The Principal/Agent Relationship

By Steve Lawler

Behavioral finance shares a rich and complicated relationship with group psychology. Both raise questions about the classical claim of the rational agent. Each discipline recognizes the rational self as more dynamic and less innate, which allows room for the rational self to fray. This fraying changes the relationship between client and investment consultant (known in psychology as “principal and agent”). This article uses behavioral finance and group psychology to examine this change.

The Principal/Agent Relationship

The principal/agent relationship is the nexus of professional practice, and the agent’s proper alignment with the principal’s interests is the nexus of the investment consulting profession. The agent, as a professional, possesses a certain body of knowledge and employs said knowledge on behalf of the client. IMCA’s Code of Professional Responsibility explicitly states this expectation: “Serve the financial interests of clients. Each professional shall always place the financial interests of the client first. All recommendations to clients and decisions on behalf of clients shall be solely in the interest of providing the highest value and benefit to the client.”

Background

Kurt Lewin (1997), the father of group psychology, holds that identity and behavior are shaped by dynamic interplay of an array of relationships. He identifies the domain of these multiple relationships as the force field of human identity and action. Lars Tvede (2000) extends this concept to include adaptive attitudes: “We develop the same attitudes as people we associate with. Journalists and analysts belong to social groups that they identify with, just like other professionals and extensive readers of each other’s output. This may lead to adaptive attitudes.” Kenneth Gergen (1997), a senior research professor of psychology at Swarthmore College, states it this way: “Our identity is found in relationship. We are socially situated and interdependent.”

The force field is the positive version of what the early social psychologist Gustave Le Bon called herd behavior and crowd psychology. The Crowd: A Study of the Popular Mind (Le Bon 1896)—often cited in behavioral finance literature—was the first to posit that the individual often is overridden by the momentum of the group. Le Bon’s work is so important to behavioral finance that it is the starting point of Martin Sewell’s encyclopedic overview (2008).

Group Psychology versus Behavioral Finance

Cognitive framing along with the concept of herd behavior and the force field are two dynamics that help us understand the principal/agent relationship.

Cognitive Framing

Cognitive framing is seeing things in terms of mental models (Senge 1980). Tversky and Kahneman (1986) write, “There is much evidence that variations in the framing of options (e.g., in terms of gains or losses) yield systematically different preferences.” Or, as philosopher Donald Wallshochl (1980) simply stated, “What you see depends on where you stand.”

Herd Behavior and the Force Field

Herd behavior and the force field take cognitive framing to the next level. Herd behavior emerges when rational individual behavior becomes irrational in aggregate. Shiller (2003) put it this way: “The behavior, although individually rational, produces group behavior that is, in a well-defined sense, irrational. This herd-like behavior is said to arise from an “information cascade,” that is, when one observes the actions of others and then takes the same action that the others have taken, independently of their own private information signals. The result is irrational social causes, financial trends, even international movements that are the upshot of groups of individuals acting rationally. The force field, however, influences individuals to behave rationally in a collective sense and supports such behavior with a self-correcting mechanism, thus enabling a more consistent pattern among groups of individuals, resulting in positive social causes, financial trends, and even international movements. Force fields in this sense behave more like markets on the macro level and over the long term.

Rationality

So what is rational? What part of rational is simply a matter of one’s cognitive framing? And what part is the result of the pull of the herd, for good or for ill? These questions point to a unique perspective on rationality and set the stage for the fraying of the notion of rational behavior as an objective and empirical claim.

Developments in Social Psychology

Specific developments in modern social psychology provide some insight into this fraying of the notion of the purely rational actor. One states that individuals have many roles that make up their identities. One individual may act as a coach, a spouse, an active participant in the political process, and other roles. These roles may not conflict but neither are they a complete overlay.

My role as a coach for my son’s basketball team works well with my commitment to giving expert counsel to my clients—most of the time. But when
my primary identity as a parent and my professional identity as a trusted advisor compete for my attention and time, my life becomes more complicated.

This dilemma could be cleared up if I would simply behave according to a standard based on a particular cognitive framework. If my standard were that professional commitments come first because they support my family, coaching comes second because it does not. My rational choice aligns with my professional commitment to serve my client. But my standard could be that my parenting obligations come first because my son will be grown before I know it and my professional practice doesn’t deal in matters of life and death, and I may decide that the client will survive until I can return his call or meet her for a consultation. Each standard bears its own unique rationality. The determining factor is my cognitive frame. Simply put, understanding my priorities settles the matter when it comes to understanding my role and behavior as an agent.

How does one know—either as principal or agent—what powers the force field or the herd mentality? Can it be understood by making explicit the cognitive framing that each party employs? Does it help to know the framing required for one to be an active member of a certain herd? Is there a useful vantage point for dealing with the fraying rational actor while maintaining trust? Am I following the herd by acting as if my son’s psyche will be damaged if I miss his game? Or am I maintaining a cognitive frame that minimizes the significance of timeliness as one core attribute of my professional service?

Performativity

Performativity holds that we become the identity of our professions through regular and shared performance of our professional roles. So to be a professional, an individual must regularly perform the activities and behaviors of that profession, even amid change. As an example, think of the relationship between Shakespeare’s Macbeth and its various interpretations. Macbeth at the Yale School of Drama is different than Roman Polanski’s 1971 film or at a local theatre group. Each is a performance of Macbeth, yet each is changed by location, technology, aesthetic, and commercial considerations as well as the unique personalities involved.

As an agent, I must perform my role in a changing community of practice. Indeed, the key to maintaining and refreshing the principal/agent relationship is continued intellectual rigor coupled with a reflective practice of one’s profession. For instance, the intellectual rigor that drives behavioral finance practitioners to search for models that explain irrationality involves regular critical reflection on existing cognitive frames. Our roles have static and consistent qualities as well as dynamic and contextually framed qualities. All of this leads to a unique new rationality in the light of behavioral finance and group psychology.

Conclusion

To understand how this new rationality works in practice, consider a framework developed for communities of practice (Wenger et al. 2002). A community of practice has a domain of knowledge that creates common identity and common ground. It also has community, which creates a social fabric of learning. Its practice is the set of tools, terms, styles, documents, rules, and approaches shared among members. This framework works both individual and group performance in dynamic professional practice. It requires openness and transparency, and it provides an effective framework for investment consulting. All of this is particularly salient at this time in financial history, when advisors need tools to deal with herd behavior and the fraying of rationality in order to protect the best interests of their clients.

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Endnote


References