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CFA SINGAPORE INSIGHTS

By Paul McCaffrey

Daniel Kahneman on better decision-making

He proposed four strategies that can be applied to both finance and life

NOBEL laureate Daniel Kahneman, who died in March at the age of 90, transformed the fields of economics and investing. At their most basic, his revelations demonstrate that human beings and the decisions they make are much more complicated – and much more fascinating – than previously thought.

He delivered a captivating mini seminar on some of the key ideas that have driven his scholarship, exploring intuition, expertise, bias, noise, how optimism and overconfidence influence the capitalist system, and how we can improve our decision-making, at the 71st CFA Institute annual conference in Hong Kong in 2018.

“Optimism is the engine of capitalism,” Kahneman said. “Overconfidence is a curse. It’s a curse and a blessing. The people who make great things, if you look back, they were overconfident and optimistic – overconfident optimists. They take big risks because they underestimate how big the risks are.”

But by studying only the success stories, people are learning the wrong lesson. “If you look at everyone,” he said, “there are lots of failure.”

The perils of intuition

Intuition is a form of what Kahneman calls fast, or System 1, thinking and we often base our decisions on what it tells us. “We trust our intuitions even when they’re wrong,” he said. But we can trust our intuitions – provided they’re based on real expertise. And while we develop expertise through experience, experience alone isn’t enough.

In fact, research demonstrates that experience increases the confidence with which people hold their ideas, but not necessarily the accuracy of those ideas. Expertise requires a particular kind of experience, one that exists in a context that gives regular feedback, that is effectively testable.

“Is the world in which the intuition comes up regular enough so that we have an opportunity to learn its rules?” Kahneman asked. When it comes to the finance sector, the answer is probably no. “It’s very difficult to imagine from the psychological analysis of what expertise is that you can develop true expertise in, say, predicting the stock market,” he said.

“You cannot because the world isn’t sufficiently regular for people to learn rules.” That doesn’t stop people from confidently predicting financial outcomes based on their experience. “This is psychologically a puzzle,” Kahneman said. “How could one learn when there’s nothing to learn?”



Whenever there is judgment there is noise and probably a lot more than one thinks, said Daniel Kahneman, Nobel Prize winner and doyen of behavioural economics. PHOTO: BT FILE

That sort of intuition is really superstition. Which means we shouldn’t assume we have expertise in all the domains where we have intuitions. And we shouldn’t assume others do either. “When somebody tells you that they have a strong hunch about a financial event,” he said, “the safe thing to do is not to believe them”.

Noise alert

Even in testable domains where causal relationships are readily discernible, noise can distort the results. Kahneman described a study of underwriters at a well-run insurance company. While not an exact science, underwriting is a domain with learnable rules where expertise can be developed. The underwriters all read the same file and determined a premium. That there would be divergence in the premium set by each was understood. The question was how large a divergence.

“What percentage would you expect?” Kahneman asked. “The number that comes to mind most often is 10 per cent. It’s fairly high and a conservative judgment.” Yet when the average was computed, there was 56 per cent divergence. “Which really means that those underwriters are wasting their time,” he said. “How can it be that people have that amount of noise in judgment and not be aware of it?”

Unfortunately, the noise problem isn’t limited

to underwriting. And it doesn’t require multiple people. One is often enough. Indeed, even in more binary disciplines, using the same data and the same analyst, results can differ. “Whenever there is judgment there is noise and probably a lot more than you think,” Kahneman said.

For example, radiologists were given a series of X-rays and asked to diagnose them. Sometimes they were shown the same X-ray. “In a shockingly high number of cases, the diagnosis is different,” he said. The same held true for DNA and fingerprint analysts. So even in cases where there should be one foolproof answer, noise can render certainty impossible.

“We use the word ‘bias’ too often,” said Kahneman. While he had spent much of his career studying bias, he was now focused on noise. Bias, he believes, may be over diagnosed, and he recommends assuming noise is the culprit in most decision-making errors. “We should think about noise as a possible explanation because noise and bias lead you to different remedies,” he said.

Hindsight, optimism, and loss aversion

Of course, when we make mistakes, they tend to skew in two opposing directions. “People are very loss averse and very optimistic. They work

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