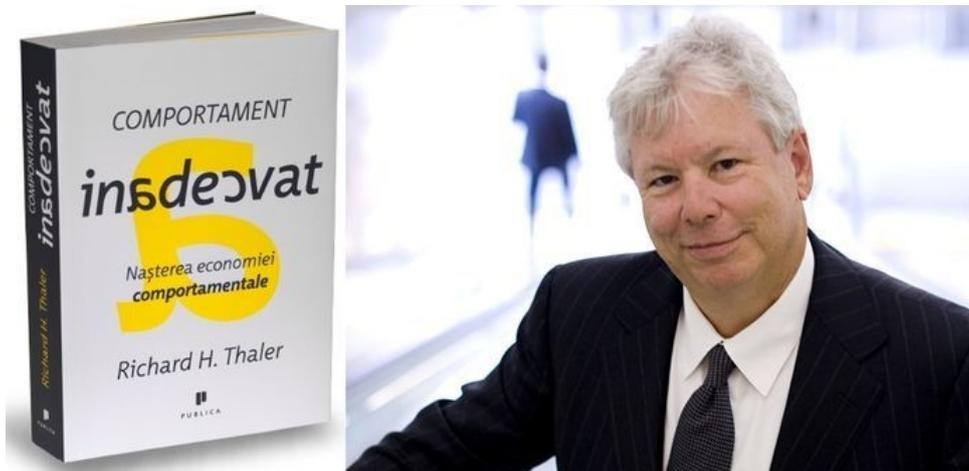


Book review**Misbehaving:
The Making of Behavioral Economics, by Richard H. Thaler****Richard H. THALER**

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Richard Thaler, Nobel Prize laureate in Economics in 2017, has a compliment from Daniel Kahneman "... what really makes him special is that he is lazy," respectively the virtue that Thaler does not work "except for things that are sufficient interesting to defeat this innate tendency to get away from work." The interesting idea that dominates this book is that people are divided into two main categories: Econs (homo economicus) and the Ordinary people (homo sapiens).

The first category is rational people who make choices (make decisions) by optimizing wealth with a budget restricted to the balance between supply and demand. These optimization models have given econs a great influence on public policy advice. In fact, optimization is a difficult, too hard of a problem to solve for ordinary people. In addition, they are animated by prejudice (over self-confidence, mental representativeness, availability of information, anchoring and mental adaptation, etc.). For them, there is no idea of gift because only cash allows them the best.

In the second category are common people with inadequate behaviors. They yield to temptations (as mental anchoring, self-attribution, disposition effect, greed, endowment effect, etc.) and emotions (fear). As a result of these biases, forecasts in economic models may be wrong and with serious consequences on the results of optimization decisions. "Basically, no economist (rational, with the exception of R. Shiller) anticipated the economic crisis of 2007-2008 and, worse, many believed that both the crash and its consequences were simply impossible."

However, there is no need to eliminate models of optimization of econs agents. These can provide a good approximation of real-world phenomena. But Thaler's book makes us aware that these models do not properly prescribe the behavior of ordinary people, and we remain cautious about substantiating economic decisions on analyzes that are vitiated by the hypothesis of an exclusively rational world. The birth and foundation of the behavioral economy, wisely explained in the book, leads us to another discipline that is "a whole economy but an economy with strong doses of psychology and other social sciences." Nobel Prizes for Beginners and Founders of Behavioral Economics (Simon, Kahneman, Shiller, Thaler, and Akerlof, Spence, Stiglitz) equate those of the traditional (classic) authors.

In fact, the behavioral economy is in opposition to the theory of efficient markets that starts from the basic hypothesis that people are rational and have homogeneous expectations and that, through their decisions, determine the formation of prices at the intersection of supply and demand. Behavioral finance easily explains why people make certain decisions. Unfortunately, they cannot make predictions as to how their future decisions will look. On the contrary, the traditional finance models anticipate the future evolutions.

Models of Merton Miller and Franco Modigliani's Arbitration Principle, of Harry Markowitz Portfolio Optimization Principles, John Lintner's on CAPM Model, and William Sharpe's on Financial Assets Valuation Model, Fischer Black Modeling, Myron Scholes and Robert Merton all have achieved good results in describing the market equilibrium, a balance that results from investor interaction on the market. Given the recent, complex economic phenomena, the authors of the behavioral economy have shown that these models are not entirely satisfactory explanatory as they do not describe or consider the behaviors of investors.

Bernoulli demonstrated in the St. Petersburg Paradox (1738) that the utility of welfare is a downward function to the point where the marginal utility of the last unit of wealth growth is equal to zero (the law of decreasing yields). Give a hungry person a piece of bread and his joy will be very great. Give a piece of bread similar to a full and his joy will be near zero).

Prospect theory (Kahneman and Tversky, 1979) moves the emphasis on wealth levels on changes in wealth: People's upset about loss is on average about 2.25 times the joy of winning the same level of wealth. Losses are therefore perceived more heavily than winnings as losses matter psychologically much more. Behaviorally, people fit differently the loss in relation to the gain, respectively, mentally fit differently an identical situation.

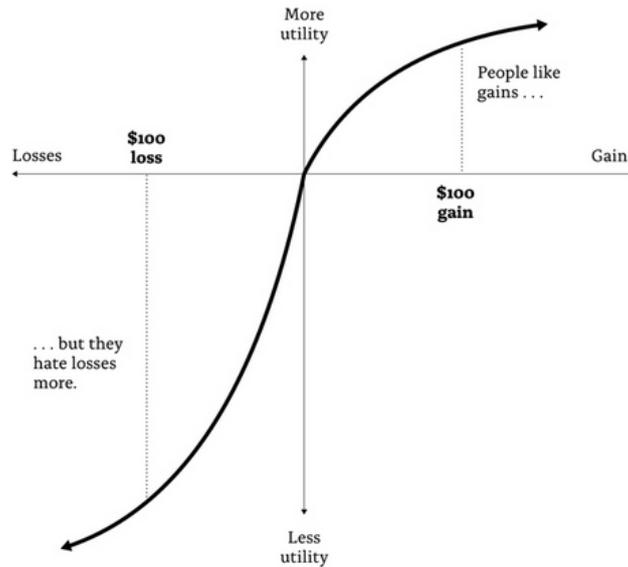


Figure 1: Thaler's (2015, fig.3) Version of KT's 1979 Value Function

The marginal utility curve of (up) and loss (bottom).

The slope is steeper for losses than for gains

Thaler's book aims to identify seemingly irrelevant factors (FAIs) to describe and predict the behavior of investors that is inevitably animated by their systematic biases. People, investors, even if they are not able to solve complex optimization problems, behave "as if" they are capable. So, company managers will not even solve cost problems or staff hiring, but they will ultimately make decisions to increase sales and hiring / disengaging staff in line with observed sales growth. The results of these decisions are, surprisingly, close to what would result from a marginal calculation.

Econs agents are inspired by optimization, but if they are asked what investment decisions their wives, relatives, students, people in general are making, they will end up saying that their decisions are basically irrational (e.g. they tend to buy expensive things they do not use, often making ridiculous economic errors and mistakes) because they do not understand "simple economic concepts". The same rational *econs agents* then claim that all economic agents act rationally, have homogeneous expectations, and act in the direction of the optimal money allocation decision. "How that?" The argument of *econs agents* about the strength of the competition law, although largely fair, is overvalued.

Mental accounting motivates Swiss-earners to go shopping beyond the border with France to take advantage of lower prices. In car parks in the malls near the Swiss border "there are always luxury cars." The same Swiss buyers find a utility of the transaction if they spend enormously on the maintenance of a horse farm for horse-riding, where they rarely take advantage of the sessions of equitation.

Thaler allocates part 6 of the book exclusively to comparison of behavioral finance versus traditional finances. Fundamental to the functioning of the financial markets was and is the Efficient Market Hypothesis (EMH), which states that asset price formation takes place solely on the basis of past, present and even future information. As a result, no investor has the possibility to predict future price developments and to take advantage of this provision.

Yet, long before the EMH's scientific elegant explanation, investment behaviors of individuals have been highlighted when prices are also appreciated by investors 'anticipation of other market operators' behavior and economic determinants (profitability and risk). This behavior was greatly explained in 1930 by J.M. Keynes, that was assimilating it as "in the beauty pageant competitions, where competitors had to choose from several pictures six of the most beautiful girls. The prize was to be attributed to the one whose choice was closest to the choice of the other competitors, not just their own preferences. Everyone is animated to try to guess the tastes of the other players and each other ... So, we expect a third degree of logic in which we devote our intelligence to predicting what the average opinion thinks it will be the average of opinions of other judges. And some players will probably practice fourth, fifth and sixth (anticipation). "

All these group behaviors (gregarious), enthusiastic or fashionable effects give a certain heterogeneity to price predictions, respectively, give an interpretation of the market reaction through speculative bubbles. This speculation on the speculators of other speculators adds to the dispersal (scattering) of courses an "over-dispersion" (a "bubble"), beyond what could be expected from a rational future earnings expectations discounting.

As revealed in Thaler's book, this ingenious intuition was also confirmed by the 1981 study by R. Shiller, which concludes that stock prices are too volatile in relation to rational expectations based on updating the dividends expected to be obtained future. "Shiller's results boomed the financial world," but the recent financial crises in 1987 and 2007, but with dramatic price cuts around the world, confirmed Shiller's conclusion. "Over a number of years, in a book written with George Akerlof, Shiller would have used Keynes's term" animal spirits "to describe the idea of capricious changes in consumer and investor attitudes."

In relation to closed-end investment funds (which reports the prices of the fund units as the ratio of the net asset value as the net assets to the total number of fund units = unit value of the net asset, VUAN), Thaler and collaborators identified four irrational puzzles; (1) why an investor buys a fund for which he pays an initial commission (about 7%) so that the fund can then trades with a discount of more than 10%?; (2) through their policy of discounts or premiums, why does a fund trade at a price different from the value of its underlying assets ?; (3) why discounts / premiums vary significantly from one fund to another and also over time and (4) why fund units converge to VUAN then the fund decides to become an open fund and sells its units with big discounts. All of these are obvious violations of the single price law on EMH is fundamentally built (i.e., in an efficient market, an asset cannot be sold at two different prices simultaneously, otherwise an arbitrage opportunity and speculation processes would arise).

Thaler's book describes a great deal of other investor behavior biases manifested in the real world:

- Exaggerated confidence on risk of a share expressed with beta coefficient (investing in small beta shares proved to be more rewarding than in high beta stocks);

- EMH prices are not necessarily the most accurate indicators (because they have often proved volatile - see price developments during the financial crisis);
- More and more behavioral economic analysis has been introduced in common law; for example, an architect must take into account the choices made by the beneficiaries in designing a building;
- For managers, the more important a decision is, the more they tend to rely on the quantitative analysis done by others;
- The "Save more tomorrow" voluntary pension plan schemes gives taxpayers the opportunity to choose a higher contribution rate today than one that will be implemented later when they receive a salary increase;
- Nudging taxpayers to do their taxes by sending one or two message notifications: "Most people pay, and you are one of the few who did not."

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Original title: *Misbehaving: The Making of Behavioral Economics*, by Richard H. Thaler

563 pp

ISBN: 978-606-722-158-9