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# Book Reviews: The Undoing Project

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## *The Undoing Project, by Michael Lewis*

I tend to get excited when the best story tellers write a new book, and when the book covers a topic I have been focused on recently this is even more so. Such was the case when Lewis covered the Nobel Prize winning duo of Daniel (Danny) Kahneman and Amos Tversky, two psychologists who developed much of the base work behind behavioral finance. I also see its roots in Robert Cialdini's books (*Influence*, *Pre-suasion*). While Kahneman (Tversky died in 1996 so did not share in the Nobel) wrote *Thinking Fast and Slow* to share their life work, here Lewis tries to identify why they worked so well together. In fast I don't recall him talking about thinking fast (immediate response) or slow (long-term investor) at all. It reads somewhere between biography and non-fiction about behavioral finance.

Some of the more interesting thoughts in the book have nothing to do with behavioral finance, but have lots to do with psychology. Lewis discusses Daryl Morey, who I would call a basketball sabermatrician. He has been GM for the Houston Rockets since 2007 using tactics similar to those described for baseball in the book *Moneyball* (also by Lewis). Prior to his work in the sports arena, Morey was a consultant. I am a consultant, and one of the things I struggle with is that as I become more experienced I recognize how much I really don't know. This is a challenge, because my competitors seem to always be sure of themselves even when they say something I am sure is wrong. Morey had this same experience and was actually told in a job interview that he had done poorly because he was "not certain enough in his opinions." According to him they said, "We're billing clients five hundred grand a year, so you have to be sure of what you are saying." People would rather have someone tell them bull s**t than be honest and describe 10 scenarios that might impact them without saying which one will occur.[1] As an aside, if you hire me - Instead of 500 grand this will cost you quite a bit under $50,000 and you will get a 50 page report to give you additional ideas based on other projects I have worked on. In this same chapter Lewis provides a definition of a nerd – a person who knows his own mind well enough to mistrust it.[2] This sounds like something Charlie Munger would say (high praise).

Both Kahneman and Tversky lived in Israel, where everyone serves a stint in the military, and both saw action in the Six Day War in 1967 and the Yom Kippur War in 1973 (when they returned from America to take up arms). Kahneman helped the Israelis design better

[1] Lewis, Michael. The Undoing Project. 2017. Page 28.
[2] Ibid. page 31.

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tools for selecting officers and training pilots. Tversky was a paratrooper. Both were professors at Hebrew University at the beginning of the first war.

Our mind tricks us. After the fact, we know exactly why we saw the event coming that no one anticipated (see Taleb's *Black Swan*) and surveys weight more heavily toward events that have recently occurred (my series of 10 emerging risk surveys). The reasons often given relate back to our days being prey to various predators on the plains of Africa (thinking fast keeps you alive in that context – you run away from a predator, as fast as you can). One of the ways to catch these inconsistencies is to devise three options, where a person chooses A over B, B over C, and C over A. This violates the law of transitivity, familiar to anyone who has ever studied algebra or logic. Lewis provides many of these examples, as did Kahneman in *Thinking Fast and Slow*, and I fall for nearly every one. Even after I've seen them before (sometimes, occasionally, I remember).

K/T developed several heuristics, where laws of chance are replaced by rules of thumb. "We often decide that an outcome is extremely unlikely, or impossible, because we are unable to imagine any chain of events that could cause it to occur. The defect, often, is in our imagination."

- Representativeness – we see a previously developed mental model rather than thinking through the facts as presented (and are generally correct). This creates systematic errors, such as looking at a kid and deciding whether they are athletic. Looking at the negative can help avoid these problems. For example, the WW2 bombs landing in London appeared to target certain areas, but really were random. If you have 23 randomly selected people in a room, the odds are better than half that at least two share a birthday.
- Availability – we more easily recall memorable events.
- Conditionality – we make contingent assumptions when none are stated. We assume normal operating conditions (e.g., normal distribution, VaR). "…people don't know what they don't know, but that they don't bother to factor their ignorance into their judgments."[3]
- Anchoring (and adjustment) – if you are shown a large (or small) number, for example, then your response is then large (or small).
- Simulation – what could happen dominates what is likely to happen – this can lead to analysis paralysis (I find it difficult to overcome this when investing for my personal accounts – it's hard to pull the trigger).
- Recency bias – recent events influence our probability assumptions.
- Hindsight bias - once we know how something turns out, our recollection is that we predicted it in advance (similar to Black Swans – Taleb)

[3] Ibid. page 192.

How do ideas form in our mind? Is it conscious, or indirect? When we study in school, or for a credential, the focus is on repeating the “right” answer. While hard to grade, I’ve always thought it would be better to provide an answer and ask the student to improve it.

Who knew that a bad experience could be remembered more fondly if the final part of the event was not so distasteful – the peak-end rule? This was tested using colonoscopies that ended with the medical instruments brought out of the body slowly or quickly. Doing so slowly made it more likely that the person would return for future tests.

The risk manager will discover, usually the hard way, that avoiding a risk receives no reward but if you miss a risk then you will get the blame. This is a human bias.

Accounting does not consider the impact on the environment, to limited supply, or to emotions. Utility theory overstates the value. Risk aversion is a fee willingly paid to avoid regret. In any case we all prefer to avoid pain more than we want to secure gain. We react more to relative changes than absolute ones, and probability is not straightforward.

The benefits of a group often conflict with the benefit to an individual. Antibiotics are such an example. In total, limiting antibiotics is better because viruses have less chance to mutate successfully. For an individual, antibiotics are either useful or neutral. There is no downside to an individual to being treated with antibiotics.

One of the fascinating revelations in the book (for me, at least) was the need to invert. “How do you understand memory? You don’t study memory. You study forgetting.” As we study other topics we should look for opportunities to utilize this strategy.

While much of the interest in this branch of psychology is applied to investment strategies, K/T worried more about geopolitical biases and the series of avoidable mistakes that could be made by political leaders relying on gut feel.[4] They thought that intelligence reports written as essays should be replaced by probabilities. Telling a story is not helpful in this context, but politicians tend to be afraid of numbers. We have seen evidence of this recently as briefings to the US president are said to be focused on charts and short sound bites.

As you read about financial economics, this should not be your first book. I believe it is more useful to someone already familiar with the concepts from other sources. For someone starting out on this topic I personally like *Why Smart People Make Big Money Mistakes and How to Correct Them* by Gary Belsky and Thomas Gilovich to start and then *Thinking Fast and Slow* by Kahneman before reading the Lewis book.

[4] Ibid. Page 247.

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### *Fed Up, by Danielle DiMartino Booth*

The author spent several years working inside the Dallas Federal Reserve Bank, bringing her Wall Street experience to a bunch of academics. Often it was unwelcome, but she developed a good relationship with Richard Fisher, a member of the Fed's Board of Governors. She left the bank when he retired, and now is entering the financial pundit scene with some serious street cred. She now has this book and gets a speaking fee of $30,000. She has hit several conservative radio/TV shows and podcasts. I find her writing style interesting and easy to listen to, and her stories about the inside of the Fed are fascinating. The book is worth a read, and she is an entertaining interview (her blog seems a bit forced and no longer offered for free). Where I was disappointed was in the book's aftertaste. I did not sense a solution. It felt like the Republicans under Obama; fully willing to say what he was doing wrong but without any of their own solutions. I hope that she runs for office at some point and comes prepared with ideas to improve the situation.

This is a book of stories and contrasts. On the one hand is the academic bureaucracy of the Federal Reserve system, where someone without a PhD is treated with pity but no one thinks to seasonally adjust data. The view presented of academic economists is not pretty, but also not surprising. Since I make jokes about the Wall Street guys over-relying on the current price rather than intrinsic value, and DDB seems impressed by Warren Buffett, it would be useful to have a companion or follow-up book try to pick the best of each group and design a valuation system for regulators that was better than the current one driven by groupthink. This could be a first step along that path. If not, savers (pensions, insurers, retirees) will crash and burn. Central banks have manipulated rates down to create liquidity, but banks won't issue loans and the velocity of money continues to hit new lows. Systemic risk is high. Contrarian viewpoints are needed and in short supply. Bankers are unable (and unwilling) to self-regulate successfully. Culture drives results.

Last year I wrote a research report on systemic risk. Regulatory capture is a big problem in finance, especially with banks and the turnstile between them and the Fed/Treasury. This makes regulators less likely to probe banks, looking instead at peripheral groups like private equity firms and hedge funds. Regulators need to add contrarian opinions to their process, bringing in experts from other fields. When I hear that a bank like JP Morgan has 5,000 people in their risk management area, and then they miss the London Whale, it makes me wonder what they are all doing. Risk is driven by culture, and if certain groups are allowed to do whatever they want with no questions asked it will not end well.

DDB describes the San Francisco bank, led by Janet Yellen (who left Harvard after not receiving tenure), as the Keynesian Fed, and the St. Louis Fed as where monetarists rule. As an aside, the St. Louis Fed has the best data sets for financial topics anywhere. Other banks classified were New York as the Wall Street Fed and Dallas as the free market Fed. I wonder if that will survive Richard Fisher's term in Dallas. It is important to have each of these groups represented, but where has any effort been expended to get them to

interact? It seems like each bank's own board would be a good source of alternative thoughts, but that does not appear to happen either.

The room is full of people to blame for the financial crisis of 2008, and this book is consistent with my prior understanding. While Dodd-Frank is often presented as the savior, Barney Frank was a big part of the problem too (especially in letting Fannie and Freddie run amok). The Bush administration (and Clinton before that) had both blame and at times tried to lower the risks from growing. While politicians were meeting with lobbyists, Zoltan Pozsar wrote *The Rise and Fall of the Shadow Banking System*, calling out the overleveraged and under-regulated shadow banking system and eventually getting a job offer from the NY Fed.[5] Using the rules-based Basel I Accord and regulatory arbitrage, credit risk transfer instruments were able to net risk while ignoring liquidity, leverage, and moral hazard. This is where instruments like credit default swaps and overnight loans were created. Today firms use alternative asset classes to reach for yield, and I believe the risks are not well understood by the buyers. A new word introduced in this book for me is rehypothecated, where collateral is used more than once. It's likely a key in the next crisis. I'll be looking to learn more about it in the meantime.

A hundred years from now there will be books that may be able to determine the incentives of all the players, including AIG and Treasury. Certainly the biggest banks ended up bigger and with larger moats.

While his earlier paper was predictive, in 2010 Pozsar wrote a paper detailing the interconnections between various financial subsidiaries.[6] The lack of transparency was addressed in Dodd-Frank through the Office of Financial Research. This group does some really good work and I fear it will be torn apart in a wave of deregulation.

A story I had not heard before was about the origin of the Jackson Hole annual conference. Each August since 1982 economists, bankers, and other noteworthy attendees discuss the current state of the economy. The location was chosen to entice Fed Chairman Paul Volcker to attend, as he enjoyed fly fishing. It worked![7] Raghuram Rajan, currently at Chicago Booth but previously Governor of the Reserve Bank of India and chief economist at the IMF, in 2005 presented a controversial paper at the conference (Greenspan's last) expressing concern about tail risk driven by a transformation of banking that made the world riskier. He expressed concern about compensation and products like credit default swaps (CDS) that allowed banks to double down on certain risks that were not transparent. No one would know where the exposures were. While he was correct, the reception to his paper was anything but cordial.

[5] Ibid. Page 121.
[6] Ibid. Page 191.
[7] Ibid. Page 92.

I write and tweet about Berkshire Hathaway more than any other company, so it was interesting to hear her comment about investment bankers who sell investments that would fail every fiduciary test if it was applied to them. She notes that their bonuses are often invested in municipal bonds and BRK stock.[8] Does this show a correlation with Buffett's disdain for most investment bankers?

I don't have a good reason for including this quote, but here goes. It's from an Arctic weather station. "Theory is when you understand everything, but nothing works. Practice is when everything works, but nobody understands why. At this station, theory and practice are united, so nothing works, and nobody understands why."[9]

DDB does make some recommendations for the Fed system, from realigning office locations to reflect today's economy to my favorite, allowing a mix of backgrounds to work in the research department of the Fed branches. If you want alternative thoughts to appear, everyone can't be Ivy League trained and from the east coast.

A couple of years ago I suggested a project where regional offices would contribute to a federal Chief Risk Officer for the US. I did not receive the project but posted my proposal in an April 2016 newsletter. DDB notes that various states had success post crisis but that the Fed did nothing to spread good ideas to other regions.[10] I worry that we have not cleared the system and that the next time will be worse since debt has reached new highs at a time when demographic trends are working against OECD growth. Politicians will blame the Fed, but the responsibility is theirs. Abdication does not absolve you from responsibility. Being a person who allows someone to abdicate does not make the Fed any better. There is a balance needed between regulation and markets, and I see no signs of them working together in a reasonable way. A generation where credit risk was free has not helped. Creative destruction only works if those responsible lose their jobs and their wealth. Otherwise financiers reap the rewards and the public pays the price.

I wish Mrs. Dimartino Booth well as she enters the group of pundits who appear for sound bites on CNBC and are well compensated for newsletters. Hopefully she will continue to share proactive solutions and not always talk Republican talking points as she seems to be doing so far. If so, she will be worth listening to.

*Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before*

[8] DiMartino Booth, Danielle. Fed Up: An Insider's Take on Why the Federal Reserve is Bad for America. 2017. Page 13.
[9] Ibid. Page 224.
[10] Ibid. Page 227.

*decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!*