Irrationality

We don't always behave in financially prudent or predictable ways, but this guy just won $1,000,000 for building a structure to study that fact.

One of the most glaring risks overlooked by businesses in our region is economic concentration. If a business regularly does contract work for the same firm, at such concentrated levels that substantially all, or most of their income is from the same source, they may be economically dependent on that client.

A short term, but potentially just a lethal version of this can occur on a one-off basis, where one very large contract is taken on. Other times it occurs on a regular basis such as a logging contractor who works primarily for one licensee (mill). When either situation occurs, their client wields an extraordinary negotiating advantage over the contractor. Or, at least this is usually the case.

In one of these one-off cases, my client's client decided not to pay him on a very big contract. It wasn't a matter of workmanship or business disagreements. He just ran out of money and decided to short my client. It was enough money to ruin the year for my otherwise very successful businessman -- and this is when it got interesting.

Knowing that it would be very expensive, and knowing that his adversary did not have the means to pay, my client decided to pursue him in the courts with vigor, in his words: "because I can afford it, and I want to send a message." The lawsuit dragged on for two or three years, and cost my client close to $100,000, increasing the net loss on the botched deal, but he felt good about it for his own reasons.

On the other hand, another client of mine, also very successful, recently turned down a large $3,000,000 contract in close proximity to his home because he didn't want or need the headache. It was the type of thing he had done time and again over the years, and probably would have easily netted him a very handsome profit, but he didn't need it, and just didn't like the idea of working that hard when he didn't need it. "Let someone else take it," he shrugged. I want to go hunting.

These are both examples of different takes on the type of study carried out by this year's Nobel Prize winner for economics, Dr. Richard Thaler. In his studies in the realms of Behavioral Finance, he has coined, or in some cases refined such terms as: Limited Rationality, Mental Accounting, and lack of self-control. In a nutshell, Thaler has made a career of challenging the assumption that people make economic decisions based on a rational evaluation of the factors at play. Economists have always known that humans are not always strictly rational, but had assumed that it statistically didn't matter. Millions of people, they argued, in aggregate pressing on markets, will tend to spend their money after weighing out carefully the pros and cons and generally acting in their own predictable self-interest.

Not only did Thaler establish the irrationality of human decision making, but he developed processes for predicting that behaviour and proposed workarounds to benefit people. For example, as a society, people tend to be crummy at saving for retirement, even though it is clearly to their advantage to do so. Thaler developed the concept of "nudge" theory, saying that governments and employers make the default option for employee savings plans a "yes." This has been adopted in various jurisdictions around the world successfully. Employees are still free to opt out, but this method is better than them having to overcome the inertia to opt in. In a twist to this idea, he suggested adding the option to save a portion of any upcoming salary increases, so the pain would be deferred until it is easier to absorb, but the savings idea would be put in motion.

Funnily, when asked how he intended to spend the Nobel Prize winnings, Thaler responded, characteristically: "I will try to spend it as irrationally as possible."

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