

Reward success, pay the price for failure — that's the game

At a recent under-9s fixture for St Brigid's rugby club, in which my eldest son was playing, I found myself shouting at the referee over an offside decision. On reflection, the referee was probably right — it was open play and he reminded me who had the whistle.

It was similar to the Six Nations this year — not for the quality of the game but for my lack of objectivity.

My abiding memory of the campaign was the Ireland-Wales match, a game in which the referee made some appalling decisions and ultimately had a greater than normal influence on the final result. I was apoplectic.

It's difficult to detach yourself and view something objectively if you are involved, either emotionally or financially. (I did have a bet on Ireland, though Paddy Power is not yet accepting bets on St Brigid's matches.) If there are incentives that make you see reality a certain way, you will convince yourself that decisions that go against you are unfair.

According to Dan Ariely, professor of psychology and behavioural economics at Duke University in America, we can extend that analogy to a business context. If you are paid a lot of money to see reality in a certain way, you will construct a view of reality that helps your intuition deal with the opposing view.

Bankers have been treated as pariahs since the financial crisis — many would argue

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with good reason. Are they really bad people or just people with a really bad incentive structure? The relationship between incentives and behaviour is vastly more complex than I'm portraying it here, but the answer to this question has profound implications for capital markets.

It is a truism that people respond to incentives. If pay and incentives are inappropriately structured, we are exposed to future blow-ups.

At the micro level this has implications for the types of



investment funds in which we invest. At the macro level it has implications for the financial system.

This was among many of the issues discussed at a talk I attended at the recent Kilkenomics festival by the best-selling author Nassim Nicholas Taleb. He has written extensively on the topic of incentives. Receiving bonuses for "performance" provides an incentive to bury risks and delay blow-ups. And not much has changed since the crisis, in Taleb's view.

He is sceptical about predictions in socioeconomic domains. Those making predictions are rarely harmed by their forecasts. Taleb advises people to take into account only what the predictors do with their own money.

I think we need something a little more workable. The starting point should be for the correct incentives to be in place, rewarding the outcomes we desire.

As Taleb observes, I'd prefer a nuclear plant manager to be incentivised by measures of safety and accident prevention than to be remunerated for maximising output.

We shouldn't be surprised by poor outcomes in markets with misaligned incentives. As Arieli observes, incentives will foster the illusion that you are doing good, so the charlatans actually think they are on the side of progress.

I am all for rewarding risks. In a properly functioning market, risk and reward are desirable, but only to the extent that there is symmetry; that if there is a downside to your actions, you must pay a price. Entrepreneurs are rewarded for their gains; they are also penalised for their losses.

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Ireland v Wales: objectivity can be difficult when it comes to sport