

News You can Use: A look at the most recent Nobel Prize Winners in Economics

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This year's shared Nobel prize in Economics went to 2 economists whose work has a lot of practical application for ordinary traders and investors. Their work on the empirical and theoretical basis of actual market operations and the impact of psychology on human judgment and decision making in the economic realm strongly supports Dr. Van Tharp's training methods for traders and investors. This article summarizes a few of their major findings and shows how it relates to IITM training in the Infinite Wealth Workshop.

Much of traditional economic theory relies on assumptions that permit extensive theoretical modeling and mathematical manipulation. However, many of the derived conclusions and models are not consistent with the perceptions of practical traders and investors, which in turn have been dismissed by academia as anecdotal. The life work of Drs. Daniel Kahneman and Vernon Smith, co-winners of this year's Nobel prize in economics, have built a bridge between the disciplines of traditional economic theory and the psychology of human decision making. They strengthened the theoretical and empirical basis of the effect of human psychology on market behavior, and developed frameworks for the design of experiments that would shed light on both theory and practice.

Here are 3 of the most troublesome assumptions of traditional economic theory that practical traders have difficulty accepting::

(1) Unbounded rationality: the concept that people make perfectly rational economic calculations prior to decision making, that they apply logic, statistics and probability correctly, that they have the time and resources to make these calculations, and that they apply the results accordingly.

(2) Pure self interest: the concept that people are motivated exclusively by their own self interest and that the values and weights they place on outcomes are predictable, uniform, logical and consistent.

(3) Complete self control: the concept that people are disciplined, thorough, systematic and complete, and that they efficiently and effectively implement the analytical decisions they arrive at, and that they treat individual situations independently from previous experience.

These assumptions are attractive to traditional economic theory because they permit decision making to be reduced to mathematical formulas which can be analyzed and manipulated with precision and depth. However, Kahneman and Smith discovered that there was considerable deviation in outcomes when they compared the predictions of economic theory with actual human action. It seems that people are not classically trained rational economists after all (and thank goodness for that!). Using the principles of psychology and the empirical evidence of their experiments, they developed models which reconciled the premises of both domains.

Here are some of their most applicable findings:

(1) As complexity and uncertainty increase, people are less likely to be rational and analytical, and are more likely to use short cuts and heuristics. Historically this has been a successful survival mechanism, but it may not have desirable outcomes in a trading system.

(2) Short cuts and heuristics are often systemically biased in ways that undermine a rational approach to decision making. For example, people consistently treat the variation in small sample sizes the same as the variation in large sample sizes, misunderstanding the volatility implied in small data sets. Stated another way, the human brain is wired to see patterns, even where they don't exist, and a few timely events can create a belief that's hard to shake.

(3) They will frequently fall prey to the gambler's fallacy, which assumes statistical dependence between independent events.

(4) They will frequently misapply the laws of probability and statistics, usually not to their advantage..

(5) Kahneman found a distinction between objective probabilities and the way people perceive those probabilities. Believing is seeing, and wishing may make it so, but those can be dangerous beliefs for a trader to have.

(6) People overweight information that is easily accessible, or in other words, repetition can quickly become the truth.

(7) They found that people weight losses twice as much as gains of equal measure. In fact, people are frequently unwilling to take a bet that offers an equal chance of losing 10 and gaining 15.

(8) People are more likely to detect the changes in the status quo than they are to detect absolute changes. This is like the frog that doesn't realize it is slowly being cooked, but will jump out of warm water. Likewise, traders can overlook substandard performance if happens a little at a time.

(9) People favored the most recent events to set the mood for their beliefs. A trader might believe his system is no longer working after a recent run of losing positions, when in fact it may still be operating within the expected range of wins and losses. Kahneman found people would stay with a bad system if they experienced a short term run of wins. That's like buying dips in a bear market.

(10) Rather than treating decisions as independent events to be decided by rational calculation, people will first frame the situation (considering context and both internal and external factors), and then evaluate using decision rules that are often, but not always and not always completely, analytical.

This process of framing ties directly into the Infinite Wealth Workshop where Van explores the nature of belief systems, and particularly those about money. By looking at where they come from and how they affect the psychology of traders and investors we learn about the powerful effect of psychology on the rational pursuit of trading success. The seminar is filled with a great deal of practical, hands on learning techniques that can improve your bottom line in the external domains of real estate, taxes, business structure, and equity investing and your peace of mind in the internal domain of personal psychology. You don't have to be a trader or investor to benefit from the workshop, because money beliefs permeate much of our external life.

My discussion of equity investing in the workshop traces the development of a simple, robust trading system that derives from beliefs about money, mutual funds, the markets and investing in general.

We examine a trading system and discuss risk management and the importance of benchmarking to understand if the system is still with design tolerance.

In short, the Infinite Wealth Workshop is loaded with practical tips, techniques and training that can make a dramatic impact on your personal bottom line.