FINANCIAL MARKETS

RICHARD THALER: NOBEL PRIZE FOR ECONOMICS

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We believe that sound investment and trading decisions begin with a strong grounding in financial education. Our goal is to make this available to everyone - and this free eBook is part of that commitment.

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THE 2017 WINNER

FOREWORD

On the 9th October 2017, Richard Thaler was named as the Nobel Prize winner for economics.

Thaler is a 72-year-old American economist and a professor of sciences and economics at the University of Chicago. He received the Nobel Prize for his impressive and extensive contributions to behavioural economics. As a leader in his field, Thaler also served as the President of the American Economic association back in 2015.

The purpose of this eBook is to explore Thaler's renowned 'nudge theory' in relation to economics. We hope you find the insights useful.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

NUDGE THEORY EXPLAINED

WHAT IS NUDGE THEORY?

Richard Thaler is widely known for something called ‘nudge theory’.

In simple terms, nudge theory is a tool that can be used to encourage people to make decisions that are in their best interest. It’s a popular concept in behavioural science - and has been used in the fields of politics and economics as a means of persuasion.

Thaler details the principles of nudge theory in his 2008 book called ‘Nudge: Improving Decisions About Health, Wealth and Happiness’, which he co-authored with Cass Sunstein.

In this book, they explain that ‘by knowing how people think, we can make it easier for them to choose what is best for them, their families and society’. Practically, implementing nudge theory can be as simple as a subtle change in the use of language.

Thaler’s book was a global success, with many in the political classes taking note.

In fact, then British Prime Minister David Cameron established a ‘nudge unit’ in 2010, in which Thaler was appointed as an advisor.

To begin with, the unit was set up to improve several public health issues. These included obesity, alcohol intake and organ donation - but it eventually went on to influence a whole range of matters.

For example, the nudge unit played a pivotal role in increasing the number of organ donations in Britain and helped encourage more people to switch their energy providers to get better value for money.

‘Nudging’ has also been used by HMRC (the UK’s tax authority) to increase tax takings. Specific nudging tactics include adjusting the language used on tax reminders. The current British Prime Minister, Theresa May, has also sanctioned the use of nudging to get the British public to switch from cigarettes to e-cigarettes.

EXPLORING THALER’S THINKING

Thaler is known for more than just his work on nudge theory.

Within economics, Thaler’s extensive work examines the consequences that occur from our decision making. He does this through the following principles: limited rationality, social preferences and lack of self-control (concepts which we will explore below).

LIMITED RATIONALITY

Also referred to as 'mental accounting', limited rationality is the act of simplifying decision making in financial areas.

We do this by subconsciously creating separate accounts within our mind. When doing this, people tend to focus on the exiguous impact of personal decisions. In other words, when it comes to finance, we tend to think about ourselves rather than other people.

During his career, Thaler has taken part in studies to explore the link between cognitive restrictions and the financial markets.

SOCIAL PREFERENCES

Thaler has also conducted theoretical and experimental research on the impact of 'fairness' in economics.

For instance, he has analysed how people's concerns about fairness can stop businesses from raising prices at less than optimum times. To address these, Thaler and some of his colleagues created something called the 'dictator game'. This tool is now used in studies all over the world to measure attitudes towards fairness.

LACK OF SELF-CONTROL

Using the 'planner-doer model' (a model used by psychologists and neuroscientists), Thaler has shown that it can be difficult for individuals to stick to their long-term plans when presented with short-term temptations.

This phenomenon is particularly true in the financial markets - and it's the reason why many traders feel the need to write a trading plan that they follow to the letter.

The Royal Swedish Academy of Sciences has praised Thaler for his lifetime's work. They said he 'built a bridge between the economic and psychological analyses of individual decision-making'.

ABOUT THE NOBEL PRIZE

2017 CONTENDERS

Despite taking the prize, Richard Thaler was not actually among the favourites to win.

There were many strong contestants in various economic fields. These included the likes of Colin Camerer and George Loewenstein for their pioneering research in behavioural economics and neuroeconomics, Robert Hall for his analysis of worker productivity and studies of recessions, as well as Stewart Myers and Raghuram Rajan for their contributions in corporate finance.

These candidates were put forward on a list by Clarivate Analytics, a former unit of Thomson Reuters.

LOOKING TO 2018

As we await an official list of prospects for the 2018 award, many are hoping for a more inclusive Nobel Prize ceremony.

Even the vice chair of the board of directors of the Nobel Foundation was said to be disappointed that more women were not included in nominations across the board.

In Nobel Prize history, just 49 out of 923 winners have been female. Only one has ever won The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel since it was introduced in 1969.

The vice chair also said that they will work to include more women and those from different ethnic and geographical backgrounds in the next nomination process.

WHAT CAN WE LEARN FROM THALER?

For many economic professionals, there has been some scepticism towards any link between economics, finance and emotional psychology. Many economists believe that patterns and activities should only be measured through the mathematical optimisation of a select group of individuals.

However, Thaler's work does seem to confirm something which is commonplace in the financial markets.

There's no question that traders and investors experience limited rationality and lack of self-control from time to time. By simply being aware of these dynamics, traders and investors have a better chance of keeping them in check.


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