Sunday, 3 January 2021

The Psychology of Money

Introduction: The Greatest Show On Earth

- The premise of this book is that doing well with money has a little to do with how smart you are and a lot to do with how you behave. And behavior is hard to teach, even to really smart people. A genius who loses control of their emotions can be a financial disaster. The opposite is also true. Ordinary folks with no financial education can be wealthy if they have a handful of behavioral skills that have nothing to do with formal measures of intelligence
- In what other industry does someone with no college degree, no training, no background, no formal experience, and no connections massively outperform someone with the best education, the best training, and the best connections? I can't think of any
- Two topics impact everyone, whether you are interested in them or not: health and money

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No One's Crazy

- Your personal experiences with money make up maybe 0.00000001% of what's happened in the world, but maybe 80% of how you think the world works. So equally smart people can disagree about how and why recessions happen, how you should invest your money, what you should prioritize, how much risk you should take, and so on
- The challenge for us is that no amount of studying or open-mindedness can genuinely recreate the power of fear and uncertainty. I can read about what it was like to lose everything during the Great Depression. But I don't have the emotional scars of those who actually experienced it. And the person who lived through it can't fathom why someone like me could come across as complacent about things like owning stocks. We see the world through a different lens. Spreadsheets can model the historic frequency of big stock market declines. But they can't model the feeling of coming home, looking at your kids, and wondering if you've made a mistake that will impact their lives. Studying history makes you feel like you understand something. But until you've lived through it and personally felt its consequences, you may not understand it enough to change your behavior
- The economists wrote: "Our findings suggest that individual investors' willingness to bear risk depends on personal history." Not intelligence, or education, or sophistication. Just the dumb luck of when and where you were born

Luck & Risk

- If you give luck and risk their proper respect, you realize that when judging people's financial success - both your own and others' - it's never as good or as bad as it seems
- No one actually thinks luck doesn't play a role in financial success. But since it's hard to quantify luck and rude to suggest people's success is owed to it, the default stance is often to implicitly ignore luck as a factor of success
- The cover of Forbes magazine does not celebrate poor investors who made good decisions but happened to experience the unfortunate side of risk. But it almost certainly celebrates rich investors who made OK or even reckless decisions and happened to get lucky. Both flipped the same coin that happened to land on a different side
- The line between bold and reckless can be thin. When we don't give risk and luck their proper billing it's often invisible
- Be careful who you praise and admire. Be careful who you look down upon and wish to avoid becoming
- Studying a specific person can be dangerous because we tend to study extreme examples - the billionaires, the CEOs, or the massive failures that dominate the news - and extreme examples are often the least applicable to other situations, given their complexity. The more extreme the outcome, the less likely you can apply its lessons to your own life, because the more likely the outcome was influenced by extreme ends of luck or risk
- People who have control over their time tend to be happier in life is a broad and common enough observation that you can do something with it
- When things are going extremely well, realize it's not as good as you think. You are not invincible, and if you acknowledge that luck brought you success then you have to believe in luck's cousin, risk, which can turn your story around just as quickly
- As much as recognize the role of luck in success, the role of risk means we should forgive ourselves and leave room for understanding when judging failures

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Never Enough

- If expectations rise with results there is no logic striving for more because you'll feel the same after putting in extra effort. It gets dangerous when the taste of having more - more money, more power, more prestige - increases ambition faster

than satisfaction. In that case one step forward pushes the goalpost two steps ahead. You feel as if you're falling behind, and the only way to catch up is to take greater and greater amounts of risk

- The only way to know how much food you can eat is to eat until you're sick. Few try this because vomiting hurts more than any meal is good. For some reason the same logic doesn't translate to business and investing, and many will only stop reaching for more when they break and are forced to. This can be as innocent as burning out at work or a risky investment allocation you can't maintain. On the other end there's Rajat Guptas and Bernie Madoffs in the world, who resort to stealing because every dollar is worth reaching for regardless of consequence
- The good news is that the most powerful tool for building enough is remarkably simple, and doesn't require taking risks that could damage any of these things

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Confounding Compounding

- Good investing isn't necessarily about earning the highest returns, because the highest returns tend to be one-off hits that can't be repeated. It's about earning pretty good returns that you can stick with and which can be repeated for the longest period of time. That's when compounding runs wild. The opposite of this - earning huge returns that can't be held onto - leads to some tragic stories

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Getting Wealthy vs. Staying Wealthy

- There are a million ways to get wealthy and plenty of books on how to do so. But there's only one way to stay wealthy; some combination of frugality and paranoia
- If I had to summarize money success in a single word it would be "survival"
- Getting money requires taking risks, being optimistic, and putting yourself out there. But keeping money requires the opposite of taking risk. It requires humility, and fear that what you've made can be taken away from you just as fast. It requires frugality and an acceptance that at least some of what you've made is attributable to luck, so past success can't be relied upon to repeat indefinitely
- More than I want big returns, I want to be financially unbreakable. And if I'm unbreakable I actually think I'll get the biggest returns, because I'll be able to stick around long enough for compounding to work wonders
- Planning is important, but the most important part of every plan is to plan on the plan not going according to plan
- A barbelled personality - optimistic about the future, but paranoid about what will prevent you from getting to the future - is vital

- A mindset that can be paranoid and optimistic at the same time is hard to maintain, because seeing things as black or white takes less effort than accepting nuance. But you need short-term paranoia to keep you alive long enough to exploit long-term optimism

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Tails, You Win

- Out of more than 21,000 venture financings from 2004 to 2014: 65% lost money. Two and a half percent of investments made 10x-20x. One percent made more than a 20x return. Half a percent - about 100 companies out of 21,000 - earned 50x or more. That's where the majority of the industry's returns come from
- J. P. Morgan Asset Management once published the distribution of returns for the Russell 3000 Index - a big, broad, collection of public companies - since 1980. Forty percent of all Russell 3000 stock components lost at least 70% of their value and never recovered over this period. Effectively all of the index's overall returns came from 7% of component companies that outperformed by at least two standard deviations. That's the kind of thing you'd expect from venture capital. But it's what happened inside a boring, diversified index
- There is the old pilot quip that their jobs are "hours and hours of boredom punctuated by moments of sheer terror." It's the same in investing. Your success as an investor will be determined by how you respond to punctuated moments of terror, not the years spent on cruise control. A good definition of an investing genius is the man or woman who can do the average thing when all those around them are going crazy
- "It's not whether you're right or wrong that's important," George Soros once said, "but how much money you make when you're right and how much you lose when you're wrong." You can be wrong half the time and still make a fortune

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Freedom

- The highest form of wealth is the ability to wake up every morning and say, "I can do whatever I want today." People want to become wealthier to make them happier. Happiness is a complicated subject because everyone's different. But if there's a common denominator in happiness - a universal fuel of joy - it's that people want to control their lives. The ability to do what you want, when you want, with who you want, for as long as you want, is priceless. It is the highest dividend money pays

- More than your salary. More than the size of your house. More than the prestige of your job. Control over doing what you want, when you want to, with the people you want to, is the broadest lifestyle variable that makes people happy
- Doing something you love on a schedule you can't control can feel the same as doing something you hate
- People like to feel like they're in control - in the drivers' seat. When we try to get them to do something, they feel disempowered. Rather than feeling like they made the choice, they feel like we made it for them. So they say no or do something else, even when they might have originally been happy to go along
- If your job is to build cars, there is little you can do when you're not on the assembly line. You detach from work and leave your tools in the factory. But if your job is to create a marketing campaign - a thought-based and decision job - your tool is your head, which never leaves you. You might be thinking about your project during your commute, as you're making dinner, while you put your kids to sleep, and when you wake up stressed at three in the morning. You might be on the clock for fewer hours than you would in 1950. But it feels like you're working 24/7

Man in the Car Paradox

- When you see someone driving a nice car, you rarely think, "Wow, the guy driving that car is cool." Instead, you think, "Wow, if I had that car people would think I'm cool." Subconscious or not, this is how people think. There is a paradox here: people tend to want wealth to signal to others that they should be liked and admired. But in reality those other people often bypass admiring you, not because they don't think wealth is admirable, but because they use your wealth as a benchmark for their own desire to be liked and admired
- You might think you want an expensive car, a fancy watch and a huge house. But I'm telling you, you don't. What you want is respect and admiration from other people, and you think having expensive stuff will bring it. It almost never does - especially from the people you want to respect and admire you
- If respect and admiration are your goal, be careful how you seek it. Humility, kindness and empathy will bring you more respect than horsepower ever will

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Wealth is What You Don't See

- Wealth is hidden. It's income not spent. Wealth is an option not yet taken to buy something later. Its value lies in offering you options, flexibility and growth to one day purchase more stuff than you could right now

- Exercise is like being rich. You think “I did the work and I now deserve to treat myself to a big meal.” Wealth is turning down that treat meal and actually burning net calories. It’s hard and requires self-control. But it creates a gap between what you could do and what you choose to do that accrues to you over time
- The problem for many of us is that it is easy to find rich role models. It’s harder to find wealthy ones because by definition their success is more hidden
- People are good at learning by imitation. But the hidden nature of wealth makes it hard to imitate others and learn from their ways. After he died, Ronald Read became many people’s financial role model. He was lionized in the media and cherised on social media. But he was nobody’s financial role model while he was living because every penny of his wealth was hidden, even to those who knew him

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Save Money

- One of the most powerful ways to increase your savings isn’t to raise your income. It’s to raise your humility. When you define savings as the gap between your ego and your income you realize why many people with decent incomes save so little. It’s a daily struggle against instincts to extend your peacock feathers to their outermost limits and keep up with others doing the same. People with enduring personal finance success - not necessarily those with high incomes - tend to have a propensity to not give a damn what others think about them
- Everyone knows the tangible stuff money buys. The intangible stuff is harder to wrap your head around, so it tends to go unnoticed. But the intangible benefits of money can be far more valuable and capable of increasing your happiness than the tangible things that are obvious targets of our savings
- Intelligence is not a reliable advantage in a world that’s become as connected as ours has. But flexibility is. In a world where intelligence is hyper-competitive and many previous technical skills have become automated, competitive advantages tilt towards nuanced and soft skills - like communication, empathy and perhaps, most of all, flexibility

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Reasonable > Rational

- Academic finance is devoted to finding the mathematically optimal investment strategies. My own theory is that, in the real world, people do not want the mathematically optimal strategy. They want the strategy that maximizes for how well they sleep at night

- A rational investor makes decisions based on numeric facts. A reasonable investor makes them in a conference room surrounded by co-workers you want to think highly of you, with a spouse you don't want to let down, or judged against the silly but realistic competitors that are your brother-in-law, your neighbor, and your own personal doubts. Investing has a social component that's often ignored when viewed through a strictly financial lens

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Surprise!

- The problem is that we often use events like the Great Depression and World War II to guide our views of things like worst-case scenarios when thinking about future investment returns. But those record-setting events had no precedent when they occurred. So the forecaster who assumes the worst (and best) events of the past will match the worst (and best) events of the future is not following history; they're accidentally assuming that the history of unprecedented events doesn't apply to the future
- The correct lesson to learn from surprises is that the world is surprising. Not that we should use past surprises as a guide to future boundaries; that we should use past surprises as an admission that we have no idea what might happen next
- The average time between recessions has grown from about two years in the late 1800s to five years in the early 20th century to eight years over the last half-century. There are plenty of theories on why recessions have become less frequent. One is that the Fed is better at managing the business cycle, or at least extending it. Another is that heavy industry is more prone to boom-and-bust overproduction than the service industries that dominated the last 50 years. The pessimistic view is that we now have fewer recessions, but when they occur they are more powerful than before. For our argument it doesn't particularly matter what caused the change. What matters is that things clearly changed

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Room for Error

- The purpose of the margin of safety is to render the forecast unnecessary
- Stock analysts give their clients price targets, not price ranges. Economic forecasters predict things with precise figures; rarely broad probabilities. The pundit who speaks in unshakable certainties will gain a larger following than the one who says "We can't know for sure," and speaks in probabilities
- Harvard psychologist Max Bazerman once showed that when analyzing other people's home renovation plans, most people estimate the project will run between 25% and 50% over budget. But when it comes to their own projects,

people estimate that renovations will be completed on time and at budget. Oh, the eventual disappointment

- But room for error is underappreciated and misunderstood. It's often viewed as a conservative hedge, used by those who don't want to take much risk or aren't confident in their views. But when used appropriately, it's quite the opposite
- Room for error lets you endure a range of potential outcomes, and endurance lets you stick around long enough to let the odds of benefitting from a low-probability outcome fall in your favor. The biggest gains occur infrequently, either because they don't happen often or because they take time to compound. So the person with enough room for error in part of their strategy (cash) to let them endure hardship in another (stocks) has an edge over the person who gets wiped out, game over, insert more tokens, when they're wrong
- Can you survive your assets declining by 30%? On a spreadsheet, maybe yes - in terms of actually paying your bills and staying cash-flow positive. But what about mentally? It is easy to underestimate what a 30% decline does to your psyche. Your confidence may become shot at the very moment opportunity is at its highest. You - or your spouse - may decide it's time for a new plan, or new career. I know several investors who quit after losses because they were exhausted. Physically exhausted. Spreadsheets are good at telling you when the numbers don't add up. They're not good at modeling how you'll feel when you tuck your kids in at night wondering if the investment decisions you've made were a mistake that will hurt their future. Having a gap between what you can technically endure versus what's emotionally possible is an overlooked version of room for error
- The idea is that you have to take risk to get ahead, but no risk that can wipe you out is ever worth taking. If something has 95% odds of being right, the 5% odds of being wrong means you will almost certainly experience the downside at some point in your life. And if the cost of the downside is ruin, the upside the other 95% of the time likely isn't worth the risk, no matter how appealing it looks
- The ability to do what you want, when you want, for as long as you want, has an infinite ROI
- Beyond the predictable struggles of running a startup, here are a few issues we've dealt with among our portfolio companies: Water pipes broke, flooding and ruining a company's office; A company's office was broken into three times; A company was kicked out of its manufacturing plant; A store was shut down after a customer called the health department because she didn't like that another customer brought a dog inside; A CEO's email was spoofed in the middle of a fundraise that required all of his attention; A founder had a mental breakdown

- Avoiding these kinds of unknown risks is, almost by definition, impossible. You can't prepare for what you can't envision. If there's one way to guard against their damage, it's avoiding single points of failure. A good rule of thumb for a lot of things in life is that everything that can break will eventually break. So if many things rely on one thing working, and that thing breaks, you are counting the days to catastrophe. That's a single point of failure
- The trick that often goes overlooked - even by the wealthiest - realizing that you don't need a specific reason to save. It's fine to save for a car, or a home, or for retirement. But it's equally important to save for things you can't possibly predict or even comprehend - the financial equivalent of field mice
- Predicting what you'll use your savings for assumes you live in a world where you know exactly what your future expenses will be, which no one does. I save a lot, and I have no idea what I'll use the savings for in the future. Few financial plans that only prepare for known risks have enough margin of safety to survive the real world

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You'll Change

- We should avoid the extreme ends of financial planning. Assuming you'll be happy with a very low income, or choosing to work endless hours in pursuit of a high one, increases the odds that you'll one day find yourself as a point of regret. The fuel of the End of History Illusion is that people adapt to most circumstances, so the benefits of an extreme plan - the simplicity of having hardly anything, or the thrill of having almost everything - wear off. But the downsides of those extremes - not being able to afford retirement, or looking back at a life spent devoted to chasing dollars - become enduring regrets. Regrets are especially painful when you abandon a previous plan and feel like you have to run in the other direction twice as fast to make up for lost time
- Aiming at every point in your working life, to have moderate annual savings, moderate free time, no more than a moderate commute, and at least moderate time with your family, increases the odds of being able to stick with a plan and avoid regret than if any one of those things fall to the extreme sides of the spectrum

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You & Me

- Bubbles aren't so much about valuations rising. That's just a symptom of something else: time horizons shrinking as more short-term traders enter the playing field

- Bubbles do their damage when long-term investors playing one game start taking their cues from those short-term traders playing another
- Cisco stock rose 300% in 1999 to $60 per share. At that price the company was valued at $600 billion, which is insane. Few actually thought it was worth that much; the day-traders were just having their fun. Economist Burton Malkiel once pointed out that Cisco's implied growth rate at that valuation meant it would become larger than the entire US economy within 20 years
- It's hard to grasp that other investors have different goals than we do, because an anchor of psychology is not realizing that rational people can see the world through a different lens than your own. Rising prices persuade all investors in ways the best marketers envy. They are a drug that can turn value-conscious investors into dewy-eyed optimists, detached from their own reality by the actions of someone playing a different game than they are
- The main thing I can recommend is going out of your way to identify what game you're playing

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The Seduction of Pessimism

- Real optimists don't believe that everything will be great. That's complacency. Optimism is a belief that the odds of a good outcome are in your favor over time, even when there will be setbacks along the way. The simple idea that most people wake up in the morning trying to make things a little better and more productive than wake up looking to cause trouble is the foundation of optimism. It's not complicated. It's not guaranteed, either. It's just the most reasonable bet for most people, most of the time

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When You'll Believe Anything

- When we think about the growth of economies, businesses, investments and careers, we tend to think about tangible things - how much stuff do we have and what are we capable of? But stores are, by far, the most powerful force in the economy. They are the fuel that can let the tangible parts of the economy work, or the brake that holds our capabilities back
- At the personal level, there are two things to keep in mind about a story-driven world when managing your money. The more you want something to be true, the more likely you are to believe a story that overestimates the odds of it being true. Everyone has an incomplete view of the world. But we form a complete narrative to fill in the gaps

- When thinking about room for error in a forecast it is tempting to think that potential outcomes range from you being just right enough to you being very, very right. But the biggest risk is that you want something to be true so badly that the range of your forecast isn't even in the same ballpark as reality
- Most people, when confronted with something they don't understand, do not realize they don't understand it because they're able to come up with an explanation that makes sense based on their own unique perspective and experiences in the world, however limited those experiences are. We all want the complicated world we live in to make sense. So we tell ourselves stories to fill in the gaps of what are effectively blind spots. Coming to terms with how much you don't know means coming to terms with how much of what happens in the world is out of your control. And that can be hard to accept
- Risk is what's left over when you think you've thought of everything

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All Together Now

- Go out of your way to find humility when things are going right and forgiveness / compassion when they go wrong
- Less ego, more wealth
- Manage your money in a way that helps you sleep at night
- If you want to do better as an investor, the single most powerful thing you can do is to increase your time horizon
- Become OK with lot of things going wrong. You can be wrong half the time and still make a fortune
- Use money to gain control over your time
- Be nicer and less flashy
- Save. Just save. You don't need a specific reason to save
- Define the cost of success and be ready to pay it
- Worship room for error
- Avoid the extreme ends of financial decisions
- You should like risk because it pays off over time
- Define the game you're playing
- Respect the mess

Confessions

- Half of all U.S. mutual fund portfolio managers do not invest a cent of their own money in their funds, according to Morningstar. This might seem atrocious, and surely the statistic uncovers some hypocrisy
- Murray, a professor of medicine at USC, wrote an essay in 2011 titled “How Doctors Die” that showed the degree to which doctors choose different end-of-life treatments for themselves than they recommend for their patients. “Doctors don’t die like the rest of us,” he wrote. “What’s unusual about them is not how much treatment they get compared to most Americans, but how little. For all the time they spend fending off the deaths of others, they tend to be fairly serene when faced with death themselves. They know exactly what is going to happen, they know the choices, and they generally have access to any sort of medical care they could want. But they go gently.” A doctor may throw the kitchen sink at her patient’s cancer, but choose palliative care for herself
- Being able to wake up one morning and change what you’re doing, on your own terms, whenever you’re ready, seems like the grandmother of all financial goals. Independence, to me, doesn’t mean you’ll stop working. It means you only do the work you like with people you like at the times you want for as long as you want
- Everything I’ve learned about personal finance tells me that everyone - without exception - will eventually face a huge expense they did not expect - and they don’t plan for these expenses specifically because they did not expect them. The few people who know the details of our finances ask, “What are you saving for? A house? A boat? A new car?” No, none of those. I’m saving for a world where curveballs are more common than we expect
- One of my deeply held investment beliefs is that there is little correlation between investment effort and investment results. The reason is because the world is driven by tails - a few variables account for the majority of returns. No matter how hard you try at investing you won’t do well if you miss the two or three things that move the needle in your strategy. The reverse is true. Simple investment strategies can work great as long as they capture the few things that are important to that strategy’s success