Daniel Kahneman on the Psychology of Your Clients ... Oh, and Your Own Mental Hiccups

by Christina Nelson

WHO: Daniel Kahneman, Ph.D.

WHAT: Senior scholar and professor of psychology and public affairs at the Woodrow Wilson School of Public and International Affairs at Princeton; recipient of the Nobel Prize in Economic Sciences; and author, most recently, of the best-selling book *Thinking, Fast and Slow*

WHAT'S ON HIS MIND: "The real enemy of wealth accumulation is loss aversion.... In principle, if you have an individual who is trying to save for old age, the less sensitive they are emotionally to small fluctuations in their wealth, the better off they are going to do in the long run."

PODCAST: Check out our podcast with Kahneman at www.FPAnet.org/Journal/Home/PodcastPage.

Daniel Kahneman, the only person to be profiled twice as a "10 Questions" interview subject in the *Journal* (the first happened in 2004), was forced into our edit team's spotlight for three reasons this year. First, his book *Thinking, Fast and Slow*—which brings together decades of his own research and others' into one concise treatise on how the mind works and its implications on fields as disparate as economics, politics, and medicine—was chosen as one of the best books of 2011 by the *Economist*, the *Wall Street Journal*, and the *New York Times*, to name a few. Perhaps this is why conversations with financial planners about client behavior at various conferences this year have inevitably included the question, "Have you read Kahneman's work?"

His name, and that of his long-time collaborator Amos Tversky, has figured prominently in *Journal* contributions over the last few years—which leads to the second reason an interview with Kahneman was pleasantly unavoidable: his discoveries about human psychology are perhaps more relevant today, in a world of economic uncertainty and market volatility, than ever before. Kahneman's rational explanations for clients' seemingly irrational behaviors—and our own—are given names such as anchoring, framing, loss aversion, prospect theory, and the endowment effect. Planners can use these terms and the theories behind them to help define, understand, and correctly react to client actions in an endeavor to serve their best interests.

This October issue's theme of behavioral finance provides Reason 3—the perfect occasion to explore how Kahneman's psychological discoveries illuminate active portfolio management decisions, overconfidence, risk tolerance questionnaires, and the misleading goal of "happiness."

1. *In a behavioral finance interview with the* Journal *back in 2004, you spoke about adopting policies in order to lessen the frequency of having to make individual decisions. With tactical asset allocation becoming more popular in the wake of the 2008 market crash, do you still hold to the general assessment that the less active you are with a portfolio the better off you'll be in the long run? Even for professional investment advisers?*

Well, you know, I should start with a disclaimer. I'm not a financial expert and ... I haven't done the research. In principle, I think it's generally true the default assumption has to be that

when there is a very active market, any individual is unlikely to beat the market. On the other hand, my guess is that the market—when we're dealing with big entities, such as asset classes or the economy of countries and so on—then my guess is that there is more room for people who understand how the system works, and that there might be more skill in making those forecasts than in others.

That doesn't mean that the average person has that skill, but it might mean that some people consistently outdo others. And there are examples of people who appear to have skill in understanding large trends in the market, and I wouldn't bet against that.

I will add, though, that I don't know of any research that supports it. The little research that I have seen indicates that people are not particularly good on average in tactical allocation.

2. *In your book* Thinking, Fast and Slow *you state, "Overconfidence is fed by the illusory certainty of hindsight." How can planners find a healthy balance between learning from the past without relying on the past to repeat itself?*

What you have to avoid, probably, is learning too much from the immediate past and from the recent past. So it's possible to learn from history—although one should be careful even with that. But certainly people have a tendency to learn too much from recent events. So, just as generals tend to fight the last war or prepare for the last war, I think people do a lot to prepare themselves against the last financial crisis. And in that sense, we are, I think, overly [inclined] to think about and learn from the past.

The point I was making in the quote that you attributed, was that we tend to explain what just happened. It gives us a feeling that we understand the world. In fact, the most important realization is that we don't understand the world very well, otherwise we would do a lot better in predicting what happens. So hindsight understanding is damaging, in the sense that it feeds overconfidence.

3. *Tell us about "what you see is all there is" and how it relates to subjective confidence.*

One of the main points I make in my book is that subjective confidence that people experience in what they think and they believe they know is not really a judgment. It is not a judgment of the likelihood that they're right. It is not an evaluation of the quality of the evidence that they have. Confidence is a feeling, and it's a feeling that comes, basically, from the coherence of the story that you're telling yourself. And people are quite able of achieving considerable confidence, even on the basis of very flimsy evidence. And that's the trap.

What we need in order to control this—and it's quite difficult to do because the feeling is so potent—but what one needs is an objective assessment of the quality of the evidence. Where does my confidence come from? How good is my story? Not as a story, but how good is my story in the sense of how much evidence supports it? And then one might find that actually their evidence is quite slim.

4. *The risk tolerance questionnaires planners use with clients are often built around your and others' work on psychology in decision making, such as loss aversion versus utility maximization. How would you go about accurately assessing a client's financial risk tolerance?*

The first question is whether there is such a thing. That is, whether there is a consistent number of parameters that describe people. Within utility theory, there is a notion of risk attitude, which is supposed to be consistent. And I think one of the results of research is that there is no such thing. So, for example, people become quite risk loving, risk seeking when they're in trouble. When they have to choose between a sure loss and a gamble, they tend to gamble. Whereas, when they deal with gains, they tend to be risk averse.

So my sense is that the hope of getting a single number isn't a very good idea. I think that people sometimes present volatility as if people were afraid of volatility; I don't think that's very compelling either.

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What I find most stable and interesting are two aspects of risk aversion. One is: what is the biggest loss that you would be willing to tolerate before you change your mind, if that's what you're doing? That, I think, is an important issue. What would shake you? How committed are you to your course of action?

Some people are really a lot shakier than others and those people should really avoid risk, because they're likely to encounter some random volatility. They're likely to encounter losses that would make them stop sleeping at

night and then they will change their allocation, which is rarely a good idea.

And the other question, which is a related one, is: what would cause you to regret what you have chosen? Some people are much more prone to regrets than others. And people who are prone to regret should not take too many risks.

I should add that I am associated with Guggenheim Partners, and the approach to risk measurement that they have been taking is really influenced by those ideas. It's very much looking for the loss that you can tolerate and the regrets—the conditions under which you will regret your current decisions.

5. *How did the work of economist Richard Thaler influence your thinking about people's behavior not always aligning with basic tenets of economic theory, such as that people make rational choices?*

It was really Richard Thaler who introduced us to economics. Amos Tversky and I did prospect theory, and although we published it in an economic journal, we were not thinking of influencing economics. The story is that Richard Thaler, who was an economist, read about prospect theory and saw in it a way to explain phenomena that he had observed that violated economic theory. And he sought us out, we became close friends, and really, he was my main teacher in economics. So he had considerable influence on me.

Thaler was the very first person who applied prospect theory to decision making that doesn't involve risk. Prospect theory was a theory of decision making and the risk. But we had that notion of loss aversion, of the asymmetric treatment of losses and gains, and Rick Thaler is the one who applied it to transactions like buying and selling and so on. And that was a very powerful move.

6. *Planners express frustration with some clients' reluctance to act on the advice given and agreed to in meetings. How might planners employ your findings on persuasive messaging to encourage sound financial actions by their clients?*

I think it's not so much research that I have done, but there is a lot of research in psychology on the requirements to get people to follow through on the intentions that they have made. And one is to make the commitments very specific. It's not enough to say, "I will call my bank." But if you can get people to say, "I will call my bank tomorrow morning first thing" or "I will call my bank Thursday morning." Make the commitment very specific. "I will call that person in my bank." The more they imagine the specifics of the action they have to take, the more likely they are to follow through with it.

And the other general idea is that the more involved the client is in the planning—if it's not something that they're just being told to do, but if it is something that they have discussed and that they have ownership in the idea of what they're supposed to do—they're much more likely to implement it.

7. *Our brains—both the fast, instinctive "System 1" and the slower, deliberate "System 2"—have a tough time making sense of statistics, often wanting to see causation where there is only chance. How might advisers recognize and work around this cognitive blip?*

In the first place, advisers should warn themselves about those issues because they are likely to be prone to exactly the same problem. For example, how much can you infer from the fact that a fund has done very well in the last four years? And the answer is, very, very little. It's almost irresistible, when somebody has done well for four years, to think that they're on to something; they know what they're doing.

But in fact, there are so many people trying that even if they were all rolling dice, some of them would be successful four times in a row, five times in a row, and so on. How much we can infer from random success is really much, much less than most people intuitively do. And that applies to financial planners themselves.

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So knowing that we tend to see patterns where there are none, and that we tend to attribute success to skill when in fact it is due to chance, that is useful mental discipline that people find very difficult to acquire.

8. *With so much market and economic uncertainty in the last few years, what discoveries from your body of research most apply to decision making in ambiguous environments that advisers should be aware of?*

I think that the main problem, which I emphasized earlier, is the idea that

changing course too often is a way to lose money. That is really a trap for investors. And in a situation of high volatility, which is clearly the situation that we have been experiencing basically for the last few years, people often tend to do two things. One is to overly infer from the last movement, "Oh, we are now in a new situation," when in fact, things are just going up and down and we're not in a new situation. So that's really dangerous.

And then thinking that we're in a new situation is likely to make you make changes. "Now I have to move to an allocation of choices that will fit the new situation" that I think exists. And so seeing a pattern where none exists is really a threat. And it's a threat when things are going poorly and when there is a lot of volatility.

9. *Planners seek to help clients live financially healthy lives and retire "happy," but in a 2010 TED conference presentation you said that the word "happiness" may not be useful anymore. How can planners best serve their clients' two selves—the experiencing self and the remembering self—in helping them build long-term well-being?*

The real enemy, I think, of wealth accumulation is loss aversion. And what I mean by loss aversion is that people react emotionally to losses. They react emotionally to the event of losing and to the event of gaining. And in principle, if you have an individual who is trying to save for old age, the less sensitive they are emotionally to small fluctuations in their wealth, the better off they are going to do in the long run.

There is an exaggerated sensitivity to the short term. People are afraid. If you face a loss, and now you regret it and you have lots of emotions and you make decisions under those emotional vibes, you are likely to panic and suffer financially.

I think people who are prone to strong emotions should not take risks or should take fewer risks, and they should try to invest funds to make themselves comfortable, even if they're not going to maximize wealth. And they should know that sometimes there is a trade-off between taking a position that will maximize things in the long run and taking a position that will maximize your comfort as you live through the ups and downs.

10. *You've spoken often about your longtime collaborator and friend, Amos Tversky, and how that relationship had a multiplicative effect on any work each of you might have accomplished alone. For planners who are considering joining study groups with their peers, do you have any advice?*

One couldn't learn from what Amos Tversky and I did; we had a sort of creative collaboration—and had a very unusual one. But it is true that if anyone is going to join a discussion group, there is a tendency when you have a discussion group to seek consensus. But in fact, discussion groups are going to be most useful when there is no consensus. That is, they're going to be most useful in enlarging the scope of ideas to which individuals are exposed.

So, not trying too hard for consensus, but on the contrary, trying to illuminate differences and to highlight differences and to explore those in a friendly spirit, that is probably the most productive use of people's setting up discussion groups and following through on them.

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