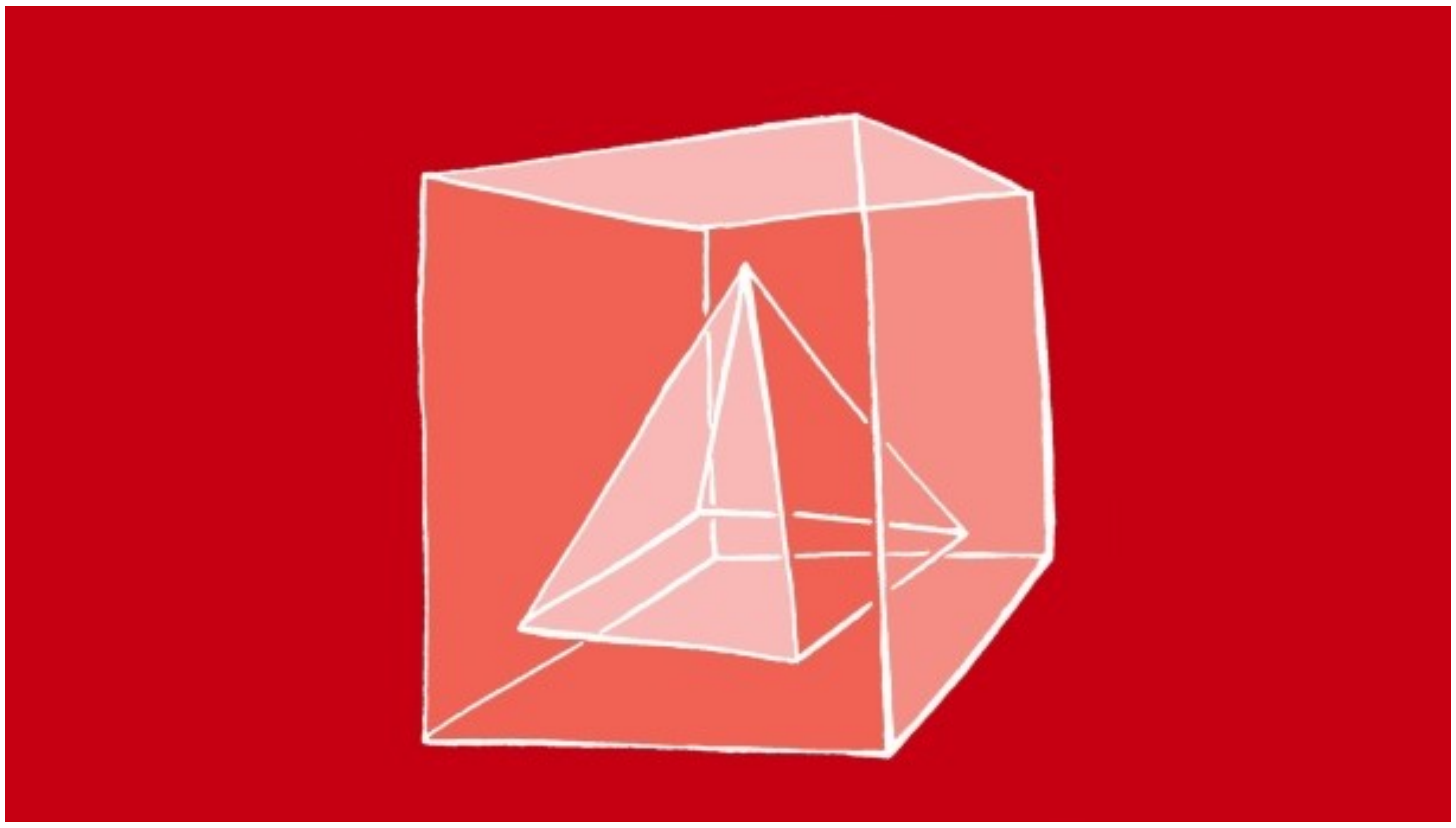
F.A.Z.-Column by Emanuel Derman

Misbehavioral Psychology

This is my tale of disappointment, of ground-breaking research gone awry and then embraced as a tool for political manipulation.

12.12.2012, von EMANUEL DERMAN



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One of the hottest topics in finance and economics for the past two decades has been Behavioral Economics, a field that originated in the research of Daniel Kahneman and Amos Tversky. Tversky died in 1996, and Kahneman was awarded The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in 2002. The Nobel committee cited their joint work on “prospect theory as an alternative, that better accounts for observed behavior” of humans making decisions “when future consequences are uncertain” (aren’t they always?).

Classical financial modeling assumes that people make decisions in a cold-blooded utilitarian way that is therefore susceptible to mathematics and statistics. Kahneman and Tversky (K&T) cataloged a collection of irrational warm-blooded peculiarities in the way people choose between alternative bets on their own potential profits and losses when playing games of chance. Here are two of their many discoveries: (i) people are found to dislike the probability of losing $5 more than they like the equal probability of winning $5; and (ii) people typically underestimate the likely occurrence of rare (“black swan”) events.

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In essence, claim K&T, people are

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psychologically inept at making rational decisions in games of chance.

Not everyone agrees with K&T. Real life is not always a game of chance; while the probability of throwing heads and tails is known exactly, the probability of human behavior is not. Animate individuals are driven by motives that can defy statistics. Our legal system recognizes this, and finds defendants guilty or innocent not on the basis of statistical evidence but on the basis of judgement and believability. You can find some criticism of K&T's approach in an interesting article by Professor Alex Stein ("ARE PEOPLE PROBABILISTICALLY CHALLENGED?" to appear in the Michigan Law Review in 2013.)

Prospect Theory

But put these criticisms aside for now and accept K&T's proof that people are bad at making rational decisions. Proceeding from there, K&T developed what they call *prospect theory*. In prospect theory, as opposed to classical economic theory, K&T replaced *homo economicus*'s rational notions of losses and gains and their probabilities by the empirically determined "irrational" values used by everyday fearful and greedy hot-blooded *homo affectus*.

Classical economic theory was elegant but flawed, and prospect theory was a beautiful idea/ideal that aimed to fix it by taking account of actual human preferences in determining economic value.

Unfortunately, that isn't what happened. First, the ambitions of prospect theory as a science of human behavior foundered in a maelstrom of increasing mathematical complexity. Second, academics use the cover of behavioral economics to write papers on all sorts of irrelevant apparent irrationalities. Third, the part of behavioral economics that did flourish enormously is the notion that people are probabilistically challenged, and that it requires governments and agencies, helped by academics, to nudge people into doing what is "good" for them. Let me illustrate.

Some strange interests of behavioral finance

Research in behavioral finance has taken a strange byway, devoted more to "psychology" rather than finance. Here are some titles and excerpts from abstracts of recent research papers from a newsletter I subscribe to. I've omitted author names but you can find the papers on ssrn.com:

The Financial Psychology of Worry and Women ("… the emerging hypothesis that researchers should explore is (that) women reveal greater degrees of worry than their male counterparts for … financial services and investment products.)

Sports Sentiment and Stock Returns ("We find a significant market decline after soccer losses.")

Who Cares About Stock Market Booms and Busts? Evidence from Data on Mental Health. ("We present evidence that the level, 6 month and yearly changes in the share price index are associated with better mental health …"

Would Women Leaders Have Prevented the Global Financial Crisis? Implications for Teaching about Gender, Behavior, and Economics.

Self-Esteem, Shame and Personal Motivation ("Overconfidence and high sensitivity to shame emerge as substitute mechanisms to induce efficient decisions.")

Willpower and the Optimal Control of Visceral Urges ("We investigate the behavior of an agent who optimally consumes a cake … over time and who recognizes that restraining his consumption too much would exhaust his willpower")

Grapes of Wrath: The Angry Effects of Self Control ("We find that exerting self control is associated with angry behavior more broadly.")

Is this stuff seriously related to business and finance, and is it useful, or is it just a self-indulgent form of grant and tenure getting?

Paternalistic Command and Control

And now for the worst part, which I illustrate using a 2011 column by an economics columnist in Australia I stumbled across. She interviewed Kahneman and then wrote:

"Kahneman says we can use this knowledge about our irrationality to influence public policy. We should make it so people have to opt out of things we find socially desirable and opt in to things we think undesirable. Innate inertia will do the rest."

Notice that there is a glib assumption in her use of "we" and "people." I emailed her: "Who is the 'we' that will determine what is socially desirable and who are the 'people' that will do the opting?"

To which she replied that "we" are the policy engineers, and then asked me (rhetorically?): "Isn't that the way democracy works?"

I don't think so. This reminds me more of the sleep-teaching of the Betas in Brave New World: "Alpha children wear grey. They work much harder than we do, because they're so frightfully clever. I'm awfully glad I'm a Beta, because I don't work so hard. And then we are much better than the Gammas and Deltas. Gammas are stupid. They all wear green, and Delta children wear khaki. Oh no, I don't want to play with Delta children. And Epsilons are still worse. They're too stupid to be able to read or write. Besides they wear black, which is such a beastly colour. I'm so glad I'm a Beta."

Along similar lines, consider Richard Thaler, a Chicago academic who has been an influential and early researcher in behavioral finance and is also the co-author of Nudge, a book he says is about "enlisting the science of choice to make life easier for people and by gentling nudging them in directions that will make their lives better."
Thaler is, according to a recent news article, part of a so-called Dream Team "consortium of behavioral scientists" working for Obama "to help their favored candidate in the 2012 presidential election." Among other activities, they "suggested how to characterize the Republican opponent, Mitt Romney, in advertisements."

It's remarkable that behavioral economics has evolved from a field of study into a tool for manipulating people, not only using the Big Data of Amazon and Google, but also in politics and government.

This is not government of the people by the people for the people. I think I'd rather be forced than nudged. At least then the battle lines are clearer.

Quelle: F.A.Z.

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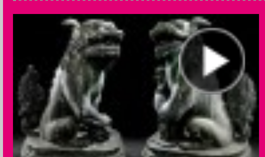

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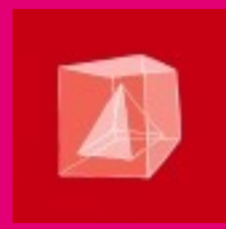

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