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«Life is full of surprises»

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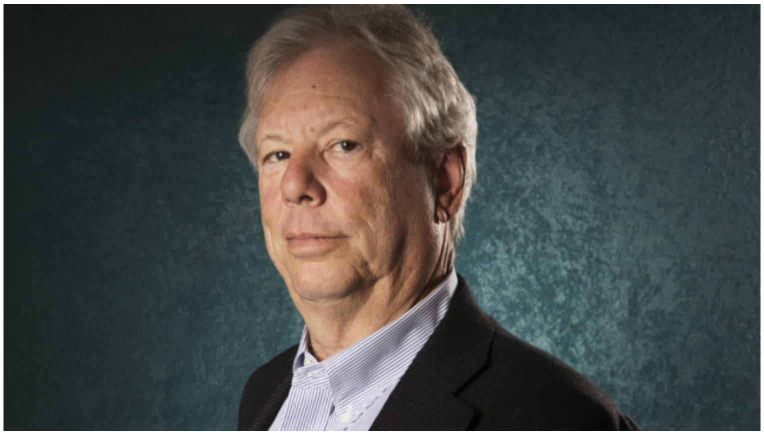

«Overconfidence is probably the biggest trap to fall into.» (Image: Richard Saker/Getty Images)

Richard Thaler, leading behavioral economist and Nobel Prize winner, explains why investors often act irrational and why he would be a bit cautious with investments in the stock market.

Greed, euphoria and fear are some of the most powerful drivers of the financial markets. Few know more about that than Richard Thaler. His research on human behavior revolutionized the field of modern economics. For his scientific work he was awarded the Nobel Memorial Prize in Economic Sciences in 2017. «He's made economics more human», the Nobel committee said in announcing the prize. The down-to-earth professor at the renowned Booth School of Business of the University of Chicago explains why he's skeptical of the standard models used in conventional economic theory, what behavioral fallacies investors should watch out for and, why the Bitcoin boom is a complete mystery to him.

Professor Thaler, for decades you have been researching the economic behavior of humans. Is there anything that still surprises you?
Life is always full of surprises. So we just should continue to expect to be surprised because human beings are complicated. After doing this for forty years, we have grabbed a lot of the low hanging fruit. Many of the things that we are learning now are more or less further examples of a certain type of behavior like inertia, inattention or lack of self-control. There are an infinite number of ways to exhibit that behavior and we will continue to find new ones and new places to make use of that insight.

Standard economic models are still based on the concept of the Homo Economicus, a super perfect economic person that always behaves totally rational. Why are you skeptical of that approach?
I call those economic men «Econs». They're kind of like the character Spock in Star Trek: They calculate very rationally, they do economics like the combination of an accountant and a financial adviser, they can make net-present value calculations in their head, they're not affected by emotions and they certainly have no self-control problems. So I have never met anybody remotely like the people that appear in economic models.

What does that mean applied on the financial markets? Are investors always behaving rational?
Let me give you an example: There is this closed-end fund that has the ticker symbol CUBA and invests in the Caribbean. But of course, it cannot invest in Cuba because that would have been illegal since it was a US fund and because there are no Cuban securities. So it has nothing to do with Cuba. Historically, this fund traded at a 10 to 15% discount relative to the value of the assets that it owned. But one day it jumped to about a 70% premium and that was the day that President Obama announced his intention to relax relationships with Cuba.

What was the explanation for this sudden movement in price?
There is no rational explanation. You might think maybe a rejuvenated Cuba would help the entire Caribbean area. But if that were the story you would expect to see the underlying assets go up, things like cruise lines. But they didn't. The value of the securities was the same. It was just the price you paid to get them packaged in this fund with the ticker CUBA that jumped, and it took about a year for this premium to go away.

You call those anomalies «fruit flies» of the financial markets. Why?
Coincidentally, the Nobel laureates in medicine last year studied fruit flies. We know that fruit flies are valuable to study in biological sciences, in part because they reproduce very often. But they're not particularly important in the grand scheme of things for us humans. If there were no fruit flies, our live wouldn't be very different. But they're useful because they give us scientific insights. So the analogy is that these little anomalies like the story about the CUBA fund are not important in and of themselves. But they're important in terms of what they can teach us about financial markets.

Another important concept in the conventional economic theory is the concept of sunk costs: Costs that have already been incurred and thus should be excluded from future business decisions. Why do we often neglect that concept in our daily lives?
I'll tell you a funny story that I heard recently and that illustrates the sunk cost fallacy perfectly. There's an American couple vacationing in the German part of Switzerland, let's say in Zurich. So they buy two expensive tickets to what they believe is going to be a symphony concert. And then, as it's supposed to start, they realize to their horror that it's not a concert but a comedy theater production. Although they do not speak a word of German they stay for the next two and a half hours until the end of the play.

Are there also sunk cost fallacies when it comes to investor behavior?
For instance, people seem reluctant to sell stocks that have gone down. I think it's something like the same psychology. Because if that American couple had just walked out of the theater, they would have had to admit that the money they had spent on those tickets was wasted. Whereas this way, they enjoyed laughing at the jokes they didn't even get. So if you're holding a stock that has gone down 50% and you sell it, you have to admit that you made a mistake. But if you hold on to it, you can always hope.

What's your personal take on the stock market right now?
I don't have a strong opinion. Stocks are relatively high by using something like Bob Shiller's Cape Index. So as an investor, I would be a bit cautious. It's not that I would stop investing in the stock market. But I would make sure I was prepared for a decline and that's going to happen at some point.

Then again, investors seem to be in a champagne mood. In the new year, the Dow Jones has started off strongly and managed to close over seventy times at an all-time high in 2017. This never happened before.
Just the fact that people are talking about this is kind of ridiculous.

Why?
If you have set a record and the market keeps going up, then necessarily it will break another record. There is absolutely nothing remarkable about it. Also , the stock market went up much faster during President Obama's first year in office than in the past year. But it wasn't setting records at that time because it just had gone down by 50%.

But what's happening in psychological terms? Do investors behave differently when they hear about new record highs in the news all the time?
When things are going very well, there is a tendency to extrapolate. For example, when real estate prices were going up very quickly during the US housing boom, people expected them to continue to go up. But we know that what goes up can come down. In fact, the more it's going up, the less confident we should be that it will continue to do so. But the more prices go up the more confident people get that they will continue to go up. That's similar to the so called hot hand phenomenon in basketball: When somebody has made a bunch of shots in a row then people think that this is likely to continue. But it's not.

Also, sometimes people say that there's a casino mentality on Wall Street. What's behind that?
In the US, there's the expression of «playing with the house money» because the casino is referred to as the house. For example, if you won $500 in the first couple hours at the tables, then you feel like you're playing with the casino's money rather than with your money. But it's in no sense their money any more. It just feels very different. I'm sure there are some bitcoin investors that have this mentality right now.

How do you experience the crypto-boom as a behavioral economist?
It's a complete mystery to me. Let's put it this way: I cannot think of any legitimate use for Bitcoin other than tax evasion. It's not a sensible replacement for money because it fluctuates too much. No one would want a currency that jumps up and down like that. I admit to not understanding any of the details of what the algorithm is or how Bitcoin gets mined or anything like that. So I would not invest in it because I'm too ignorant. But the idea that I would want to use Bitcoin instead of Dollars, Euros or Swiss Francs to pay my bills seems absurd to me. I wouldn't want to do that unless I was a drug dealer.

You're also advising governments on incorporating ideas from behavioral economics into policy design. How does that work?
What we try to do is to advise policies that nudge or gently push people in some direction but don't require anybody to do anything. Basically, we try to nudge people in a way which is the direction they would go if they were fully informed. A good example is GPS: If you use Google Maps to get around, it's just a suggestion. If you decide on your way that you want to look at the beach, Google Maps doesn't tell you, you can't go there. In fact, it will just compute a different route. So our goal is to create a world that's easier to navigate. I would like the equivalent of Google Maps for every part of my life.

What would be such a nudge in our daily life?
There's one nudge that I think of on numerous occasions: In London they drive on the wrong side of the road. So when you're a pedestrian, cars come from the opposite direction of what you're used to. Because of that they have those signs at intersections in downtown London telling you to look right. I think those signs have saved my life on numerous visits to London.

What would be a helpful nudge for investors?
For instance, well defined and well-constructed default investment vehicles. Most people have no idea how to invest. Therefore, if in a defined contribution pension plan somebody has put together a low cost diversified index fund and says «if you don't know what you're doing, buy that», then most people will do better that way than they would on their own.

Do you also have an advice for investors when it comes to avoiding common behavioral fallacies?
So far, we haven't talked about overconfidence and that's probably the biggest trap to fall into. There is this expression by the American author Mark Twain: «It's not what you don't know that gets you into trouble. It's what you know for sure, that just ain't so.» People greatly overestimate how much they know. I'm helped by that because my wife is always asking me: «Are you sure?» Everybody needs my wife following them around and asking them: «Are you sure?»

So what would be your advice?

I recommend people to keep track of their predictions. For example, many people think they're very good at investing in the stock market. Especially people who have started investing during the last ten years. The thing is that the stock market has just gone up since 2009. So picking stocks at random would do pretty well and most of us wouldn't have any idea how to figure out what their true return has been. Also, people tend to remember their winners and to forget about their losers. So the best lesson is in all aspects of your life that when you're making predictions try to keep track of them and then see how smart you really are. It's not as smart as you think.