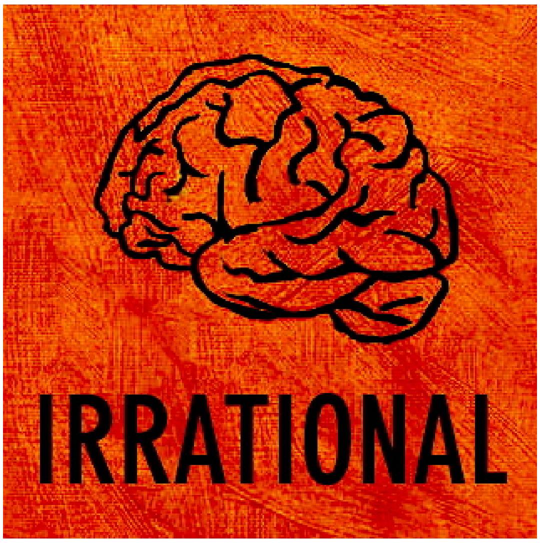

Richard Thaler received the Nobel Prize in economics last week, principally by showing that people don't always behave rationally and, in fact, we are systemically irrational.

Here's an example: Two friends are given tickets to a basketball game in the Northeast. The night of the game there is a tremendous snowstorm. One friend calls the other and suggests there is no way they are going to the game now, in the snowstorm, and they don't go. But, he said "You know, if we had paid for those tickets ourselves, we'd be going."

Studies by Dr. Thaler show that if the friends had paid for the tickets, they would likely driven through the snowstorm because they didn't want to "lose" their money. Classical economics would say that's crazy, but it's true. People pay huge attention to "sunk costs," often irrationally.

Because of Dr. Thaler and others, we know more about human biases and anomalies that impact our financial decisions. These include compartmentalizing (putting money in mental boxes), mental accounting (thinking differently about money in your pocket versus money in the bank) and the endowment effect (once you own something you value it more than before you owned it).

Dr. Thaler not only helped discover our biases but also identified ways to make irrational behavior work to our advantage. Savings and retirement has always been a big area for him. He applauds the fact that if we compartmentalize (have a "mental box") for retirement savings we are doing a very good thing. Putting money in a 401(k) plan makes it much "stickier" than other money and it stays there.

In 2004, Dr. Thaler and Shlomo Benartzi published “Save More Tomorrow.” It is based on the idea that instead of asking people to save more now, ask them to save more in the future. We tend to irrationally discount our future commitments. Hence, we tend to put off savings because retirement is so distant, but we will commit to future savings because it is also so distant. Dr. Thaler suggested that people save 50% of every raise. No need to give up anything now. And, this concept would mean that if you save 50%, then the remainder will be left for current spending, without any guilt. Every raise therefore increases both spending and savings- a much more palatable idea than taking away some of our current income to save.

Over the past few decades, most company pension plans have been discontinued and replaced by company sponsored defined contributions plans, where employees needed to make contributions. These voluntary accounts should have worked better. Rational employees were expected to save and invest to meet their long-term goals. But, it didn’t work that way-participation rates early on were very poor. Dr. Thaler was asked about the problem and his response was that workers can be their own worst enemies- “without help, they’ll never retire.”

His solution: “Nudge” them into joining company retirement plans, using a concept known as automatic enrollment. Rather than waiting for employees to complete paperwork, companies would automatically enroll them and workers, if they don’t want to be in, can opt out.

Last year, 58% of companies were automatically signing up workers. That’s up from 8% in 2000. And some companies are automatically escalating the contributions or giving the employees the option to do so. Thaler and Benartzi’s research shows, as compared to 2011 data, 15 to 16 million more people are saving. Assuming an average contribution of $2,000 a year, that’s $30 billion a year in additional contributions.

Dr. Thaler, with his colleague Hersh Shiffrin, suggested that our mental accounting of money is often a battle in our brains between the “doer” (focused on short-term rewards) and the “planner” (focused on the long-term.) How choices are presented to us (“the choice architecture”) makes a big difference in our decision. Making enrollment in the 401(k) occur by default and requiring a worker to “opt out” will likely put the “planner” in control, not the “doer.”

One of our key jobs and challenges at DWM is to assist our clients by framing questions and choices in the appropriate way. Like Dr. Thaler, we understand that wealth, health and happiness decisions are not always rational yet we do our best to find a way to “nudge” both your doer and planner parts of your brain in order to help protect and grow your assets and your legacy. We haven’t made a $30 billion impact yet, but we’re passionately working on it every day.