
Effective Agency, Individual Involvement, and Default Choices

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Defined-contribution plans put the investment burden on individuals. Given individuals' lack of expertise, many experts propose structuring investment defaults to nudge individuals' choices. Although this may be a necessary step, it is hardly sufficient. In the end, there is no substitute for intelligent discussion to establish the appropriate investment path customized to the needs of each individual.

We need effective “agency” (meaning experts faithfully helping those they are supposed to assist) for individuals making a critical but unusual decision, such as picking investments for their retirement nest egg. Effective agency, however, must be more than a mere matter of establishing a choice of defaults, or removing choices altogether. Consider retirees who are deciding how to structure their retirement income. Evidence shows that older people who are involved in making their own decisions do better in life. Given that quality of life should be our concern, and not just retirement security, we should want to get older people more involved in the financial decisions that affect them, not less.

The Importance of Individual Involvement and Preferences

Many of my colleagues focus excessively, often singularly, on default options. I think such a focus runs the risk of treating older people, indeed adults more generally, like children. My preference would be to place much more emphasis on treating the effective agency of critical decisions as requiring substantial input from the affected individual. Moreover, most important choices should be tailored to cater to people’s individual preferences.

This latter point can be clarified with an example. I recently co-authored an article on prostate cancer. There are more than a half dozen primary treatments for prostate cancer, and a 70-year-old man (call him Rex) with prostate cancer will likely receive the default treatment. But what is the default treatment? It depends on which doctor Rex goes to. If Rex goes to Dr. Smith, he gets radiation. If Rex goes to Dr. Jones, he gets surgery. If Rex goes to Dr. Brown, he gets

watchful waiting. The choice of treatment may depend modestly on Rex's condition, but mostly, it depends on Rex's doctor.¹

The choice of treatment, however, should consider personal preferences and personality types. For example, with Dr. Brown as the patient's doctor, the "preferred" treatment for 70-year-old men with prostate cancer is watchful waiting. This option is a very good treatment for someone who can get up in the morning and go about his business without dwelling on the fact that he has prostate cancer, but I would maintain that this is not a good treatment for a man who would obsess every moment about his situation. And the trade-off between the risks of longevity and loss of sexual function surely depend on preferences as well.

Similarly, personal preferences and personalities should count for a great deal in terms of what individuals should do with respect to investment decisions and, particularly, lifetime consumption decisions. For instance, some of those who hold equities, particularly after the recent experience, will worry constantly about them, anticipating another late 2008 meltdown. Others, however, can hold equities without worrying about future crashes at all. People also have very different preferences for their lifetime consumption patterns.

Nevertheless, most financial planners are not good at asking clients such questions as, If things really went badly, would it be easy for you to live with your daughter? Could you reduce your consumption by 20 percent if needed? Would investment decisions that turned out poorly make you feel regret for the rest of your life?

My point is that people's preferences do differ, and decisions by advisers (agents) should be made in conjunction with the affected individuals and customized to their individual preferences and circumstances. The big challenge to our industry, I believe, is to find ways to create for many people the types of beneficial agency that many of us now provide for elderly relatives.

For example, most people have never had the opportunity to discuss with a financial planner how much their current savings rate would translate into in terms of retirement funds. If they did, more might realize that their current savings rate is woefully inadequate, thereby giving them the opportunity to make the necessary adjustments. We should give more people the chance to have this kind of discussion, rather than focus on designing and selecting default options.

Whose Default Options?

One point that I think we all can agree on is the need to save more. I would love to see the average American shift his or her savings rate up by 30 percent. But getting agreement on where those savings should be placed is quite another matter. Many

¹Benjamin D. Sommers, Clair J. Beard, Anthony V. D'Amico, Irving Kaplan, Jerome P. Richie, and Richard Zeckhauser, "Predictors of Patient Preferences and Treatment Choices for Localized Prostate Cancer," *Cancer*, vol. 113, no. 8 (October 2008):2058–2067.

have argued that people should be more heavily invested in equities, which, of course, would not have worked out so well recently. Richard Thaler, who is one of the authors of the Save More Tomorrow² plan, observed in 1997: “for long-horizon investors, ...we find the case for equities compelling” (p. 199).³ But this position illustrates one problem with defaults. Although a heavy concentration in equities might be Thaler’s preferred default for a young retiree, for someone like Zvi Bodie, who advocates a 100 percent annuity default, a heavy-equities option would be a terrible default. And of course, others would argue for yet different defaults. Moreover, a default option that works out badly, however desirable *ex ante*, subjects the agent to blame.

This hardly suggests that everyone should make investment decisions on his or her own without any guidance. For example, some of my noneconomist colleagues have been drawing what I think are inappropriate lessons from the dire current situation. They have concluded, based on their recent financial collapses, that they should spend more because their savings are likely to melt away. If I could talk with them for half an hour, I think I could convince them to pursue a more prudent course of action. So, clearly, I hardly recommend abandoning investors in general if even highly intelligent and well-educated people can easily get saving decisions disastrously wrong.

As is common, the middle course is best. The investment decision process should involve an expert agent providing some guidance but should give the affected individual significant involvement. A first step should be a discussion of preferences and tolerance for risk. This would also foster personalization of choices.

Conclusion

If nothing else, recent experience shows that many of the models developed to deal with financial situations should be called into question. Effective agency cannot be reduced to a set of default options. Rather, knowledgeable intelligence, with involvement by the individual, must be applied at every step along the way.

²Shlomo Benartzi and Richard H. Thaler, “Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving,” *Journal of Political Economy*, vol. 112, no. 1 (February 2004):S164–S187.

³Jeremy J. Siegel and Richard H. Thaler, “Anomalies: The Equity Premium Puzzle,” *Journal of Economic Perspectives*, vol. 11, no. 1 (Winter 1997):191–200.