Why did you do that?

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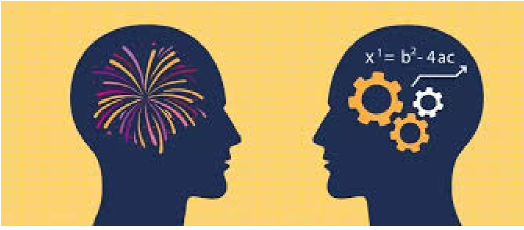

Richard Thaler had a problem. As a graduate student at the University of Rochester, he began to have misgivings about the material being taught in his economics classes. At first, he was unsure whether the problem was with the material being taught, or his inability to fully comprehend it. He was, by his own admission, hardly a stellar student. However, after Thaler became a professor of Economics at the University of Rochester, his doubts grew and he wrote them down as a list. He called the list "Dumb stuff people do." The list, as it turned out, would forever change economic theory and in turn, created an entirely new field called "behavioral economics."

In 2017, Thaler was awarded the Nobel Prize in Economic Sciences for his pioneering work in what is today called behavioral economics. The reason that the field is called "behavioral" is that while traditional economics is predicated on the idea that people think rationally and make well-informed decisions, Thaler proved that there is a psychological component to how people make decisions. In his own words, they do dumb things that a "rational" person would never do. Regardless of race, religion, or level of education, people are predictably unpredictable! They are seldom rational and most controversial of all, they can come to a different conclusion with just a little nudge from an outside influence.

For the layman, the idea that people are not rational may seem self-evident. All one needs to do is search YouTube for "dumb things people do" to discover that not only do people act foolishly, but others enjoy watching them do so! However, for traditional economists, the idea that people are not rational (even when they think they are being rational) is considered heresy.

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Thaler refers to the discrepancy between how traditional economists assume people act and the way people *really* behave as "Econs" vs. "Humans." Econs are robot-like and have full knowledge about all of their choices and are always optimizing each decision. Humans, on the other hand, are a lot more complicated. Instead of thinking through each decision, we make quick decisions using rules of thumb that we have developed over time, or "heuristics." The problem is that these "heuristics" often lead us to make poor decisions. (Understanding how the brain has a short-term reactionary mode and a long-term logical mode is the central theme in Daniel Kahneman's famous work, *Thinking Fast and Slow*.) The most common example of how Econs differ from Humans is with saving for retirement. It has been proven that when given a choice, most people fail to save enough money for the future. Despite our best intentions, we don't always make the best choices. We often struggle between short-term desires and long-terms goals and make choices that may not be consistent with our logical and rational minds.

To understand the scale of Thaler's work is to realize that it impacts almost every facet of our lives. Why does the stock market have periods of volatility? Why is obesity one of the largest drivers of health care costs in the U.S.? More broadly, why do certain government programs (that have the best intentions) fail to produce the intended results? As Thaler sees it, the answer to these questions is that people in these situations are not acting as rational Econs, but instead, the irrational Humans that we are. From tax cuts to health care to investing in the stock market, behavioral economics challenges the very foundation of the assumptions upon which traditional economics is based.

Business owners and investors would find Thaler's work captivating. Traditional economics teaches that in competitive markets, firms will continue to produce an item until the marginal cost exceeds the marginal revenue. When I asked Thaler about this, he responded that most companies have no idea what their marginal cost or marginal revenue is for any one item. Companies simply operate to maximize profits, and the best way to do this is to avoid being in a competitive market in the first place! The reason companies are constantly innovating and adding new features is to maximize their profits by differentiating their products or services from others, thus making it difficult, if not impossible, for the consumer to compare competitors. Only by differentiating itself from Microsoft was Apple able to keep its market share and not have to compete on price.

For investors, Thaler offers perhaps the greatest insight of all by turning conventional financial theory on its head. The idea that the stock market is efficient is a fallacy, he writes. Also, the price of a stock does not always reflect its intrinsic value, and the stock market often overreacts. According to Thaler, dividends are a much better indicator of a stock's value. Thaler's intellect is on full display as he carefully unwinds one of the widely accepted tenets of investing: the idea that the stock market is a "random walk" and that investors cannot beat the market over the long run. What makes Thaler's dissection of the material so amazing is how he does it using language that anyone can comprehend. He is even funny at times. It is as if he is writing for the younger Thaler (or frankly many of us!) who sat in college economics classes and also had misgivings about the material being taught, but lacked the experience or self-confidence to challenge the professor.

Thaler's work would be of interest alone if it simply proved that traditional economics was based on false assumptions regarding how people behave. However, that would not be revolutionary. What makes his work groundbreaking is that he showed that since people are not always rational, their choices can often be altered. As he wrote in his best-selling book *Nudge*, people can be "nudged" into making certain decisions without even realizing it. If you put fruit where it is visible, you are more apt to eat it, especially if you are trying to eat healthily! If you leave your iPad out of the bedroom, you are more likely to go to sleep earlier. Most of all, if we accept that we are a lot less rational than we think we are and truly explore why we do what we do, then we can begin to make better decisions for us, our families and our communities. It all starts with one simple question: Why did you do that?