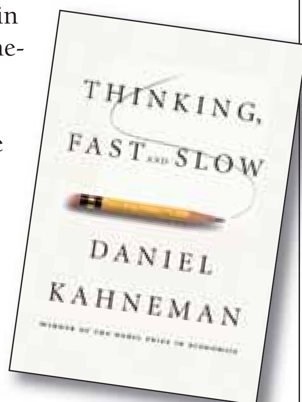
Paying Attention *Literally*

BY RHEA WESSEL

***Investors' failure to understand the two different types of thinking is costly,* says Nobel laureate Daniel Kahneman**

When separate lines of research in cognitive psychology, game theory, decision making, and economics converged several decades ago, the result was the hybrid field of behavioral economics. Among the pioneers were Amos Tversky and Daniel Kahneman, whose collaboration in the study of judgment and decision making led to Kahneman receiving a Nobel Prize for economics in 2002. (Tversky had died six years earlier, making him ineligible to receive the award.)

Now, Kahneman has written a book that attempts to synthesize the findings of the past four decades. *Thinking, Fast and Slow* is, as the author puts it, "a psychodrama with two characters"—System 1 and System 2. System 1 is fast, intuitive thinking, which occurs automatically and usually without our awareness that it is happening. System 2 is the slower, more deliberate, "more effortful" type of thinking or what is usually seen as rational thought. We like to believe we operate mostly in the domain of System 2, but Kahneman presents a case that System 1 is far more influential than our conscious experience tells us. The psychodrama is about the subtle and complex interplay between the two systems.



This is where cognitive errors, heuristic biases, and similar defects come in. In the area of investing, such problems have been widely popularized as "behavioral finance" and will be familiar to investment professionals. Many of these difficulties occur because decision makers tend to confuse the two systems. "This is the essence of intuitive heuristics," writes Kahneman. "When faced with a difficult question, we often answer an easier one instead, usually without noting the substitution." He cites the example of a chief investment officer who proudly believed he had made a well-informed decision to invest in a particular stock. But the case for the investment amounted to nothing more than enthusiasm for the company's products. Kahneman was surprised to learn that this accomplished professional investor never asked a fundamental economic question: Was the stock currently overpriced? "Unfortunately," the author observes, "professionals' intuitions do not all arise from true expertise."

In writing the book, Kahneman has set out to raise the level of discourse about decision making—by individuals, groups, firms, policymakers, and so forth. If we have a better understanding of how decisions are made under varying conditions and a richer vocabulary to describe the problems we face, we may learn to take a more productive (or less counterproductive) approach to problem solving. "In at least some cases," he concludes, "an accurate diagnosis may suggest an intervention to limit the damage that bad judgments and choices can cause."

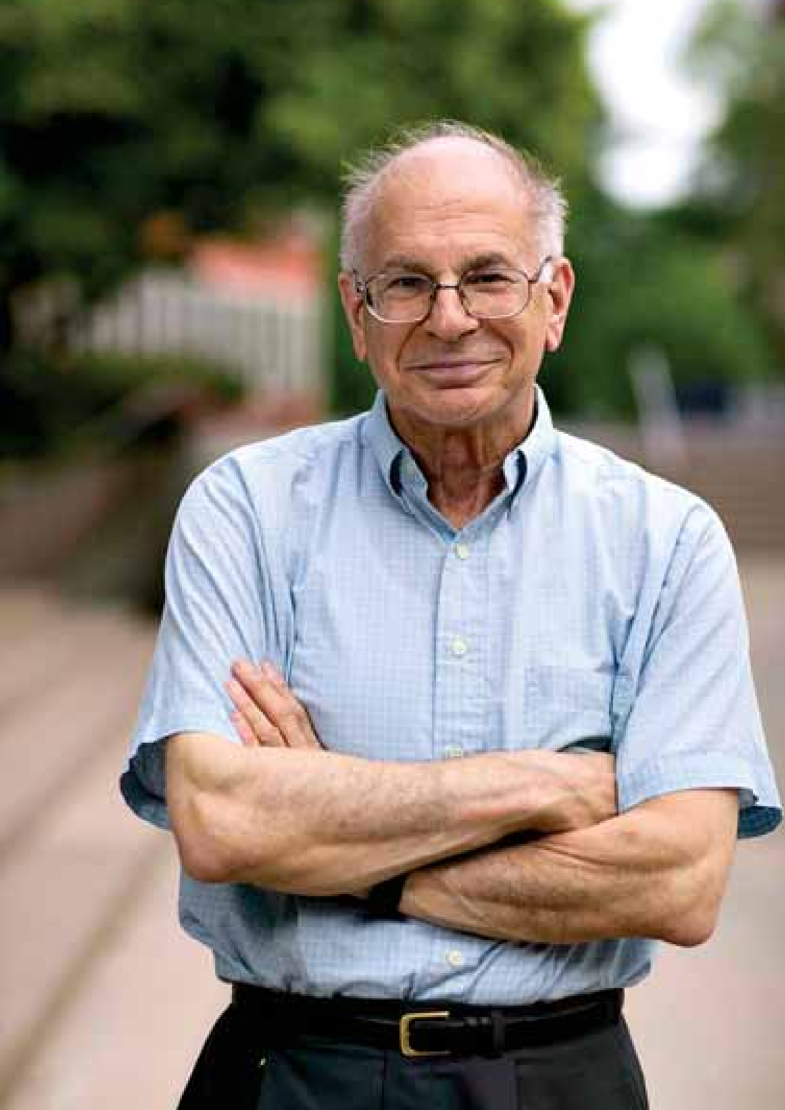
In a recent interview with *CFA Magazine*, Kahneman shared his views on these and other topics.

Given the susceptibility of human decision making to errors of judgment, what is the value of becoming an expert in matters of the financial system and asset analysis?

There isn't any really good news about the ability of people to pick stocks better than chance. So, here I don't have an encouraging message, and you have probably heard me say I'm a pessimist. That said, advisers can make a contribution by consulting with people on the risks they are taking. And it is clear that there are different asset classes with differing risks, so this is useful. Financial analysts may understand tax considerations better than others, and acting on this advice is extremely useful.

What about the value of financial education and financial literacy?

One aspect of financial education is learning what you can do and what you cannot do—what is feasible and what is not. I would hope that financially educated people are educated with proper modesty about their abilities. One other thing that is most troubling is that individual participants in the market seem to feel they know more than the market, which is extremely unlikely.



> "The often-used phrase 'pay attention' is apt: you dispose of a limited budget of attention that you can allocate to activities, and if you try to go beyond your budget, you will fail."
> —Daniel Kahneman, *Thinking, Fast and Slow*

You're talking about overconfidence.

I think overconfidence in offering advice is often sincere. People really believe in the advice they give. But, that doesn't make that advice worth following. And again, I don't see how a financial analyst would think that he has advantage over the market, over a hedge fund player, or over people with a lot of information about market conditions when it comes to advice about particular stocks and market bets. It's extraordinarily unlikely, and yet people seem to believe in it, which is odd.

What is your advice to someone who seeks to keep their judgments in check?

Whether people can develop what I call intuitive expertise depends on the circumstances. If we live in an environment that is essentially regular, people can learn the rules of the environment and develop expertise. This is true for chess players and firefighters and anesthesiologists. It cannot be true if an environment is largely random, and that is the case for financial markets.

How can we learn to think in more probabilistic ways?

People can learn to see small decisions as instances of categories of decisions that recur. If you think in terms of "you win a few and you lose a few," that is a way to expand your horizon. And it is very clear that thinking in terms of "you win a few and lose a few" reduces loss aversion and risk aversion and, by and large, improves the rationality of decisions. The same is also true when you're looking at problems. If you can see a problem as a member of a broader category of problems, then that will improve your ability to forecast with greater acumen.

But optimism can still slip in.

Optimism bias is not necessarily a bad thing. If a person is an optimist, it is certainly a good thing to know about that person. Optimists are happier than others and they may live longer. So, optimists are lucky to be optimists.

In addition, optimism helps people perform better. If a soccer team believes it has a chance to win, even if they are the underdog, the team is likely to play better. On the other hand, and the example I always give, I have absolutely no interest in having an optimist as my financial adviser.

Is your work being used right now for reforms in the financial or political system?

The only policy recommendation I gave was to point people to the book *Nudge*, by Richard H. Thaler and Cass R. Sunstein. *Nudge* incorporates most of my thoughts on policy.

What is it that you would like to see as the legacy of *Thinking, Fast and Slow*, and have you received any feedback about its impact?

Basically, I put together most of what I would like people to know about what I have done and how I think about a pretty large field.

It's too early to say whether the book will have any significant impact. Most of the time, the base theory is that books don't have much impact, but some books in recent years have changed the language. The word "nudge" has come into use; the word "black swan" has come into use. It's mildly possible that the ideas of System 1 thinking and System 2 thinking may come into wider use.

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