INVESTING

Framing & Skewed Choices

Decisions of people depend, in part, on the way the choices are stated

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Assume that you are suffering from a serious heart ailment and you are advised surgery. You are curious about the odds, and the doctor says that of the 100 patients who go through such a surgery, 90 are alive after five years. This piece of information is comforting and you will opt for the surgery. What if the doctor had said that of the 100 patients who undergo this surgery, 10 are dead after five years? If you are like most people, this doctor's statement sounds very alarming and you may not opt for the operation. People react very differently to the information that "90 of a 100 are alive" than to the information that "10 of a 100 are dead" even though both the statements convey the same information

. This is known as the framing effect and it matters in many domains. The idea is that decisions of people depend, in part, on the way the choices are stated. In the financial world, framing plays an important role in driving investors to make inferior decisions.

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Neo-classical economists are of the view that there is a direct relationship between the object and the choice made. However, behavioral economists believe that when people make choices in the marketplace, they do not respond to the actual objects they are choosing. There is no direct relationship between a stimulus and response. The choice depends on how the decision-maker describes the object to himself. We are vulnerable to how choices are described to us. Advertising is a business that tries to shape how people think about their choices. If the seller can invest in advertising that frames the choice, that frame will skew the buyer's decision.

The older economic theories assumed that the market was a place where the buyer and the seller came together. Seller will produce a better product, the market will price it efficiently and the buyer will pay a price that will maximise everyone's interest. However, for behavioral economists, the market is not a simple place where buyers and sellers meet for mutual beneficial exchange. Here, framing plays an important role. Once you introduce framing, you can be sure that the buyer will not be acting entirely in his self interest, if the seller has invented a frame for the buyer, skewing the choice in favour of the seller.

In the stockmarket, where greed and fear are dominant and money is the supreme component driving frenzy, framing and advertising play an important role. In the past, an advertisement by a mutual fund showed money growing on trees! Another ad by an insurance company, for instance, tries to frame the product with the claim that a life of dignity is simply and easily achieved, thereby trying to differentiate it. Yet another ad shows a bank branch official patiently listening to a customer even when the office is about to close, thereby creating the frame of good customer service. Smart advertising is trying to frame your choice in such a way that it influences your decision.

The latest and the most vivid are the advertisements of insurance companies offering a capital guarantee and the returns of the highest NAV on their Ulip schemes. Who would not be carried away with the promise of capital guarantee and, at the same time, getting the highest NAV? A win-win situation. Well, you are a victim of the framing effect. Your automatic system immediately grabs the information and without processing it, it comes to a decision based on the way the information is presented. To know more on how your decision is skewed by the frame "Assured Highest NAV", please go to my blog "Frame the Choice: It will Skew the Buyers Decision" on www.ppfas.com.

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