Book Synopsis

from Craig Weightman

The Psychology of Money

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Introduction

Premise of the book: Doing well with money has little to do with your smarts and much to do with how you behave. Behavior is hard to teach, even to really smart people.

- The key is compounding savings, i.e. spend less than you make and intelligently investing the remainder over your lifetime.
- The soft skill of behavior is the psychology of money
  - Knowing what to do tells you nothing about what happens in your head when you try to do it.
  - We think about and are taught much the way we are taught about physics, not enough like psychology (emotion and nuance).
  - We can understand why a bridge collapsed (physics), but understanding a financial crisis is better understood through the lenses of psychology and history, not finance.

This book discusses the 18 most important flaws, biases, and causes of bad behavior affecting people when dealing with money.

Chapter 1: No One's Crazy (Your personal experiences with money are a very negligible percent of what's happened in the world, but about 80% of how you think the world works)

- Everyone has their own unique experience with how the world works and this is more compelling than what you learn second hand.
- The challenge in learning is that no amount of studying or open-mindedness can genuinely recreate the power of fear and uncertainty.
- Some lessons have to be experienced before they can be understood.
  - Individual investor's willingness to bear risk depends on personal history.
  - When one person's view of money was formed in a different world from another's, what the first person thinks is outrageous makes perfect sense to the second person.
- Money has been around a long time, but the modern foundation of money decisions - saving and investing - are based around very modern concepts. The concept of retirement is less than 100 years old (WWII). The 401k is less than 50 years old and ROTH IRA is less than 30.
  - It should surprise no one that many of us are bad a saving and investing.
  - The number of persons over 25 with a bachelor's degree was less than 1 in 20 in 1940 and is 1 in 4 by 2015.
  - Index funds (funds that follow the stock market) are less than 50 years old, while hedge funds (protect against sudden changes) took off less than 25 years ago.
  - Consumer debt did not become widespread until after WWII.
  - Dogs have been domesticated over the last 10,000 years, but we have had < 50 years experience with the modern financial system.

Chapter 2: Luck and Risk (Nothing is as good or as bad as it seems)

- Both luck and risk are hard to measure and hard to accept, therefore they are often overlooked in our analysis of anything. We understand statistics, but cannot translate that knowledge to our personal lives or to those specific people around us.
  - Bill Gates was 13 in 1968, when he, Paul Allen, and Kent Evans were introduced to a time-share computer in high school.
  - Most colleges did not have this much access in 1968. At this time there were about 300 million high school aged people in the world; 18 million in the U.S.; 270,000 in the state of Washington; and 300 attended Lakeside High School in Seattle (1 in a million odds of LUCK).
  - All three students were extremely bright and took full advantage of their luck. Kent died in a mountaineering accident before he graduated high school. The odds of being killed on a mountain in high school that year was about 1 in a million (RISK).
- Everything worth pursuing has a less than 100% chance of success and risk is what happens when you end up on the unfortunate side of that equation. Was it risk, or did you just not work hard/smart enough?
  - The line between "inspiringly bold" and "foolishly reckless" can be a millimeter thick and only visible with hindsight.
- Identifying traits we should emulate or avoid can become agonizingly hard, because we cannot separate out risk and luck from hard work and knowledge. Two things can point you in the right direction...
  1. Be careful who you praise and admire. Be careful who you look down upon and wish to avoid becoming.
  2. Focus less on specific individuals and case studies and more on broad patterns.
- Bill Gates: Success is a lousy teacher. It seduces smart people into thinking they can't lose. Failure can also be a lousy teacher, because it seduces smart people into thinking their decisions were terrible, when sometimes they just reflect the unforgiving realities of risk.

Chapter 3: Never Enough (When rich people do crazy things)

- Kurt Vonnegut to his friend Joseph Heller, 'A fund manager made more money in a single day than Heller had earned from his popular novel Catch-22 over its whole history.' Heller replied, 'Yes, but I have something he will never have -- enough.' For many people, a lot of them rich, there seems to be no limit on what is enough.
  - Bernie Madoff built a highly profitable securities firm, but it wasn't enough. The question we should ask is why someone worth hundreds of millions of dollars would be so desperate for more money that they risked everything in pursuit of even more.
  - Warren Buffett: 'There is no reason to risk what you have and need for what you don't have and don't need.'
- The hardest financial skill is getting the goalpost to stop moving.
  - Modern capitalism is a pro at two things: generating wealth and generating envy.
  - Happiness can be defined as results minus expectations.
  - Social comparison is the problem here.
    - The ceiling of social comparison is so high that virtually no one will ever hit it. It is a battle that cannot be won.
- "Enough" is not too little.
  - Enough is realizing that an insatiable appetite for more will push you to the point of regret.
- There are many things not worth risking, no matter the potential gain.
  - Your reputation
  - Your freedom and independence
  - Family and friends
  - Your happiness
- ...the key is knowing when it's time to stop taking risks that might harm them.

Chapter 4: Confounding Compounding ($81.5B of Warren Buffet's $84.5B net worth came after his 65th birthday)

- History of the ice ages can teach us about money
  - It wasn't until the 19th century that scientists agreed the earth had, on multiple occasions, been covered with ice.
    - In the 1900s a scientist correctly theorized how this happened.
    - The gravitational pull of the sun and moon change the tilt of the earth's axis slightly in cycles lasting tens of thousands of years.
    - This created moderately cooler summers and not all of the previous winter's ice melted.
    - The following winter more ice was added and the remaining ice grew ever larger each summer.
    - Over time the ice grew into a continental ice sheet and an ice age started.
  - The compounding of ice each year eventually created (and later reduced) an ice age.
  - The key here is how big something can grow over time from a relatively small change in conditions.
- If something compounds a small starting base, it can lead to extraordinary results that seem to defy logic.
  - The real secret of Warren Buffett's success is that he has been a good investor over 75 years. Had he started later and stopped sooner, no one would have heard of him.
  - Compounding works by smart investing over time, not constantly changing your targets.
- The practical takeaway of all this is that the counter-intuitiveness of compounding may be responsible for the majority of disappointing trades, bad strategies, and successful investing attempts.
- Good investing isn't about the best returns, but earning pretty good returns over a long time. The highest returns tend to be one-off hits that can't be repeated.

Chapter 5: Getting Wealthy and Staying Wealthy (Good investing is not necessarily about making good decisions, but about consistently not screwing up)

- Getting money is one thing - keeping it is another. Both require different skills.
  - Getting money requires taking risks, being optimistic, putting yourself out there.
  - There is only one way to stay wealthy - some combination of frugality and paranoia.
  - Keeping money requires humility and fear that it can be taken away, i.e. frugality and an acceptance that at least some of what you made is attributable to luck.
- There are two reasons why a survival mentality is so key with money.
  1. Few gains are so great that they are worth wiping yourself out over.
  2. The counter-intuitive math of compounding.
     - Compounding only works if you give it time.
     - Warren Buffett didn't get carried away with debt, he didn't panic and sell during recessions, he didn't attach himself to one strategy or trend, he didn't rely on others' money, he didn't burn himself out and quit.
- You need to hold enough cash to survive downturns and cash needs, without having to sell your primary investment.
- The most important part of any plan is to plan on the plan not going to plan.
  - A plan is only useful if it can survive reality.
  - Room for error, i.e. margin of safety is required.
- A mindset that can be paranoid and optimistic at the same time is hard to maintain, but you need short-term paranoia to keep you alive long enough to exploit long-term optimism.

Chapter 6: Tails You Win (You can be wrong half the time and still make a fortune)

- Long statistical tails in finance have tremendous influence, where a small number of events can account for the majority of outcomes.
    - By 1938 Disney had produced several hundred hours of film, but - in business terms - only the last 83 minutes of Snow White mattered - this was the giant hit that dwarfed all previous misses..
    - Effectively all of the Russell 3000 stock companies returns came from 7% of the companies, and 40% of them lost 70% of their value. Yet, the Russell 3000 has increased 73-fold since 1980, i.e. success.
    - The idea that a few things account for most results is true for your portfolio and should be part of your own behavior as an investor.
    - The decisions you make today or tomorrow will not matter nearly as much as what you do during the small number of days (<1%) when everyone around you is going crazy.
        - How you behaved as an investor during the few months in late 2008 and early 2009 will likely have more impact on your lifetime returns than everything you did between 2000 and 2008.
    - If tails drive everything, then there will be much that won't go as you predicted.
    - George Scoros: 'It's not whether you are right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong.'

Chapter 7: Freedom (Controlling your time is the highest dividend money pays)

- Most people want to control their lives and money can help with this.
    - Angus Campbell: 'Having a strong sense of controlling one's life is a more dependable predictor of positive feelings of well being than any of the objective conditions of life we have yet considered.'
- Using money to buy time and options has a lifestyle benefit few luxury goods can compete with.
- Aligning money towards a life that lets you do what you want, when you want, with who you want, where you want, for as long as you want, has incredible return.

Chapter 8: Man in the Car Paradox (No one is impressed with your possessions as much as you are)

- People tend to want wealth to signal to others that they should be liked and admired. 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.
- Humility, kindness, and empathy will bring you more respect than horsepower ever will.

Chapter 9: Wealth is What You Don't See (Spending money to show people how much money you have is the fastest way to have less money)

- We rely on outward appearance to gauge financial success, but wealth is what you don't see. Wealth is financial assets that haven't yet been converted into the stuff you see.
- The way to be rich is to spend a portion of the money you have, and not spend the money you don't have, i.e. borrow.
    - Rich is current income and wealth is the assets that allow for that cash flow.
    - Diet and exercise analogy: Exercise is like being rich, while wealth is like turning down that treat meal and actually burning net calories.
- People are good at learning by imitation (noticing the rich people), but the hidden nature of wealth makes it hard to imitate.

Chapter 10: Save Money (The only factor you can completely control generates one of the only things that matters.)

- Building wealth has little to do with your income or investment returns, and lots to do with your saving rate.
- In the 1970s it looked like we were running out of oil. The biggest reason we overcame the oil crisis is we started building things to be more efficient.
    - Finding more energy is largely out of our control, while conservation and efficiency is what we can do best.
- People do need to be convinced to save money.
- Personal savings and frugality are parts of the money equation that are in our control.
    - Wealth is the accumulated leftovers after you spend what you take in.
        - You can build wealth without a high income, but not without a high savings rate.
        - A high savings rate means having lower expenses, and having lower expenses means your savings go farther than they would if you spent more.
- Past a certain level of income, what you need is just what sits below your ego.
    - When you define savings as the gap between your ego and your income, you realize why many people with decent incomes save so little.
- Savings is a hedge against life's inevitable ability to surprise the hell out of you at the worst possible moment.
- Saving without a spending goal gives you options and flexibility, the ability to wait and the opportunity to pounce, along with the ability to withstand setbacks without touching your investment.
- The flexibility and control over your time is an unseen return on wealth.

Chapter 11: Reasonable > Rational (Aiming to be mostly reasonable works better than trying to be coldly rational)

- Academic finance planning is rational and devoted to finding the mathematically optimal investment strategies.
- People are neither rational nor irrational - they are human. We don't like to think harder than we need to, and we have unceasing demands on our attention.
    - In the real world people want strategies that maximizes how well they sleep at night.
- We tend to love our investments - which is not a rational, emotionless way to choose decisions affecting our future. However, lacking emotion about your investment strategy also means you are more likely to abandon those same investments when things become difficult - the opposite of your initial strategy of 'buy and hold'.
    - There are few financial variables more correlated to performance than commitment to a strategy during its lean years.
    - if you Invest in a promising company you don't care about, then the path of least resistance is to abandon it during hard times when it is not making money for you.
- Day trading and picking individual stocks is not a rational action for most investors - that is why index funds were created - and the odds are heavily against your success. However, it is human nature to try and predict what will happen in the short term. Here again people will tend to be reasonable, rather than strictly rational.

Chapter 12: Surprise! (History is the study of past change, ironically used as a map of the future)

- Things that have never happened before happen all the time. History is not a map to the future.
- Most scientists use history as a guide to predicting the future, but investing is not a hard science, but a massive group of people making imperfect decisions with limited information about things that will have a massive impact on their well-being.
- The cornerstone of economics is that things change over time. Experience leads to over confidence more than forecasting ability.

- Dangerous things can happen when you rely too heavily on investment history.
  - You'll likely miss the outlier events that move the needle the most. The 'big tail' events and people.
    - The future is fueled less by analysis and more by imagination - a skill not looked upon kindly by the financial forecasting community.
    - The correct lesson to learn from surprises is that the world is surprising.
    - The unprecedented nature of surprises means that we won't be prepared for them.
  - History can be a misleading guide to the future of the economy and stock market because it doesn't account for structural changes that are relevant to today's world.
    - Personal financial advice and analysis of saving is not comparable to past advice because of new options not available in the past (401k). Most historical data is out of date.

Chapter 13: Room for Error (The most important part of any plan is planning on your plan not going according to plan)

- Some of the best examples of smart financial behavior can be found in 'card counters' playing blackjack.
  - Although card counting is statistically proven to work, it does not guarantee you will win every hand. We must make sure we have enough money to withstand any swings of bad luck.
- Almost everything related to money exists in a world that is governed by odds, and a margin of safety leaves you room for error.
  - People want certainty and will follow someone who promises a specific result before they follow someone who speaks in probabilities.
  - The world of finance is not a world of certainties.
- Two things cause us to avoid thinking about room for error.
  1. We feel someone must know what the future holds, because we don't want to think the future is completely unknown.
  2. If you believe 1. then you are doing yourself harm by not taking actions exploiting that knowledge and you want to maximize your gain.
- Places to think about room for error.
  - Volatility - can you survive your assets declining 30% in value?
  - Saving for retirement - are you targeting a specific amount, rather than a range of outcomes?
- Risk is necessary to get ahead, but no risk that can wipe you out is worth taking.
  - Leverage can be a real problem, i.e. taking on debt to make your money go further increases your risk.
- If many things rely on one thing working you better have a plan for what to do if that thing fails (single points of failure).
  - The biggest single point of failure with money is a sole reliance on a paycheck to fund short-term spending needs, with no savings available.

Chapter 14: You'll Change (Long term planning is harder because people's goals and desires change over time)

- An underpinning of psychology is that people are poor forecasters of their future selves.
  - People from 18-68 underestimate how much they will change in the future.
- Long-term financial planning is essential, but things change...
  - Going in - we should avoid the extreme ends of financial planning, making change easier later on.
  - We should also accept the reality of changing our minds.
    - Don't hold future decisions 'prisoner' to past decisions.

Chapter 15: Nothing's Free (Everything has a price, but not all prices appear on labels)

- The price of successful investing is market volatility, fear, doubt, uncertainty, and regret - all of which are easy to overlook until you are dealing with them in real time.
    - This price is not immediately obvious, but when your wealth is declining you want to do something/anything to get it to stop declining.
- An unsuccessful alternative is to try and anticipate volatility and downturns, timing their investment sales and buys. History shows these people do less well than those who choose what they believe in and simply hold on while the market fluctuates around them.

Chapter 16: You & Me (Beware taking financial cues from people playing a different game than you are)

- Financial bubbles keep happening and we don't seem to be able to learn from them. Why? It is not just greed.
- There is a false notion that assets have one rational price in a world where investors have different goals and time horizons.
    - Are you looking at a 30yr, 10yr, or 1day horizon?
    - If you are a day trader the price doesn't matter, just so long as that day's trading goes in the direction you want it to.
    - If you are holding for a 30yr return it very much matters what the current price is and how it relates to the company and industry.
    - You have to know what type of investor the person you are following is talking to.
- An iron rule of finance is that money chases returns to the greatest extent it can.
    - When an asset has momentum it will attract day traders.
    - Bubbles form when the momentum of short-term returns attracts enough money that the makeup of investors shifts from mostly long-term to mostly short-term. For the housing market we had an influx of people interested only in 'flipping the house' as their housing goal, pushing housing prices ever upward. Long term values didn't matter.
    - When a long-term investor starts taking cues from the short-term traders, problems really begin to compound.
    - Another anchor of psychology is that it is hard to grasp that other investors have different goals than we do. This leads to listening to 'experts' we think are talking directly to us, when they are not.
    - Much consumer spending is socially driven: subtly influenced by people we admire. These people frequently don't have the same goals or limitations we do, but they do influence our decisions.
    - The best defense is to understand your own time horizon, while realizing others may not think like you.

Chapter 17: The Seduction of Pessimism (Optimism sounds like a sales pitch, while Pessimism sounds like someone trying to help you)

- Optimism is a belief that the odds of a good outcome are in your favor over time, even with setbacks. The world tends to get better for most people most of the time.
- The asymmetric aversion to loss is an evolutionary shield. Organisms that treat threats as more urgent than opportunities have a better chance to survive and reproduce.
- Forecasts of great optimism are rarely taken as seriously as are prophets of doom. Newsrooms have known this and lead with disaster stories.
- Money is ubiquitous, so something bad happening tends to affect everyone and captures everyone's attention, while good things generally only affect people locally.
- In a connected system where one person's decisions can affect everyone else, financial risks capture attention in a way few other topics can.

- An iron law of economics: extremely good and extremely bad circumstances rarely stay that way for long because supply and demand adapt in hard to predict ways.
    - Pessimists often extrapolate present trends without accounting for how markets adapt.
    - Threats incentivise solutions in equal magnitude.
- Progress (optimism) happens in too slowly to notice, but setbacks happen too quickly to ignore.

Chapter 18: When You'll Believe Anything (Why stories are more powerful than statistics)

- Stories are the most powerful force in the economy. They are the fuel that can let the tangible parts of the economy work, or press the brakes that hold our capabilities back.
    - 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.
    - The bigger the gap between what you want to be true and what you need to be true to have an acceptable outcome, the more you are protecting yourself from falling victim to an appealing financial fiction.
- There is no greater force in finance than 'room for error', and the higher the stakes, the wider it should be.
- We tell ourselves stories to fill in the gaps of what are effectively blind spots.
- Stories are about how much control we have...
    - When planning we focus on what we want to do and what we can do, neglecting the plans and skills of others whose decisions might affect our outcomes.
    - Both in explaining the past and predicting the future, we focus on the casual role of skill and neglect the role of luck.
    - We focus on what we know and neglect what we don't know, making us overly confident in our beliefs.

Chapter 19: All Together Now (What we've learned about the psychology of our own money)

- Go out of your way to find humility when things are going right and forgiveness/compassion when they go wrong. It's never as good or bad as it looks.
- Less ego, more wealth. No matter how much you earn, you will never build wealth unless you can put a lid on spending the money you have today.
- 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 increase your time horizon.
- You can be wrong half the time and still make a fortune. Become OK with a lot of things going wrong.
- Be nicer and less flashy. No one is as impressed with your possessions as you are.
- Use money to gain control over your time.
    - 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 (the gap between what could happen and what you need to happen).
- Avoid the extreme ends of financial decisions.
- Define the game you are playing and don't assume others are playing that same game.

Chapter 20: Confessions (What works for me - the author)