Amos Tversky and Daniel Kahneman. Through a series of tests, Tversky and Kahneman found that there were consistent biases in the ways people responded to a situation, and that these biases could be traced to mental shortcuts, or what are called "heuristics." Some of these heuristics were pretty obvious. For example, people tend to make inferences from their own experiences; if there has been a recent airline accident, they will overestimate the chance of dying in a plane crash. Others were more surprising. In one set of tests, Tversky and Kahneman asked people to estimate what proportion of African nations were members of the United Nations.

They discovered that they could influence the subjects' responses by spinning a wheel of fortune in front of them to generate a random number; when a big number turned up, the estimates suddenly swelled.

Following in Tversky and Kahneman's footsteps, Ariely has pushed the limits to see how irrational people can be at times. In a Boston mall he offered people a choice between a free $10 Amazon gift card and a $20 gift card for $7. Much to his surprise, people most often chose the free Amazon card. In another study, Ariely offered a Hershey's Kiss next to a Lindt Truffle. For those who are not chocolate aficionados, a Hershey's Kiss costs around 5 cents, whereas a Lindt Truffle is around 75 cents, as it is considered a superior product. At first, Ariely offered the Kiss for 1 cent and the Lindt Truffle for 14 cents and found that people acted rationally, overwhelmingly (about 73%) choosing the Lindt chocolate over the Kiss. He then altered the test by offering the Hershey's Kiss for free and the Truffle for 14 cents. The lowering of the Kiss by 1 cent made a huge difference—69% now chose the free Kiss over the Truffle. A basic cost/benefit analysis would indicate that the Truffle was still a better deal, but the fact that the Kiss was free was enough to sway how people chose.

Ariely used the above test to point out just how powerful "Free" can be to motivate people. In another test, he examined the idea that for some items, a lower price is actually not perceived as a good deal. To test this hypothesis, Ariely had a group of people try a new medicine to relieve pain. He told each participant that the new pain reliever would be priced at $2.50 per capsule and provided each subject with a wealth of marketing materials touting the efficacy of the soon to be released product. When administered, almost all of the participants reported less pain, which was very interesting, considering that it was a simple capsule of Vitamin C.

Noting the placebo effect of the medicine, Ariely then had another group test the new product, but this time provided no marketing materials and told them that it was a discounted medicine that cost 10 cents per capsule. Did this change the results? It sure did. Only half of the participants indicated any pain relief. (This time, the free medicine was not perceived as a good deal.) Ariely doesn't limit himself to testing consumer behavior, and no subject is sacred. Not surprisingly, the more excited we get, the less rational we are in our decision-making. Sadly, many retailers use this very idea of altering the environment to make people irrational during the holidays. A December 8, 2012 New York Times article entitled "Suffer. Spend. Repeat." opened by telling readers that stores "crank up music, repeat the same songs, over and over again, pipe in smells, race shoppers around to far-flung points of purchase and clog their heads with confusing offers. All of which makes it more likely we'll part more readily with more money." For retailers, creating a stressful environment has been found to increase sales, as the consumer is no longer thinking rationally.

The key to Ariely's work is that he points out that our poor choices are systematic and not isolated events. We make the same choice over and over again, even when it is against our economic interest, and in doing so, (unwittingly) challenge standard economic thinking that we are always rational. We are swayed not by our rational minds, but by external influences. This is not only a problem for economists, but for democratic theory as well. When it comes to public policy decisions, people exhibit curious, but once again predictable, biases. They value a service (say, upgrading fire equipment) more when it is described in isolation than when it is presented as part of a larger good (such as improving disaster preparedness.) How a policy is presented can also sway behavior. A study by Falkinger and Walther noted that taxpayer compliance is greater when an incentive is offered rather than a penalty, even though both approaches are intended to assure compliance.

Ariely goes to great lengths to demonstrate how irrational people can be at times and how our actions contradict a simple cost/benefit analysis. Why do we continue to eat foods that we know are not good for us? Is it the smell of the 880-calorie Cinnabon in the mall that we find irresistible? Why do people lie when the honest answer would be so much easier? Why do people pay so much for diamonds, which are neither unique, rare, nor frankly a good investment?

To many people, Ariely's discoveries are not shocking. A friend of mine in the dessert business knows all too well that if people are shown a dessert after a meal, they are much more inclined to order one, even when they are already full. A successful lawyer told me that he knew of a prosperous car salesman that had a sign in his office that said "85% emotion, 15% logic." When asked about the sign, the salesman said that this is how people make decisions when buying a car! For investors, understanding our capacity to become predictably irrational is a valuable lesson. Behind many hot stocks is a great story, and behind most (if not all) market bubbles is a group of irrational people who have convinced themselves that they are not only rational, but also pretty darn smart! This is why investors who value stocks (as we do at Walsky) and look for dividends perform numerous mathematical models. These calculations provide an objective valuation, often called the intrinsic value. For companies that don't pay dividends and may have weak financials, the valuation is much more difficult to calculate, and relies more on the narrative that has been presented to the investor. As it turns out, behavioral economics has strong implications for anyone who invests.

While behavioral economics is a relatively new field, one should not conclude that Ariely's goal is to one day make traditional economics obsolete. Instead, his goal is to create a much more realistic theory of consumer behavior. As much as we pride ourselves in being rational, there is a little bit of Homer Simpson in all of us. We eat the cake when we are not really hungry, spend too much time watching TV, buy things based too often on emotion, and in the heat of the moment, can be anything but rational. What Ariely hopes is that by better understanding our shortcomings, we will more easily identify moments when we might be irrational, and therefore make better decisions in the long run. It is a sensible aspiration for such an "irrational" man.