Too good to be truthful: Why competent advisers are fired

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Outline I

Advice

- Advice is everywhere
    - financial advice
    - politicians and managers depend on adviser/consultants
    - consumer rely on sales personal
    - patients on physician
    - internet users on search engines
- incentives are not aligned
- infeasibility of incentive contracts
- repeated nature
- even best advice might turn out badly

Competent advisers are fired

- SEC bans Jack Goldman from financial services for life
  - buy recommendation for AT&T to get his kids into a prestigious preschool
- Trump firing his campaign adviser Roger Stone
  - "I terminated Roger Stone last night because he no longer serves a useful function for my campaign. I really don't want publicity seekers who want to be on magazines or who are out for themselves."
- Sultan Suleiman the Magnificent kills Grand Vizier Ibrahim Pasha and his own son Mustafa after they ran successful military campaigns
- ...

This paper I

Claim

Advisers are fired because they are competent.
If perceived a bit less competent, they would have kept their job!

- low perceived competence: fire adviser
- uncertain competence:
  - risk of firing due to incompetence disciplines adviser
- high perceived competence:
  - no risk of being fired due to incompetence (any time soon)
  - free to push his own agenda
  - advice by highly competent adviser is not very useful
  - firing credible and necessary

This paper II

Figure: Reasons for firing a competent adviser (α: belief that A is competent)

Model I

- in each period
  1. adviser (A) recommends 1 of n options
  2. decision maker (DM) follows recommendation; both observes whether hit or miss
  3. DM decides whether to continue or stop (outside option W_O)
- payoff
  - DM: hit gives 1, miss 0
  - each period 1 of n options is hit
  - each period A has 1 bonus option yielding 1, otherwise 0

Model II

- information
  - DM: options indistinguishable (prob $1/n$ to be bonus or hit for each)
  - A: knows bonus option
  - competent A: noisy signal regarding hit option
  - incompetent A: no information
- discounting $\delta \in (0, 1)$
- DM's belief of facing competent A: α

Assumption

Outside option dominates incompetent advice but not best competent advice.

Strategies and solution concept

- Markov strategies with state variable α
- some results: all equilibria (also non-Markov)

Fire the incompetent

Proposition

In equilibrium, there exists an $\underline{\alpha} > 0$ such that DM ends the game whenever $\alpha < \underline{\alpha}$.

- assumption that outside option dominates eternal incompetent advice $\rightarrow$ result for $\alpha = 0$
- continuity

Fire the competent: logic

- suppose DM continued for sure if $\alpha > \bar{\alpha}$
- for α close to 1, A is sure not to be fired in the next T periods
- A recommends bonus for α high enough
  - for T large enough recommending the bonus option for T periods dominates every strategy that requires not recommending the bonus option today
- then $\alpha = \alpha^+ = \alpha^-$
- DM's value at α is $1/(n(1-\delta)) < W_O$
- contradicts that DM continues for all $\alpha > \bar{\alpha}$

Fire the competent: formal

Theorem (fire at the top)

There exists an $\varepsilon > 0$ such that in every equilibrium there exists a sequence of beliefs $(\alpha_i)_{i=1}^{\infty}$ converging to 1 where DM ends the game with at least ε probability at every element of the sequence.

If equilibrium strategies are piecewise continuous, then there exists an $\bar{\alpha} < 1$ such that $W(\alpha) = W_O$ for almost all $\alpha > \bar{\alpha}$. Furthermore, there exists an $\varepsilon > 0$ such that DM continues with probability $\beta^-(\alpha) < 1 - \varepsilon$ in case the recommendation does not fit his needs for almost all $\alpha > \bar{\alpha}$.

Expected length of game

Theorem (finite length)

For every belief and every equilibrium, the expected length of the game is finite and bounded from above by

$$\bar{T} = T' \left(2 - \frac{1}{\log(1 - p_n^{T'}(1 - \delta))} \right)$$

where

$$T' = \left\lfloor 2 \frac{\log(1 - \delta)}{\log(\delta)} - 1 \right\rfloor .$$

Discussion

- 2 reasons for firing (a competent expert)
  - perceived incompetence $\rightarrow$ hidden information
  - justified mistrust $\rightarrow$ moral hazard
- 2 inefficiencies
  - bad advise
  - firing of qualified experts
- what can overcome inefficiencies?
  - aligning incentives: "Global Analyst Research Settlements" 2003 required banks to separate investment banking and analysis
  - adviser commitment
  - (if δ is close to 1, the upper bound on game length becomes infinite)
- both hard to imagine in most applications (intrinsic misalignment, verifiability of signal)

Conclusion

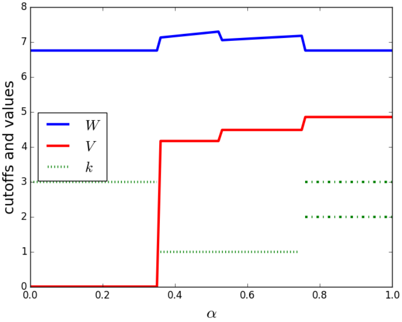
- being perceived as very competent might get you fired
- DM benefits most from advise if he is unsure about competence
- inefficiency of firing competent advisers
- commitment problem
- non-monotonicity of advice quality in reputation
    - apparently overlooked by empirical literature e.g. on sell side analysts

Literature

- repeated cheap talk
  - sender observes state of the world (no types) (Renault et al. 2013, Park 2005...)
  - type of sender is honesty, not competence (Benabou and Laroque 1992, Sobel 1985) $\rightarrow$ no "too good"
- reputation for competence (Ottaviani and Sørensen 2006)
  - sender assumed to maximize perceived competence
- can reputation prevent opportunism? (Fama 1980, Holmström 1982...)

Example I

- n $= 3$, $p_1 = 0.9$, $p_2 = 0.08$, $p_3 = 0.02$, $\delta = 0.95$ and W_O $= 6.75$
- $\alpha \leq 0.35$: stop game
- $0.35 < \alpha < 0.75$: continue, $k(\alpha) = 1$ (best advice)
- $\alpha \geq 0.75$: continue if hit, mix if miss, A mixes



Commitment

Definition

An equilibrium is called regular if

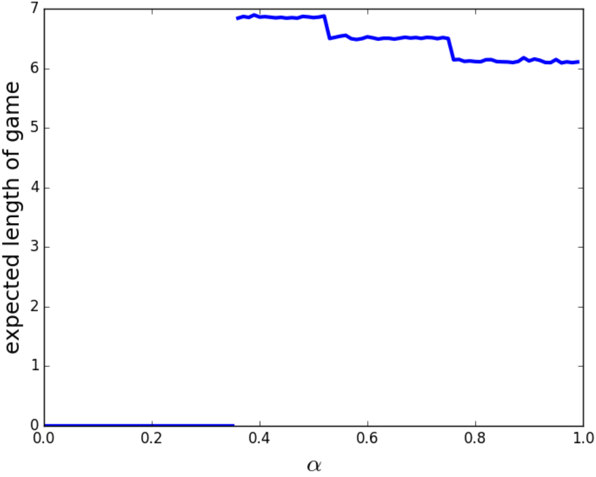
- players use piecewise continuous strategies,
- there exists an $\bar{\alpha} < 1$ such that $\beta^{+}(\alpha) = 1$ for $\alpha > \bar{\alpha}$ and $\beta^{-}(\alpha) < 1$ for $\alpha > \bar{\alpha}$ and
- A uses a mixed strategy for $\alpha > \bar{\alpha}$.

Proposition (Commitment)

In a regular equilibrium, $\lim_{\alpha\to 1} V(\alpha) < 1/(n(1-\delta))$

- A receives less than committing to "always best advice"

Example II



Example III

Distribution of game lengths for α: 0.4, 0.6, 0.8, 0.95