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Tricks and treats are not just limited to costume-wielding children at this spooky time of year. Richard Thaler, a professor at the University Of Chicago School Of Business has made his career studying the tricks psychology plays on us when we make decisions about our money. It seems that our efforts to reap the treats of our life's efforts can be undermined by our own human behavior.

On October 9th, it was announced that Prof. Thaler will receive the Nobel Memorial Prize in Economics for his work in establishing the field of behavioral economics. Thaler is noteworthy for a number of books, including "Nudge" (2009, with Cass Sunstein) and the most recent (2015) titled "Misbehaving: The Making Of Behavioral Economics". As a financial planner dealing with clients' naturally occurring instincts for being human when dealing with money issues, I think it is worthwhile to explore what Thaler's work means to us.

There are two different types of people, according to Thaler. The first type, which he refers to as Econs (homo economicus), are perfectly rational when it comes to decisions about money. An Econ can always be expected to choose the optimal approach, whether it comes to getting a mortgage or saving for retirement. The second type, which encompasses all of the rest of us are Humans (good old homo sapiens). Thaler's construction of the field of behavioral economics can be said to stem from his development of the idea of the Econ and the Human.

Economic theorists have long based their models on what a rational person would be expected to do in the situation being studied. Using rational modeling allowed most economists to miss the signs leading to the 2008 financial crisis, since what happened simply *could not* have happened. Just as bumblebees defy the laws of physics and fly at will, Humans usually don't even know what fundamental economic law they are ignoring when they choose to behave as Humans. Thaler introduces the concept of *supposedly irrelevant factors* (SIFs for short) as a means of illustrating the flaws of economic models based on the "imaginary Econ".

A key to Thaler's exploration of how people behave in economic decisions was to ask people two different questions about a particular hypothetical choice to be made. Even though the economic outcome from both questions would be the same, often people would respond with wildly different answers. A wine-collecting professor (of economics, no less!) with some bottles that had risen to $100 in value would not dream of paying $100 to buy the same bottles today. At the same time, a wine merchant offered to buy his wine at these prices, an offer that the professor turned down. An Econ who would choose to drink a $100 bottle of wine would be equally willing to buy it or sell it for the same price.

How money comes to you affects your thinking about spending that money. A refund can look like a windfall – free money – even though it is simply a return of hard-earned money you paid out in the past. Workers often have too much money withheld from their paychecks each week so they can receive a refund from the IRS, even though the excess withholding is an interest-free loan to the government and the money could be better used during the year.

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One of the most important contributions of Thaler's work lies in value theory. We begin by looking at the impact of the same increase in wealth as experienced by a rich person and a poor person. The poor person places a high value on a sudden increase, while the same increase matters little to the rich man.

Value theory can be used to compare the impact of a hypothetical gain with an identical loss and the different responses people have to them. An Econ would no doubt rationally view these as the same, but through his research, Thaler established that Humans are more averse to losses than they are to identical gains. If the wine-loving professor dropped a bottle of $100 wine, he feels twice as hurt as the pleasure he might gain if someone gave him a similarly valued bottle. The implications of this loss aversion are particularly noteworthy for investors.

Misbehaving contains the results of Thaler's extensive work in behavioral finance. One fascinating conclusion we can all appreciate gauges the risk tolerance of an investor by how frequently the investor checks his portfolio results. Those who checked 8 times per year chose to put 41% of their money into stocks; for those who checked only once a year, the allocation was 70%. The frequent checking – and observing of the ups and downs – is a reason why investors demand a higher return from stocks than they do for safer investments. Thaler, when asked for investment advice tells friends to invest heavily in stocks and then read only the sports section of the newspaper. Crossword puzzles are acceptable, but watching CNBC or similar networks is strictly forbidden.

Logical investors often react to news about companies by trading – either buying or selling based on their thinking about whether the news changes the value of the company. Yale's Robert Shiller, a fellow Nobel winner (2012, Economics) and colleague of Thaler's posited that stock prices move far too much to reflect true changes in value. Despite many critics of Shiller's thesis, the debate may have been settled by the stock market crash of October, 1987 – with *no news triggering the selloff.* Note that stocks quickly recovered their value and the market ended up a bit for all of 1987. Shiller was proven right, as only in an irrational world could such a crash occur.

Thaler is perhaps best known for innovations that help retirement savers save more money. His work, first written in *Nudge,* shows that participants are more likely to enroll and defer salary if the enrollment process is automatic. Knowing that Humans don't always do what is in their best interest, automatic enrollment gets employees saving right away unless they opt out. New employees who have to make an active choice enroll at much lower rates than those who are automatically enrolled, despite tax and employer matching incentives that Econs would always respond to. A further enhancement, Save More Tomorrow gets participants to put future raises into their retirement plan by making the decision before getting a raise. Human behavior shows that once a raise hits your checking account, you are reluctant to give it up.

Thaler's nudging – he calls it "libertarian paternalism" – is meant to help you help yourself without giving up your right to behave as you wish. We all have our moments when we act Human about money – even those of us who advise others. The highly readable *Misbehaving* as well as the earlier *Nudge* are worth reading, even if for no other reason than for us to see how Human we are.

Thomas E. Dexter, CFP®

Resources

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https://en.wikipedia.org/wiki/List_of_Nobel_Memorial_Prize_laureates_in_Economics

https://en.wikipedia.org/wiki/Richard_Thaler