



Richard Thaler’s “Misbehaving” and Implications for Investors and Advisors

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by Joe Tomlinson

Richard Thaler is out with a new book, *Misbehaving*, tracing his career in behavioral economics. It offers an appealing combination of entertaining writing and serious discussion of the many areas he has researched. The book is a natural complement to Daniel Kahneman’s classic, *Thinking, Fast and Slow*. I’ll briefly compare these two books and then address what Thaler’s work says about two issues particularly important to financial advisors.

Misbehaving is a quicker read than Kahneman’s book, but it still provides a wealth of material on a behavioral economics. It’s also a more personal book, chronicling Thaler’s career starting in the late 1960s when he began to take note of inconsistencies between the economists’ model of rational choice and how people actually behaved. The books are different in that Kahneman has studied human decision-making from a psychologist’s viewpoint, whereas Thaler’s is from an economist’s perspective, with much of the focus on how his views differ from those of classic economists.

A central theme of both books is the distinction between normative and descriptive theories. Normative describes the “right” way to make decisions in terms of a logically consistent approach to optimizing a goal. It’s the classical theory on which many economic models are based, including models that assume individuals make decisions with an aim of maximizing utility. Descriptive theories attempt to characterize how decisions get made in practice – with limited information, affected by a variety of biases and often relying on imperfect rules of thumb. It’s important to understand the descriptive aspects in order to better predict behavior and help people to achieve their long-term goals.

Kahneman makes a distinction between what he called “system 1” thinking, which is quick and automatic, and “system 2,” which demands much more effort. Thaler makes a similar distinction between humans and Spock-like “econs.” Dealing effectively with financial issues such as choosing an asset allocation, determining a retirement withdrawal plan or deciding how to react to a market downturn calls for system 2 or econ thinking. However, people are limited in their intellectual and emotional capacity, so system 1 and the human approach to decision-making more often come into play.

Investment insights

Historically there have been opportunities to earn higher risk-adjusted returns by following certain

investment strategies, for example, investing in small-cap value stocks. The econ view, consistent with the efficient market hypothesis (EMH), is that such anomalies should not exist, but clearly they do. The lack of enthusiasm for such strategies among econs reflects further arguments (despite some contrary evidence) that the risks have been mis-specified or that such anomalies will be arbitrated away in the future. Therefore it is not worth following these strategies unless one is willing to accept more risk.

But the behaviorists make the argument that such opportunities are likely to persist into the future. The difference stems from human versus econ decision-making. The human approach relies heavily on system 1, characterized by an incomplete view of history, overconfidence based on over-reliance on recent information and headlines, and confirmation bias stemming from the way the mind filters information.

Chapters 22 and 23 of *Misbehaving* summarize research that Thaler did with Werner De Bondt in the 1980s, proposing a behavioral explanation for the value premium. They started by noting the surprisingly high trading volumes in stocks, and they hypothesized that this resulted from investor overconfidence and overreacting to new information. They tested their hypothesis by constructing portfolios of winner and loser stocks based on past performance and demonstrated that, going forward, the losers outperformed the winners. The losers, having produced poor results for a number of years, tended to fall in the value category. More details can be found in their 1985 paper.

Thaler's research on the value premium and overreaction in the valuation of individual stocks parallels Robert Shiller's research on overall stock market overreaction, which led to his development of PE 10 or cyclically-adjusted price-to-earnings ratio (CAPE) as a predictor of long-term stock market performance. An often-debated question is whether PE 10 will continue to be a useful indicator. Econs argue that investment professionals will incorporate the PE 10 effect in tactical investment strategies and arbitrage its predictive power away. The behavioral view is that such professionals are still human and will continue to exhibit the same biases in decision-making that have made PE 10 a useful indicator historically. Thaler describes Shiller as a "fellow co-conspirator" in the behavioral economics crusade.

Thaler's most ingenious application of behavioral economics to investments was the research he did with Shlomo Benartzi on the equity risk premium puzzle, summarized in chapter 20 of the book and originally presented in this 1995 paper. Classical economic theory and utility theory in particular could not explain the large difference between historical returns for stocks versus bonds. Benartzi and Thaler's research with individual subjects came up with the concept of "myopic loss aversion," concluding that ability to tolerate stock market risk is an inverse function of the frequency of checking on performance. Thaler lightheartedly suggests investing heavily in stocks, but avoiding all stock market news, especially cable television.

Thaler's research 20 to 30 years ago seems primitive compared to the much more mathematical performance attribution analysis being done today. However, history – including its countless market inefficiencies – keeps repeating itself, which supports the behavioral perspective. That underlies the striking difference in human versus econ views on investment opportunities.

The annuity puzzle

Perhaps the starkest difference in human versus econ behavior involves the much analyzed “annuity puzzle.” The econ view was first articulated by economist Menachin Yaari in 1965. He developed a theoretical demonstration showing that individuals without a bequest motive could maximize lifetime utility by annuitizing all their savings. The reality is that very few individuals choose to purchase annuities, at least the simple kind (e.g., single-premium immediate annuities - SPIAs) that turn savings directly into lifetime income. There have been numerous articles and papers over the years attempting to explain this dichotomy.

Neither Kahneman’s nor Thaler’s books discuss the annuity puzzle, but both books discuss behavioral biases that are applicable and other sources address the issue directly. The endowment effect – that people place higher values on things they already own than on what they would receive in the future – may partially explain the puzzle. We see individuals reluctant to “sell” savings in exchange for lifetime income, but we don’t see popular demand to allow cashing in the lifetime income from Social Security. The endowment effect is tied in to the “status quo bias,” inertia and regret avoidance – people experience greater regret when problems emerge as a result of taking action (e.g., buying an annuity) rather than staying with the status quo (e.g., leaving money in savings). Regret avoidance is also tied in with loss aversion, an indication of how the various behavioral biases are tied together.

Another contributor to the annuity puzzle is that humans are not good at doing the translation between savings and lifetime income. A recent study by economist Jeffrey Brown and a group of co-authors surveyed individuals about the savings/income tradeoff and included the question, “How much would you pay for an additional \$100 per month in Social Security income?” The median answer was \$3,000. But the price for an inflation-adjusted SPIA with an initial monthly payout of \$100 is about \$30,000. Small wonder that people are reluctant to purchase SPIAs.

Jeffrey Brown was also involved in an earlier study that demonstrated the impact of behavioral framing effects on the attractiveness of annuities. Framing the annuity as purchasing additional lifetime consumption proved more attractive to survey participants than an investment framing where returns vary with the length of life.

Overconfidence is another bias that may discourage annuity purchase, particularly if amplified by advisor overconfidence about producing superior retirement outcomes without annuitization.

This study by Steven Sass and Jorge Ramos-Mercado on Americans’ shortsightedness about finances provides more bad news for annuities. They found that Americans of all ages and income levels tend to focus on day-to-day finances while ignoring long-term financial issues. A shocking finding was that having no retirement plan had no significant effect on self-assessments of financial well-being, even for those approaching retirement. Although there are other surveys where Americans express retirement concerns when prompted, this particular study indicates that such concerns don’t rise to top-of-mind naturally, reflecting the behavioral bias of being present-focused.

Given all these behavioral considerations and today’s historically low interest rates (lowering annuity payout rates), it’s a wonder anyone buys an annuity.

Can the puzzle be solved?

There has been considerable progress in developing ways to encourage employees to save more for retirement, and a natural question is whether any of the lessons learned can be applied to de-accumulation after retirement. Thaler has been a leader in applying innovative ideas from behavioral economics to savings accumulation – advocating that 401(k) plans include auto-enrollment and auto-escalation provisions to make saving for retirement as automatic and painless as possible. His Save More Tomorrow program is summarized in chapter 31 of the book and covered more extensively in the book “Nudge,” which he co-authored with Cass Sunstein. Making effective change on the accumulation side depends heavily on 401(k) plan sponsors changing the way they administer their retirement savings plans.

When we turn to the de-accumulation side and the annuity puzzle, things are much more in the hands of individuals and their advisors, but there may also be things employers can do to set employees up for retirement. Thaler and his co-authors provide some suggestions in this [article](#) on annuitization puzzles, focusing on steps the government could take to facilitate more annuitization. They looked at Social Security and how communications could be changed to encourage deferred claiming to generate higher benefits and build a more substantial base of guaranteed lifetime income before considering additional annuitization.

The authors then addressed what can be done to make more automatic de-accumulation features available, paralleling what has already been accomplished on the accumulation side. Their simple idea is that if you want to facilitate people doing something, you need to make it easy to do. Unfortunately, a significant barrier discouraging employers from encouraging annuitization is the potential legal liability for plan sponsors in choosing annuity carriers.

British economists David Blake and Tom Boardman have entered this discussion with their proposed spending optimally throughout retirement (“Speedometer”) program for de-accumulation. Their approach parallels Thaler and Sunstein’s Save More Tomorrow, and they apply Thaler’s econ and human concepts in addressing the behavioral issues that underlie the reluctance to annuitize and the suboptimal drawdown of retirement assets. They present their proposal in this [detailed paper](#), which is worth careful reading to appreciate how they have addressed the many behavioral issues.

The de-accumulation side presents bigger challenges than accumulation, but there is hope with innovative proposals that deal with the behavioral barriers.

The political dimension

Thaler has been accused by some of advocating paternalistic policies and too intrusive a role for government. His counterargument is that, if people make predictable errors, it may be feasible to devise policies that reduce the error rate without taking away the right to choose. The goal is to reduce what people themselves would call “errors.” I personally favor placing a lot of emphasis on the behavioral issues in designing policy solutions and delivering financial advice, but I realize many others will continue to view behavioral biases as irrelevant anomalies. The debate will go on.

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