

## QUESTIONING BASIC ASSUMPTIONS TO ENCOURAGE SUSTAINABLE DEVELOPMENT

*Economic and financial theories assume that individuals act rationally and consider available information when making decisions about spending or saving money. In the real world, finance and economics is nonlinear because it is driven by homo sapiens. The questions and debates could impact individuals, companies or policy makers in the next few years. In the long run, they may even provide an opportunity to rethink the basic assumptions used to define macroeconomic systems. Ideally, economic models and practices could become more sustainable.*

Our current economic and financial system is based on basic assumptions about human nature. For example, classic macroeconomic theory assumes that: 1. more is always preferred to less, 2. consumers like diversity and choice, and 3. consumers will buy more if they earn more (Williamson, 2011). Classic microeconomic theory assumes that individuals will make decisions based on the perceived utility of a choice, on the expected value of the outcome, and based on preferences and some form of constraint, such as the amount of time or money available. Finally, economic and financial theories assume that individuals act rationally and consider available information when making decisions about spending or saving money. These theories and assumptions,

as well large amounts of data and statistics, created the models that influence how we understand, manage, and use our economic and financial systems. The models are clean, linear, and based on averages (Savage, 2009).

In the real world, finance and economics is nonlinear and messy, because it is driven by complex, ever changing, and uncontrollable homo sapiens who tend to be anything but average. The disparity between economic principles based on mathematical models and economic reality can be excused as errors, outliers, or cyclical phenomena. Experts in the field of behavioral economics and behavioral finance - which include economists, psychologists, philosophers, and biologists - however, suggest that disparities

should be examined and used to shape new economic policies and practices. Thus, some experts question the basic assumptions about human nature used to drive the economic system and study the variability of economic actor behavior (Kahneman, 2011). Others examine the intertwined personal, corporate, and political interests that shape "the system" and give the economic actors real faces and identities (Shefrin, 2007). Still others propose that a system developed when the economic world was composed primarily of small and medium sized companies may no longer be viable in a globalized economy with large, multinational corporations (Sedlacek, 2011).

Although the field is not new, it has only recently received widespread attention. Based on my own research and practice, I will illustrate how questions and debates in behavioral finance and economics could impact individuals, companies, or policy makers in the next few years.

### QUALITY OF LIFE AND HAPPINESS

Economic growth should create wealthier nations. Wealthier nations can choose to have better healthcare, education, and sanitation and should ultimately have citizens with higher quality of life and happiness. This is largely true. However, homo sapiens are also happier and healthier when they have relatively limited choice, are appreciative of what they have, and



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live in a world with simple rules (Schwartz, 2004). Depression, burnout, and suicide are increasing in the wealthiest areas of the world. In the workplace, managers and employees are overwhelmed with information, choices, and products - and their productivity suffers.

Almost daily reports concerning stock prices, national economic growth, and consumer spending suggest that an economy that is not growing is a bad economy. At the same time, health professionals and consultants are helping individuals and companies deal with their stress, inefficiencies, and related problems by encouraging them to simplify their lives. How can we deal with this paradox in the currently richest areas of the world?

Perhaps some countries, companies, and individuals will decide that they are "rich enough" and focus on stabilizing or maintaining their economic growth rather than stimulating continuous growth. At the individual level, this is relatively easy. However, what happens if an

ever growing number of potential economic agents opt for less consumption and violate the first three premises of macroeconomics? At the company level, some small and medium sized businesses already follow the principle of financial stabilization or “big enough” and reinvest their profits to either optimize production or reward employees. Few of them openly declare their strategy because the decision not to pursue growth is valued negatively. Doing the best within specific constraints may be the best way to reach personal – and maybe even corporate – health and well-being – but it will not stimulate much social respect. In the long run, the debate concerning economic growth, the definition of wealth, and the relationship to individual and national health and well-being may provide an opportunity to rethink the basic assumptions used to define the

macroeconomic system. There is no universal “human nature”. Moreover, we know that human behavior is shaped by incentives and by beliefs about what others in society value and respect. Therefore, by choosing principles and assumptions that reflect another reality, we could create an economic system that will address the paradox of growth and well-being and become sustainable. For example, the following kinds of assumptions may be useful alternatives: 1. economic growth should stimulate education, health care, and allow for a comfortable life, 2. less is preferred to more, and 3. quality and sustainability are more important than quantity.

### CONTINUOUS GROWTH OR ADAPTATION TO CHANGING MARKETS?

What goes up must go down. In nature or in physics, it is difficult to find example of something that continuously grows. However, recommendations concerning risk-taking and decision-making in financial markets suggest that stocks should be preferred to bonds because stocks promise long-term growth. The argument is that - in general and over long periods of time - the market should always go up. How rational is this belief? Defenders suggest that everything is cyclical. Yes, what goes down can always come up. But if something is cyclical then it does not grow over time; it simply moves up and down on both sides of some mean value and

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economic actors should adapt their behavior accordingly. Of course no one knows the mean value of the current economic system. We may still be far below the mean and have much potential for growth (the optimist argument) or we are already high above the mean and things can only get worse (the pessimist argument).

To compensate for these unknowns, we examined if and how individuals adapt to changing market conditions in a simulation experiment (Wranik & Hopfensitz, 2011). We asked professionals and students to make real investment decisions in two types of markets, one with a positive expected value (which we will call a “good market”, since it should go up), and one with a negative expected value (which we will call a “bad market”, since it should go down). All participants experienced both markets, albeit unknowingly half started out in a good market and the other half started out in a bad market. Although they did not know that market conditions would change when they started out the simulation, they were clearly informed when the market conditions did change, and received unambiguous information concerning the probabilities of earning money in each. They were free to invest part or all of their money over 15 periods per market condition. Classic economic assumptions about rational decision-making would predict that there should be no (or little) investment in the bad market,

### REVOIR LES HYPOTHÈSES DE BASE

Les experts de la finance comportementale mettent en question les *a priori* du système économique actuel et souhaitent souvent stimuler les discussions. Le but ultime est de favoriser le développement continu des modèles et des pratiques en économie et en finance et de permettre une adaptation du système aux besoins des agents économiques.

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- more investment in the good market, and that behavior should change based on new information. Moreover, we expected professionals to adapt more effectively to market conditions and to earn more money than students. Surprisingly, neither students nor professional invested more in the good market than in the bad market, despite complete information concerning probabilities and the corresponding expected value. Generally speaking, individuals ignored the new information and failed to adjust their behavior. Rather, they were primarily influenced by their gains and losses at the beginning of the simulation. Thus, those who started out in a positive market remained in a positive frame of mind and “did not believe” the information about the negative market and those who started out in the negative market “did not trust” the positive information and stayed in a negative frame of mind. It seems that individuals learned to believe or not to believe in how the market will evolve, which influenced their beliefs about investment over time. Beliefs and expectations about the future drive economic behavior. The baby boomers grew up in a relatively positive environment concerning stock market evolution, the current twenty and thirty year olds may grow up in a relatively negative envi-

ronment. How will this influence beliefs and practices concerning long-term investment decision-making? More important, with retirement savings becoming primarily an individual responsibility, how will economic actors spend and save their money during their lifetimes to ensure that they have enough during old age? Finally, can financial institutions effectively provide advice and services that provide their clients with long term security while making a reasonable profit?

### LONG-TERM RETIREMENT DECISION-MAKING

Experts working in financial institutions know that their products and services should respond their clients' specific needs. Until recently, however, market segmentation was made primarily based on socio-demographic characteristics (age, gender, wealth, and income expectations), and largely ignored psychological characteristics (values, beliefs, personality, emotional competence) that predict long-term savings and investment behaviors. Our research examining real retirement decisions for approx. 3,000 clients, however, showed that psychological characteristics (emotional intelligence, impulsivity, personality) are significantly related to financial behaviors such as risk taking and trading frequency (Ameriks, Wraniak, & Salovey, 2009).

Moreover, these influences were much greater than expected and remain strong even after controlling for socio-demographic variables.

Thus, clients vary on psychological characteristics, these characteristics can be measured, and they influence real long-term savings and investment decisions. Continued collaborations between psychologists and financial experts could help institutions provide personalized services to their clients, which truly reflect their expectations and beliefs, and allow them to optimize their income both during their active life and throughout the retirement years. By treating clients as complex and unique persons, rather than as economic agents, financial institutions may find that both individual and corporate interests can be satisfied.

### CONCLUSIONS

Our economic system is based on assumptions about human nature. These assumptions are currently being questioned and the ensuing debates could pave the way for revised economic models and practices. By following the debates and becoming an informed participant, the next few years should be exciting for individuals, companies, and governments interested in living within an economic system that is continuously developing and improving to serve its seven billion economic agents. ■

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