

**Kahneman, Daniel – Thinking fast and slow***Farrar, Straus & Giroux, 2011, [Behavioural Finance]* Grade ★★★★★

The author of this book won The Nobel Memorial Prize in Economic Sciences in 2002 for his prospect theory. However this book was written after that with the prospect of getting him a wider audience. He was very sceptical of whether he was going to be successful with this or not, and true to his investigative profession, he paid 10 students to criticize what he had written. They all thought it was a great book. So have most others. Some even claimed it to be one of the most important books, ever. From an InvestingByTheBooks perspective however, that is quite an exaggeration.

Thinking fast and slow is a book on how the brain works and is made up of five parts. In the first part Kahneman claims that our brain is controlled by system 1 (fast, automatic, no effort, no sense of voluntary control) and system 2 (slow, requires concentration and effort). In the second part he gives several examples where system 1 leads to the wrong conclusions. The author discusses anchoring, availability and emotional biases and regression to the mean. Part 3 continues in the same way but focuses on the illusion of understanding. Part 4, called choices, is where Kahneman brings forward his Noble Price winning prospect theory. In the final part he becomes more philosophical, thinking about life and giving advice - such as to choose the vacation that will give you the most pleasure while it lasts, not the one that will give you the most memories.

EQTBooks is about investing and if I simplify things, behavioural finance is the category which marries investing with psychology. Over the last years we have seen several books in this area, many which EQTBooks has reviewed. It's also a popular category among investment professionals since it's easy to relate to the psychological aspects. In today's lingo it's called sentiment, risk on/off and VIX = fear index, and it's given a lot of attention. I would argue that there are two types of books in

this category - books written by people from the financial industry (Maboussin, Taleb, Montier) and books written by academics (whom tend to look at chess, poker and investing as areas where psychology plays a role). This book belongs in the latter category and since it's academic the stock market is considered efficient. This is dealt with in part three and chapters like "The illusion of understanding" and "The illusion of validity" gives you an understanding of the author's view. In general if you are not a specialist in the field you tend to know less and rely on statistics. One conclusion which relates to this is the claim regarding on golf, in which I have some insight. Kahneman claims that golfers try harder to make a par putt than a birdie putt, based on statistics. Well, I know I try harder for birdies than par putts but that doesn't mean I am more successful.

The book has several interesting conclusions. Among my favourites are the recommendations to anchor your judgment of the probability of an outcome on a plausible base rate; to question your evidence; be aware of your own biases; and slow down to let system 2 take charge more often. Even the author admits to problems in living up to the ideas of this book and gives some examples of where he was too excited about a project to care about his own biases. One concrete advice to ensure improvement in a process relates to when you are going to hire someone. Select 6 key traits, score candidates 1-5 on these. Choose the one with the highest score. Resist your wish to change the ranking based upon likeability etc., i.e. let system 2 take charge over system 1.

If you want to know more about the psychology of investing, choose other books like those written by people in the financial industry. But read them using system 2. The awareness of the existence of the two systems is useful. That's my main take away from this book.

Bo Börtemark, January 5, 2013