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COMMENTARY

A Better Mousetrap: Economics, Psychology, Blind Spots and Reform

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This article explores one aspect of the behavioral economics of the current financial crisis, namely, the loss of trust between clients and their financial advisors. The operation of unconscious mechanisms of denial, displacement, and the development of a number of blind spots leading to overt and covert hostility is explored. Means of dealing with the situation are suggested.

Keywords: Trust, Financial advisors, Blind spots, Covert anger, Reform

INTRODUCTION

Most of current economics is based on Adam Smith's doctrine that the state of the economy is guided by rational decisions. Whereas the fact is that much actual human behavior is dominated by emotional, stereotyped, and irrational thought processes, group thinking, blind spots, and wish-fulfillment fantasies (which many economists are now beginning to recognize (Brooks [2009]). Economists normally focus on the myriad quantitative measurements in the physical economy; psychologists focus on human attitudes toward, in this case, financial and investment considerations. Among these have been clear signs for a year or more that the inevitable bursting of the property and equities bubbles were falling into the blind spots of people who did not wish to see them. In this way they were able to set up a number of unconscious defense mechanisms and to persuade themselves that the first iron law of economics—that those who spend more than they earn ultimately come to grief—had been repealed. The result of this was disaster.

The media has laid the blame for this disaster on Wall Street and has tended to cast many of the people working in this industry in the role of greedy, unscrupulous, and reckless villains. However, several recent leaders in the *New York Times* have argued that this judgment is not fair. There are, of course, a few villains, but the main fault in most cases lies with the system, not the players. In the Darwinian laws that govern all human behaviors, including those in Wall Street, a system that focuses almost entirely on high short-term gains (that entails high risk) in a system where money managers are forced to compete will inevitably lead to a bubble, especially if backed with apparently safe and sophisticated, but ultimately flawed, ways of measuring risk, as was provided by the Value-at-Risk (VaR) computations. Of course, other related toxic feedback loops are also part of this system, for example, over-cozy relations between Wall Street with its rating agencies and the Securities and Exchange Commission (SEC), recycling of government regulators in and out of Wall Street, and so forth.

Many commentators speculate that we are nearing the bottom of the slump and recovery is inevitable, even if it takes a couple of years. However, this has to be seen against evidence that new blind spots are developing. The danger posed by such blind spots is that the person who has one does not realize that there is anything wrong. In order to detect them special techniques are needed.

1. The first reaction of the Bush Administration was to try to solve the problem by throwing money at it without correcting the fundamental flaws in Wall Street—a blind spot if there ever was one.
2. This has been accompanied by partial nationalization of large swathes of the banking, insurance, housing,

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and automobile industries (with more to come). However, this process brings it own new problems along with it that fall into other blind spots. These changes were thought necessary because of the widespread opinion that, as *laissez faire* capitalists have been shown to be incompetent to run business—having effectively wrecked it—turning over running much of the economy to a medley of bureaucrats and politicians is likely to do any better. For example, the U.S. Government gave the automobile industry 3 months to devise a plan of reorganization in such a way as to prevent collapse. The difficulty is how would a politician or a government bureaucrat know how to evaluate such a necessarily highly technical plan? The history of even the most benign socialist, or partly socialist, regimes suggests that this is unlikely to happen (as in the United Kingdom in 1947–1955).

3. The flaws in the system, plus the way the media have presented the current financial melt down, have severely damaged the confidence of the public in Wall Street, and all things to do with Wall Street, that may take a long time to recover—even if things go right, for which there is no guarantee of a happy ending. It is possible that all this focused, but in part possibly misdirected, resentment will adversely affect brokerage houses in the shape of loss of business, disgruntled clients, and mass action lawsuits. It is generally recognized that the credit crunch is due largely to the loss of confidence and trust without which a financial system cannot work. Much attention has been paid to the loss of trust among banks, but less to the loss of confidence among wealth management organizations and their clients. People who have lost up to a third of their savings are likely to look around for someone to blame. The media have already declared that this blame lies with greedy, immoral, and incompetent Wall Street bankers. This will persuade many of the public. But on which part of the wealth management organization will this anger be focused? I suggest that much of this anger will focus not on shadowy figures on Wall Street, or even on the more shadowy entity know as "the system," but rather on the people clients actually meet and see managing their affairs, that is, their personal financial advisors. This is due to the operation of a well-known unconscious mechanism known as displacement. Anger needs a target. If the real target is unavailable, then the emotion is displaced onto a convenient available surrogate. So another blind spot is likely to develop. These blind spots are unconscious mechanisms that prevent us from paying attention to that which we do not wish to know about: in this case, the painful thought by a financial house that many of its clients, influenced to a greater or lesser extent by the media, do not trust it any longer. Even if the financial consultant, who is in the front line here, has done nothing personally to lose this trust, if the media repeatedly says that Wall Street is populated by greedy, immoral, and incompetent financiers, this may tend to engender uneasy doubts in the clients of the wealth management industry about the soundness of the advice they receive from their advisors. After all, clients might start to entertain thoughts such as "if Bernie Madoff was able to deceive the brightest and the best on Wall Street for 40 years with a flagrant Ponzi scheme, how can I be certain of anything after that?" A 2007 survey by the Paladin Registry found that 78.3% of a sample of 4,000 investors rated the problem of estimating the trustworthiness of their financial advisors as the single greatest challenge to their achieving their financial goals. "A big demand is unmet for trustworthy advice," says Bob Frank, a professor at the Johnson School of Cornell University. "There's a widespread perception that people were convinced to buy things based not on the best interests of the buyer but on the best interests of the seller" (Cox [2009]). These displaced negative feelings can be expressed in subtle and indirect ways that financial advisors need to know. Financial advisors also need to know how to spot when a client's attitude and behavior is being affected by displacement or some other unconscious emotional mechanism, and how to deal with this when it occurs. This may result in the avoidance of a series of painful misunderstandings and inappropriate ways of dealing with the issues. Again, it is the system here that is mainly at fault, not the players.

Over the last 30 years I have worked with three financial advisors. Two have provided excellent trustworthy service, but the third turned out to be a scrambler—that is, he was in the habit of turning over the stock in his portfolios too quickly so as to earn extra (and unnecessary) fees, thus unethically transferring funds from his client's portfolio into his own pocket. However, I was appalled to discover that his parent company valued him highly—despite squawks of protest from the occasional client who woke up to what was happening—due to the fat fees he brought in. This episode gave me first-hand experience of the problem. So can a system be evolved in which the advice offered is accepted by the client as representing the best interests of both the buyer and seller? If a finance house employs a system that meets these needs, the world will beat a path to its door.

De Goey [2004] has long campaigned for the reform of whole financial advisory system. He advocates involves scrapping the present widespread commission basis (more suitable for selling used cars) and replacing it with a truly professional fee-for-assets-under-management system. So it would be better to do this and not indulge in recriminations and lawyer-friendly lawsuits. This reform needs to incorporate insights into the psychology involved. Little research has been done of the psychological aspects of what determines trust between banks, and trust between clients and their financial advisors. Thus we need to conduct these investigations and develop ways to acquire these insights and improve the financial system. In the meantime, financial advisors need to be trained in the psychological aspects of dealing with overt and covert client hostility.

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