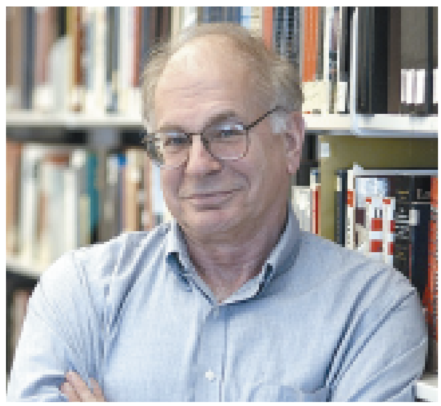
Voice

10 Questions with…

Daniel Kahneman on Humans and Decision Making

As a young boy growing up in pre-World War II France, **Daniel Kahneman** originally wanted to study philosophy. In an autobiographical narrative he wrote upon winning the 2002 Nobel Prize in economic sciences (available at www.nobel.se), Kahneman says, "I will never know if my vocation as a psychologist was a result of my early exposure to interesting gossip, or whether my interest in gossip was an indication of a budding vocation.…The people my mother liked to talk about with her friends and with my father were fascinating in their complexity. Some people were better than others, but the best were far from perfect and no one was simply bad." After a vividly remembered encounter with a German SS soldier, the young Kahneman went home "more certain than ever that my mother was right: people were endlessly complicated and interesting."

Kahneman has traveled a long and interesting path from Palestine and Paris to Princeton, studying endlessly complicated and interesting humans and how we make decisions. His body of work and study on decision-making, much of it in collaboration with the late Amos Tversky, includes heuristics—mental "shortcuts" people use to help make decisions when faced with incomplete information or complex problems—and "prospect theory," which found that people place different weights on gains and losses and on different ranges of probability. Put more simply: your clients are far more distressed by prospective losses than they are made happy by equivalent gains. Taking it a step further, some researchers are convinced that, when faced with sure gain, most investors are *risk averse*, but become risk takers when faced with certain loss.



Daniel Kahneman

Who: Daniel Kahneman, Ph.D.
What: Professor of psychology and public affairs, Princeton University, Princeton, New Jersey, and recipient of the 2002 Nobel Prize in economic sciences
What's on his mind: "All of us would be better investors if we just made fewer decisions."

Until recently, Kahneman taught Psychology 101 to entering freshmen at Princeton—"It was always a very pleasant assignment to introduce young people to psychology"—but has now given that course up. Next month, Kahneman will be one of the keynote speakers at **FPA Denver 2004**, bringing **Psychological Foundations of Behavioral Finance**—think of it as your own advanced version of Psych 101—to financial planners in attendance. Voice recently talked with Kahneman about investing, realistic views of humans and their decision-making, and how our very humanness often conspires against us.

1 How do you describe your field of expertise?

I'm a psychologist, and I received the Nobel Prize for my work over the years, collaborating with Amos Tversky, on decision making. Yes, people do sometimes refer to me as an expert in behavioral finance or behavioral economics, but my field is psychology. Others integrated my work into what is now called behavioral finance, chief among them the economist Richard Thaler, a friend and colleague. Thaler is really the guru of behavioral finance. Perhaps you could say that these scholars of behavioral finance learned a little psychology from me!

2 There seems to be a lot of interest in behavioral finance now. Why did it take so long? And are you optimistic that both advisors and individuals may have taken it to heart enough to learn some lessons during the last several years?

In the context of how ideas develop and are explored, this wasn't a long time at all—about a quarter of a century between

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being completely ignored and becoming a part of the dialogue. That's actually quite rapid. I have no complaints. Whether people have learned lessons, it's hard to say. I'm sure there are certain things about investing, the markets, and decisions that have penetrated people's consciousness, but I'm really not sure that average investors have suddenly become more sophisticated and knowledgeable about their own mistakes, mental abilities, errors, and biases. Human beings are not all that quick to reform themselves in many domains, and that would be true for investing as well.

3 Are mental biases and shortcuts simply a very human way of saying 'I do the best I can with what I know and who I am'? Does our very nature as humans conspire against us?

Most people are just not aware when they're making mistakes and using shortcuts that they're doing it. As humans, we form impressions of events and people and we're very accustomed to acting on our impressions and our intuitive judgment. But if the impressions we've formed are wrong—say, that "the market" will do such and such if such and such happens—well, there's just not a whole lot we can do about it. Think of it in the way we react when we cross the street every day—we make a judgment based on an impression about how far away the coming car is and how quickly it will reach us. In other words, we risk our lives based on how well we "see" things. So impressions are really for better or for worse. It takes a completely different line of thinking to do better than trusting your impressions.

4 What do you mean by a different line of thinking?

Well, for example, if you're not terribly good at making decisions one at a time, then you should adopt more-general policies. In other words, if you're not good at evaluating stocks, buy index funds! That sounds simplistic but it illustrates taking a different approach and adopting different procedures, not necessarily teaching yourself to do better what you're not very good at. That can be fruitless. In addition, most behavioral finance experts would likely tell you that a person who buys an index and holds probably does better, on average, than a person who follows intuition or hunches about stocks.

5 If individual investors aren't always very good at this, aren't we asking an awful lot of advisors and money managers, who also exhibit these very human traits?

Oh yes, sure. I mean they certainly do have more information and knowledge available to them, and they also have an abundance of confidence. But they're actually just as prone as individuals to overconfidence and other mental biases. So it's inevitable that advisors and professional managers will often serve as the client's scapegoat when they fail, too. This is closely tied to the clarity of hindsight, when everything looks obvious.

6 You've said that we'd all be better investors if we just made fewer decisions. That's often hard to do, though, in a world full of so many choices.

Keep in mind the point about adopting policies, not making individual decisions. If you buy and hold an index, you're making fewer decisions. It's a policy *you* can enforce. You won't get distracted. One of the key lessons of behavioral finance, I believe, is that if you're not constantly active and monitoring and checking, you're likely to do better in the long run.

7 If we humans tend to filter out the bad—in other words, our mistakes—isn't that just another example of our being…well, human?

Yes, it's a survival tactic for life, and a natural human trait. Of course, being optimistic is very good for us. It even helps the immune system—if you're optimistic you'll get fewer colds and recover more quickly. It's a good thing to be optimistic but not necessarily to let yourself

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Prospect Theory: How Would You Choose?

In their "prospect theory" experiments, which they published in *Econometrica* in 1979, Kahneman and Tversky presented groups of subjects with this problem:

- *In addition to whatever you own, you have been given $1,000. You are now asked to choose between (A) a sure gain of $500, or (B) a 50 percent chance to gain $1,000 and a 50 percent chance to gain nothing.*

Another group was presented with this problem:

- *In addition to whatever you own, you have been given $2,000. You are now asked to choose between (A) a sure loss of $500, or (B) a 50 percent chance to lose $1,000 and a 50 percent chance to lose nothing.*

In the first group, 84 percent chose A. In the second group, 69 percent chose B. The two problems are identical in terms of net cash to the subject; however, the phrasing of the question causes the problems to be interpreted differently.

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be controlled by your optimism in making decisions you can't make well.

8 If we're so prone to falling prey to what "the experts" are saying about individual investments or the market and its movements—using that as an "anchor"—is there an element of institutional manipulation?

Most people think they're above average; those in the business, with their abundance of confidence, definitely think so and believe they're in the business of beating the market. I choose not to be cynical about it. I think it's sincere optimism, not manipulation. They believe they can equal or beat the market. And we buy that because we're optimists at heart and because we trust people who appear confident.

9 Richard Thaler made an interesting observation about behavioral finance in an article called "The End of Behavioral Finance," in which he asks, what other kind of finance is there?

Yes, he believes one day behavioral finance will be viewed as a redundant phrase and that eventually economists will incorporate as much "behavior" into their thinking as they observe in the real world. However, the view that humans have self-control, self-interest, and rationality is still the majority view of economists. That's one type of analysis; this is simply another.

10 Have you applied your insights to your own decisions about money and investing?

It's made me much more passive. I do less and worry less about it. I know I can't do it very well myself. I'm quite relaxed about it.

From Psychology to Behavioral Finance: Kahneman, Tversky, Richard Thaler, and Blizzards and Basketball Tickets

Daniel Kahneman's long-time collaboration with fellow psychologist Amos Tversky, and their work on decision theory, took on a new dimension when economist Richard Thaler, of the University of Chicago, became interested in how their findings could be applied to finance and economics. "The founding text of behavioral economics was the first article, in 1980, in which Thaler presented a series of vignettes that challenged fundamental tenets of consumer theory," says Kahneman. In this excerpt from his Nobel biography (**www.nobel.se**), Kahneman recounts his introduction to Thaler and Thaler's experiment that illustrates "mental accounting":

> Richard Thaler was a young economist, blessed with a sharp and irreverent mind. While still in graduate school, he had trained his ironic eye on his own discipline and had collected a set of pithy anecdotes demonstrating obvious failures of basic tenets of economic theory in the behavior of people in general—and of his very conservative professors in Rochester in particular. One key observation was the endowment effect, which Dick illustrated with the example of the owner of a bottle of old wine, who would refuse to sell it for $200 but would not pay as much as $100 to replace it if it broke. Sometime in 1976, a copy of the 1975 draft of prospect theory [Kahneman's and Tversky's now-famous article on prospect theory, published in 1979 in *Econometrica*] got into Dick's hands, and that event made a significant difference to our lives. Dick realized that the endowment effect, which is a genuine puzzle in the context of standard economic theory, is readily explained by two assumptions derived from prospect theory. First, the carriers of utility are not states (owning or not owning the wine), but changes—getting the wine or giving it up. And giving up is weighted more than getting, by loss aversion. When Dick learned that Amos and I would be in Stanford in 1977–78, he secured a visiting appointment at the Stanford branch of the National Bureau of Economic Research, which is located on the same hill as the Center for Advanced Studies. We soon became friends, and have ever since had a considerable influence on each other's thinking.
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> The endowment effect was not the only thing we learned from Dick. He had also developed a list of phenomena of what we now call "mental accounting." Mental accounting describes how people violate rationality by failing to maintain a comprehensive view of outcomes, and by failing to treat money as fungible. Dick showed how people segregate their decisions into separate accounts, then struggle to keep each of these accounts in the black. One of his compelling examples was the couple who drove through a blizzard to a basketball game because they had already paid for the tickets, though they would have stayed at home if the tickets had been free. As this example illustrates, Dick had independently developed the skill of doing "one-question economics." He inspired me to invent another story, in which a person who comes to the theater realizes that he has lost his ticket (in one version), or an amount of cash equal to the ticket value (in another version). People report that they would be very likely still to buy a ticket if they had lost the cash, presumably because the loss has been charged to general revenue. On the other hand, they describe themselves as quite likely to go home if they have lost an already purchased ticket, presumably because they do not want to pay twice to see the same show.