Behavioral Finance

Daniel Kahneman's top advice: Don't churn accounts

Renowned behavioral economist Daniel Kahneman says advisers must recognize the cost and futility of betting against the market and trading too much.

April 8, 2014 *By THUNNICUTT*

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Asked to crystallize a career of studying how people think into one bit of guidance for financial advisers, the Nobel laureate Daniel Kahneman didn't hesitate.
His advice: "Don't churn" accounts and trade too much.
"Don't trust your own confidence, he said Tuesday, in a keynote address at a conference of money managers and financial advisers in New York hosted by the Investment Management Consultants Association. "You are likely to be overconfident because most people are."
In a wide-ranging and challenging speech, the man credited with popularizing the study of how human behavior affects economic decision-making warned advisers that, while their job is to project confidence, an overconfidence in their ability to predict the markets could hurt their clients.
"By and large having few ideas is better," said Mr. Kahneman, an eminent Princeton University psychologist.
Referencing a study of chief financial officers at Fortune 500 companies who wrongly predicted the moves of the S&P 500, he asked advisers why they would expect to do any better.
Mr. Kahneman said the role of advisers is less about portfolio positioning than understanding the frequently irrational biases of their clients. In his view, behavioral research shows that clients have an exaggerated bias against losses as well as a hindsight bias that gives them the false sense that the future is predictable.
(More: Know a client's emotional biases to get through volatility)
Those biases, among other implications, mean that clients will blame themselves and their advisers for not predicting the future unless they are coached to anticipate failures and do not check their returns on a day-to-day basis. And clients with a greater aversion to losses will need a different portfolio than ones with less of an aversion to losses.
Mr. Kahneman said women often demonstrate a better ability to restrain the destructive impulse to take action on investment ideas as well as to moderate the emotional biases of clients.
"Women are quite possibly better at figuring out the client, and the emotional state of the client, and men ought to emulate women in those respects," said Mr. Kahneman, whose audience Tuesday was mostly men.
(More: Why well-designed technology is more powerful than investor education)
While advisers can develop a great deal of expertise about their clients' mindsets and specialized planning issues, such as taxes, the markets simply do not offer enough consistent information to allow the average person to develop that experience.
"You live in a world in which experience is possible," he said of financial markets. "Expertise that supports intuition about the future — that's not possible."
Mr. Kahneman faced a loaded question that put the economist in an awkward predicament: What do you think about ***active management***?
Mr. Kahneman, who has written at length about what he sees as the futility of stock-picking in his 2011 book, "Thinking Fast and Slow," said "that's a painful question to ask in front of an audience of mostly active managers," he said.
He said he hopes he doesn't have any active management in his portfolio, but admitted that he didn't check in very often with his financial adviser.
"I'm very interested in him not being too active," Mr. Kahneman said. "I have doubts about active investing."

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