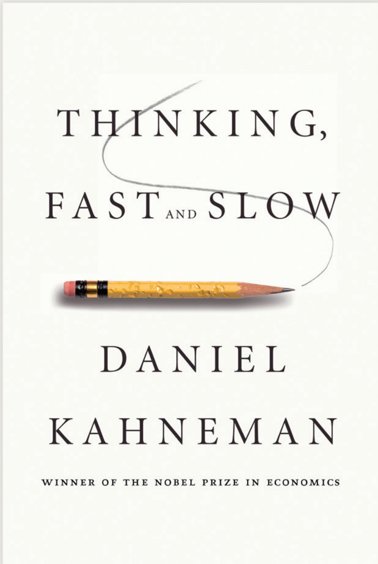
BOOK REVIEW

THINKING FAST AND SLOW
BY DANIEL KAHNEMAN



Over the last decade the popularity of the 'discipline' of behavioural economics (like all economics, I hesitate to call it a science), has steadily increased. One reason for this is the readability of its literature, based as it is on interesting behavioural experiments, all of which are like short stories - good at entertaining readers and conference audiences alike. The fact that the *'experiments'* are often conducted with students (very convenient for academics) seems to be widely ignored, although in most disciplines, including customer insight, convenience samples are rightly castigated.

Be that as it may, behavioural economics is highly topical and widely discussed. As a brief re-cap, humans have two fundamentally different ways of perceiving the world and making decisions. The left cerebral hemisphere is supposed to be the coldly logical, verbal and dominant half of the brain, while the right was seen as the imaginative side, emotional, spatially aware but suppressed. Slow and fast personalities in one head.

Behavioural economists claim that the right hand, emotional side of the brain drives most behaviour even though people may be unaware of it. In 2002, Daniel Kahneman won the Nobel Prize for Economics for his work (much of it with Amos Tversky who died in 1996) challenging the assumptions of traditional economic theory that people make rational choices based on their self-interest. Kahneman claims that people often make decisions using rules of thumb rather than rational analysis, and factors economists traditionally don't consider, such as fairness and desired rather than probable outcomes.

There are strong grounds for supporting right brain predominance. Humans' successful evolution was based on thousands of years of right brain instinctive judgements and it has some great strengths. It's highly sensitive to environmental cues, signs of danger etc but due to its fast thinking, it also has severe weaknesses for today's more complex decisions. It simplifies, it jumps to conclusions and it's subject to irrational biases. Kahneman calls this *"System 1"*. The rational left-brain thought processes are *"System 2"* and in the book they are portrayed as the leading characters in a story but Kahneman is very clear who's pulling the strings. *"Although System 2 believes itself to be where the action is, the automatic System 1 is the hero of the book".*

In recent years, work by behavioural scientists, plus the recent failure of financial markets, has led many people to question traditional economics. One field of economics where it had always been assumed that the irrational biases of System 1 should matter least was the stock market. Here decisions should be rational and knowledgeable, based on huge amounts of accessible information. Economists coined a phrase, 'efficient markets', stating that prices in stock markets are 'correct', reflecting the true value of a share over a period of time. If investors believe the price of a security to be under- or over-valued, they will buy or sell it until the price returns to equilibrium. But even before the failure of the markets in 2008, many, including Kahneman, were doubting the efficient markets theory.

Kahneman stated that people often overestimate their abilities, making them over-confident. For investment this can cause serious problems. In the book Kahneman explains that while investors tell themselves that they are making educated decisions, these are often no better than blind guesses. He cites research that examined 10,000 individual private investors over seven years. The research tracked every time the traders bought or sold stock. If the 'efficient markets' theory is correct, stock that they bought should have done better than stock they sold. But on average shares they sold did better than those they bought, by a very substantial margin: 3.2% per annum! "It is clear," concludes Kahneman, *"that for the large majority of individual investors, taking a shower and doing nothing would have been a better policy than implementing the ideas that came to them".*

Having sold over a million copies, the book has been described as a "masterpiece" and a "landmark book in social thought", while Kahneman himself has been called the *"most important psychologist alive"*. It's over 400 pages long but very readable. CI

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