



**“ It’s nonsense to say money can’t buy happiness.
But people exaggerate the extent to which
more money can buy more happiness. ”**

Master of the Imperfect Mind

Daniel Kahneman won a Nobel for explaining why people habitually make the wrong moves when investing or spending their money. Who better to tell you how to do it right?

➤ **It isn't often that a psychologist** helps explain personal finance, but Daniel Kahneman isn't an ordinary psychologist. In 2002 he won a Nobel Prize in economics for his research into how people confront uncertainty. Raised in France and Israel, formerly a professor at the Hebrew University of Jerusalem, UC–Berkeley and Princeton, Kahneman has spent half a century studying how the human mind works—or fails to. Just retired at age 73, Kahneman is now writing a book about decision-making in collaboration with MONEY's Jason Zweig. The two recently chatted on the record.

Q. Are people rational?

A. Economists argue that people are rational—that they use all available information to make decisions and that those decisions are consistent over time. Psychologists say that is totally unrealistic. Economists think about what people ought to do. Psychologists watch what they actually do.

Q. Such as?

A. How people respond to a risk depends partly on how it is described. An investment said to have an 80% chance of success sounds far more attractive than one with a 20% chance of failure. The mind can't easily recognize that they are the same.

Q. You once said we'd all be better investors if we just made fewer decisions.

A. Two decisions really matter: how much of your wealth you want to put at risk and how much risk you want to take with it.

Q. Those aren't easy decisions!

A. No, but they are few. Investing should be an orderly process in which you make long-term commitments along the course those two big decisions set for you. Small decisions tend to be based on what the market does, and are likely to be wrong. That's why you should implement policies in a broad frame rather than make decisions in a narrow frame.

Q. What's the difference?

A. Here's one example. If you use a narrow frame and make small decisions, you will buy and sell stocks one at a time. You will have high trading costs, sell your winners too soon and

hang on to your losers too long. On the other hand, if you use a broad frame and implement a policy, you will rebalance regularly and automatically. You will buy or sell stocks as a class, rather than one by one, and you will do so only when they cross a target level that you have set in advance.

Q. Why does everything in life seem to go over budget?

A. That's what I call the planning fallacy. When you have a project to complete, you try to be realistic about how long it will take and what it will cost. But your plan is still largely a best-case scenario, because it is based only on your inside view.

Q. So if you're renovating your bathroom, say, don't just ask the contractor for his estimate—

A. —but also look at broader statistics, like the national average of what it costs to remodel a bathroom—

Q. —which, when we renovated the one in my house, was a lot closer to the final price than my contractor's lowball estimate had been. I thought I was getting a bargain. [Pause.] Can we change the subject, please? Does money make people happy?

A. It's nonsense to say money doesn't buy happiness, but people exaggerate the extent to which *more* money can buy more happiness. Happiness is determined by factors like your health, your family relationships and friendships, and above all by feeling that you are in control of how you spend your time.

Q. Can buying things make us happier?

A. There's an important difference between pleasures and comforts. Pleasures are things like flowers, feasts, vacations—investments in family, friends and memories. Comforts are material goods like a big new car or a giant plasma TV or—

Q. —a renovated bathroom.

A. That's right. Comforts always seem like a better idea before you buy them than afterward. Trust me, you will get more durable satisfaction out of the money you spend on pleasures. \$

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