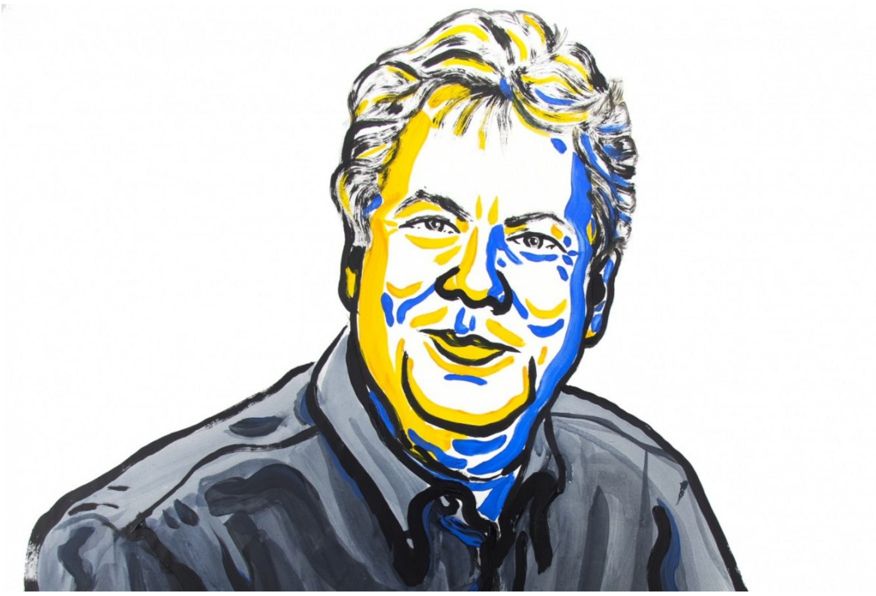
Why Richard Thaler matters to markets

With Thaler's Nobel Prize win, behavioural economics has officially made its way into the mainstream



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Awarding the Nobel Prize for economics to Richard Thaler is not only a recognition of his work but also of the way people think about markets: that it now incorporates psychological concepts, not just mathematical ones.

Thaler's work touches – possibly unnoticed - many of the ways professionals in financial markets think and work. His theories of mental accounting, house money and the endowment effect can explain not just how individual investors make decisions, but the choices fund managers and traders make too.

Thaler even appeared in the movie The Big Short with Selena Gomez (an honour some might say rivals his Nobel Prize) explaining how Tversky, Gilovich and Vallone's hot hand fallacy related to the 2007 collapse of the USA mortgage market.

And while it was his 2008 book Nudge, co-authored with Cass Sunstein, that brought him to the attention of the general public, his influence in finance and economics pre-dates this by decades.

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Thaler was one of the earliest traditionally trained economists who systematically questioned some of the fundamental thinking behind economic models, which he outlines in his 2015 memoir '' The making of behavioural economics: Misbehaving".

Arguably his earliest prominent interventions began in 1987 when the first of his "anomalies" columns was published in the American Economic Association's Journal of Economic Perspectives. That column was on the January effect – the tendency for stock prices to rise in the first month of the year. He continued to write these columns for the next two decades.

Richard Thaler's best behavioural economics insights

Thaler is not the first person to receive the Nobel Prize for questioning the concept of rationality that underpins much of the markets analysis finance, and economic professionals make.

Winners Daniel Kahneman (2002), Robert Shiller (2013) and Herbert Simon (1978) each questioned it too. Arguably, Vernon Smith - who shared the prize with Kahneman in 2002 – also fits within this group.

And what was pioneering in 1987 is almost standard fare nowadays. Asset managers now incorporate behavioural approaches in considering portfolio construction and market valuation; regulators now have behavioural science units to apply lessons from the field to products and markets.

But Thaler himself, writing in the American Economic Journal in 2016 says in fact that the journey has only really begun. "Indeed, my sense is that we are at the beginning of a new wave of theoretical developments made possible simply by turning our attention to the study of Humans rather than Econs," he writes.

And when the journey is complete, in a sense economics will only have come full circle.

In his own words

"I think it's time to stop thinking about behavioural economics as some kind of revolution. Rather, behavioural economics should be considered simply a return to the kind of open-minded, intuitively motivated discipline that was invented by Adam Smith and augmented by increasingly powerful statistical tools and datasets.

"This evidence-based discipline will still be theoretically grounded, but not in such a way that restricts our attention to only those factors that can be derived from our traditional normative traditions."

If economics does develop along these lines, the term "behavioural economics" will eventually disappear from our lexicon.