‘Misbehaving’: A Master Class in Behavioral Economics

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Richard Thaler’s book Misbehaving tells the story of the emergence and growth of the field of behavioral economics in a clever, highly relatable manner. Thaler provides his reader with a full history and background on a field that he has been instrumental in defining and developing. He is certainly qualified to opine on this subject as he is an accomplished economist and professor at the University of Chicago’s Booth School of Business, and not to mention, winner of a Nobel Prize for his work on the very subject of behavioral economics. Throughout the book he repeatedly supplies his reader with understandable, relevant, real-world examples, pushing them to understand how and why what we call “economic theory” isn’t really working to the benefit of those who it’s in place to support: humans.

At its core, behavioral economics is focused on building economic theory upon real human behavior, as opposed to theoretical models based on rational expectations. It’s about taking a new approach to thinking about economics by simply acknowledging the existence and relevance of human nature, with all of its failings and contradictions. Too often the economic models that govern academic thought, public policy, investing, and ultimately, the way our society functions, are built upon unrealistic expectations. Thaler uses the term “misbehaving” to explain individual decision-making that is inconsistent with the idealized model of behavior that lies at the heart of economic theory. As humans we do a lot of misbehaving. Economic models suggest investors, among others, are rational, selfish, optimizing, unbiased, and un-overconfident creatures. But this is not always how it works in the real world, and proving this is Thaler’s primary contribution to this burgeoning body of work.

Before going too much further, we feel it is important to note that Thaler does not entirely denounce the use of economic models. Similar to the belief that we hold at Crawford, Thaler feels that economic models serve as extremely useful starting points. He goes on to explain that only when they are assumed to be accurate descriptions of human behavior do they become problematic. In other words, economists and investment analysts can get in trouble when they begin to make highly specific predictions that depend explicitly on the fact that everybody is economically sophisticated. After only reading a few pages of his book, it becomes clear that Thaler is fascinated by the stories and the myriad of ways in which people depart from the fictional creatures that populate current economic models. We find this book to be helpful in understanding real-world economics, and we recommend it to those interested in a deeper dive into behavioral economics. Thaler presents a compelling argument that economic models have a tendency to make a lot of bad predictions, and these predictions can have serious financial consequences.

A few of the numerous examples Thaler uses to explain the human tendency to misbehave are related to spending, saving, and other every-day, “household” financial behavior. For instance, he suggests that the very existence of budgets violates one of the first principles of economics: that money is fungible with no restrictions on what it can be spent on. He also notes the irrationality that’s inherent in the ways that we process sunk costs. We don’t ignore them like we should, and we try so hard to get our money’s worth out of the things we’ve already paid for. And why, in a game of poker do we have a tendency to gamble with the house’s money, not treating our winnings as real money? Our perceptions of fairness when it comes to pricing are also seriously thwarted. Think about all of the times you’ve bought something because the deal was too good to pass up. Self-control and choosing between now and later can be increasingly difficult, and we have a diminishing sensitivity to gains and losses as well. Losses sting more than equivalently sized gains feel good. All of these human tendencies are in direct conflict with economic theory, and it doesn’t stop here.

Thaler goes on to explain that he eventually discovered that nothing would help the case of behavioral economics more than to prove its relevance to financial markets. In validating its relevance in a field where the stakes are high, Thaler could highlight that there are ample opportunities for professional investors and traders to exploit the mistakes often made by other analysts and novice investors. This is where some of Thaler’s message ties directly back to what we do at Crawford.

The truth of the matter is, like the examples listed above clearly demonstrate, humans aren’t always rational, which ultimately gets reflected in the financial markets’ behavior. With all of this being said, Thaler was presented with a serious roadblock to his endeavor. Financial markets have long been thought to be perfectly rational and efficient in their movements, popularly exemplified in Eugene Fama’s Efficient Market Hypothesis (“EMH”). With this in mind, it is fair to say that Thaler’s declaration of mean reversion in the stock market would prove to be a particularly radical act, primarily because the widely understood EMH says otherwise.

The EMH has two primary components which are somewhat related but conceptually distinct. The first of these components is rooted in the concept of the rationality of security prices. This is the idea that even if some people do make mistakes, a few smart people will always trade against them and “correct” prices, thereby reducing the effect on market prices. The other component of the EMH revolves around whether it is possible to beat the market, pronouncing that it is impossible. Thaler refers to this as the “no free lunch principle.” The EMH states that assets will always sell at their true, intrinsic values, and because all publicly available information is reflected in current stock prices, it is impossible to reliably predict future prices and make a profit.

Thaler begins his counter argument by pointing out that, if prices are always right, there can never be bubbles. And it is certainly impossible to dismiss the series of booms, bubbles, and crashes that humans have witnessed throughout the course of modern history. Thaler points to many different examples of these extreme events and the corrections that followed. He also points out that if prices are always right, there would be no basis on which value investing could exist. For years, Benjamin Graham has been highly revered in professional and academic circles (See our review on The Intelligent Investor), and he is considered to be the father of value investing. Throughout his life, Graham urged his followers to buy stocks when they're cheap, or in other words, when temporary moments of mispricing emerge. To put it bluntly, this praised and widely adopted style of investing is not possible alongside the EMH. In short, if you argue that stock prices will not diverge from their intrinsic values, then by definition, they cannot be cheap, and value investing cannot exist. How can this be if securities always trade at their intrinsic price?

To make his case, Thaler conducted a number of experiments and exercises using psychology to prove that investors do, in fact, overreact. In essence, he looked at groups of stocks that had historically outperformed and underperformed to prove that reversion to the mean is largely present in financial markets. He also proved that reversion to the mean is not necessarily related to the required rates of return that investors demand for taking on varying degrees of risk. He has spent a large part of his career finding and documenting anomalies in individual and firm behavior and market prices while also developing improved theory.

At Crawford, we believe that understanding some of the shortcomings of human nature are essential to protecting against sub-optimal decision making. Avoiding inherent biases and other aversions can improve investment results while exploiting the mistakes of others. Crawford has several conventions built into its investment process to protect against overconfidence and behavioral biases, including structuring investment team compensation in such a way to ensure strategy objectives are honored and risk controls are maintained. The quality bias we seek to continually reinforce is a big part of this. In fact, our ability to capitalize on the low beta anomaly, one of the biggest quandaries of investing, is indication of our appreciation for the wisdom of this body of work.

The EMH is a great normative benchmark of how the world should be. Thaler even admits it's actually nearly impossible to do research in behavioral finance without a rational model as a starting point. But the fact of the matter is that prices are often wrong, and sometimes, very wrong. At Crawford, we seek to capitalize on these moments, providing our investors with value-tilted approaches to long-term, risk-adjusted investing.

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