The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Another Nobel Prize for behavioral economics

By Stan Clark - Senior Investment Advisor

In October the Nobel Committee awarded the 2017 Nobel Prize in Economics to the University of Chicago's Dr. Richard Thaler "for his contributions to behavioral economics." I couldn't be more pleased for Dr. Thaler – and for all those devoted to the field of behavioral economics.

Anyone familiar with the Stan Clark Financial Team knows we are big fans of behavioral economics and its sub-discipline behavioral finance. We developed our approach to investing and financial planning based on its concepts. It's gratifying to see it grow from a backwater, heretical offshoot of traditional economics to a place of increasing influence.

I became a student of behavioral finance before it was even called that. Soon after starting in this business in 1987, I read David Dreman's book *New Contrarian Investment Strategies*, which Thaler mentions in his recent book *Misbehaving – The Making of Behavioral Economics*. Thaler credits Dreman as "the first person to suggest an explicitly psychological explanation for the value effect, one based on the tendency for people to extrapolate the recent past into the future."

Thaler's best-known contributions were offshoots of his best-selling 2008 book *Nudge*. These led to positive changes in pension-plan policies in numerous countries, increasing savings rates and improving how people invested those savings.

Thaler's *Misbehaving* is both an entertaining review of the history of behavioral economics and a summary of its key concepts. Thaler himself discovered several of these concepts, including the Endowment Effect and Mental Accounting.

Thaler went into academia because he was curious. He felt a business career like his father's would be too boring. He chose economics because it seemed somewhat practical.

His early career didn't show promise. He wasn't good at math, and economics and finance in the early 1970s were math-oriented. But Thaler's curiosity led him to notice many ways that real humans acted differently from the rational, consistent beings idealized by traditional economists. Real humans did "stupid" things that these idealized economic humans wouldn't. Thaler's fellow economists did not take kindly to his pointing this out - which didn't help his career.

In 1976 a turning point occurred. A former student of Daniel Kahneman's introduced Thaler to the early work of Kahneman and Amos Tversky. Thaler saw the deviations he had noted could not be dismissed as random variations. Rather, systematic biases caused real humans to behave much differently in their economic decisions than traditional economists suggested. Financial journalist and author Michael Lewis credited Thaler as the first economist to grasp the significance of psychologist Kahneman's work.

Thaler worked with Kahneman and Tversky at Stanford and later at the University of British Columbia. He features prominently both in Kahneman's book *Thinking Fast and Slow* and in Lewis's recent *The Undoing Project*. Lewis says it was Thaler who pointed out that his bestseller *Moneyball* was a good summary of the errors documented in behavioral economics - a point Lewis wasn't aware of until after he wrote the book.

The influence of behavioral finance has grown over the years. But humans are still humans, and knowing about the errors they make is just the first small step in avoiding these errors. Many economics and finance academics still find it difficult to switch from theories that supported their entire careers. And there are influences in our world, including the media and a good portion of the investment and financial planning profession, who exploit the errors that humans continue to make.

But for those willing to learn about the errors we are prone to, and to avoid them, the rewards are great. ■

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