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THERE IS SUCH A THING AS TOO MUCH CHOICE

By PATRICK CAIRNS

Back in 2000, two psychologists published a study about jam. Sheena Iyengar and Mark Lepper wanted to know what happens when you give consumers more or less choice.
On different days at an up-market store, they put out a display table that had either just six types of jam on display, or 24. And then they monitored shopper's behaviour.

What they found is that when they put out the bigger display table, with 24 jams, they attracted a lot more interest. Yet people were actually far less likely to buy anything.

When when the table only had six jams on display, not as many shoppers stopped. But those that did were about ten times more likely to actually buy one.

Choice paralysis

Many other studies have come to similar conclusions — that too much choice can actually stop people from acting. It seems that the more options people are given, the more they fear choosing the wrong one.

This even carries over into how good people feel about their decisions afterwards. The more choices they are given, the more likely consumers are to feel unsatisfied with the selection that they made, even if they actually made a good one.
When products are complex, these reactions are heightened. If something is difficult to understand, sales are boosted when the choice is smaller.

Choosing an investment

Given these findings, it should be no surprise then that many people feel intimidated by the investment industry. Often they are so overwhelmed that they feel unable to save.

The UK currently has around 3 000 funds on sale. That is a lot of jam. It is no wonder that many people don't want to choose one. The chances of making a bad choice seem pretty high. When asked why they don't invest, people commonly respond that they don't have the knowledge, or that they can't tell the good from the bad.

Unfortunately, many asset management firms compound this problem. Instead of offering a small, simple, clearly-defined range of funds, they seem to think that the more funds they manage, the more chance they have of attracting investors.

This 'something for everyone' approach is often more about the marketing department than the investment team. It comes from asset managers thinking about what concepts they might be able to sell, rather than what makes genuine sense as a way to add value for clients.

The thematic example

One of the clearest examples of this, is how some firms chase investment fads and launch questionable thematic funds. It's not hard, for instance, to currently find dozens of funds focused on technology.
But these types of funds always raise three obvious questions. The first is that if the managers running these funds truly believe that there is money to be made in these themes, why don't they just invest in those themes in the funds that they already have?

Secondly, these thematic funds can only be popular if the idea behind them is already popular itself. And if that is true, they run the risk of being performance chasers and buying into bubbles.

And, finally, what happens when the theme isn't so sexy any more? A number of technology thematic funds were launched into the height of the dotcom boom in 1999 and 2000. Most of them were shut down again when that bubble burst.

Getting it all

It's not hard to believe that this overwhelming, and mystifying level of choice is a good part of the reason why index funds have become so popular. Being able to invest into the FTSE 100, the S&P 500, or the MSCI World index effectively narrows the choice for investors.

Instead of worrying about picking the right manager, or the right sector, or the right theme, investors in a passive product are simply deciding to invest in the market. Of course there is still some choice involved in choosing which market to invest in, and which provider to use, but these are far simpler than trying to understand the nuances of active management.

That is one of the reasons why index investing is referred to as 'democratising' investing. It makes it far simpler and more accessible to everyone. And in a complex industry, with far too much choice, that means more people are more likely to actually make the decision to save at all.

One of South Africa's most respected financial journalists, PATRICK CAIRNS is a trusted commentator on the world of investments and the quirks of behavioural finance. Over more than a decade he has built a reputation for keeping the industry honest, and putting the interests of investors first.