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The Psychology of Money

(Timeless lessons on wealth)

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Abstract:

Two topics impact everyone, whether you are interested in them or not: health and money. The health care industry is a triumph of modern science, with rising life expectancy across the world. Scientific discoveries have replaced doctors' old ideas about how the human body works, and virtually everyone is healthier because of it.The money industry—investing, personal finance, business planning—is another story. Finance has scooped up the smartest minds coming from top universities over the last two decades. Financial Engineering was the most popular major in Princeton's School of Engineering a decade ago. Is there any evidence it has made us better investors?

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1. Introduction

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. Through collective trial and error over the years we learned how to become better farmers, skilled plumbers, and advanced chemists. But has trial and error taught us to become better with our personal finances? Are we less likely to bury ourselves in debt? More likely to save for a rainy day? Prepare for retirement? Have realistic views about what money does, and doesn't do, to our happiness? Most of the reason why, I believe, is that we think about and are taught about money in ways that are too much like physics (with rules and laws) and not enough like psychology (with emotions and nuance).

2. Luck & Risk

Luck and risk are siblings. They are both the reality that every outcome in life is guided by forces other than individual effort. NYU professor Scott Galloway has a related idea that is so important to remember when judging success—both your own and others': "Nothing is as good or as bad as it seems." Luck and risk are both the reality that every outcome in life is guided by forces other than individual effort. They are so similar that you can't believe in one without equally respecting the other. They both happen because the world is too complex to allow 100% of your actions to dictate 100%
of your outcomes. They are driven by the same thing: You are one person in a game with seven billion other people and infinite moving parts. The accidental impact of actions outside of your control can be more consequential than the ones you consciously take. But both are so hard to measure, and hard to accept, that they too often go overlooked. For every Bill Gates there is a Kent Evans who was just as skilled and driven but ended up on the other side of life roulette.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. Years ago, I asked economist Robert Shiller, who won the Nobel Prize in economics, "What do you want to know about investing that we can't know?" The exact role of luck in successful outcomes," he answered. I love that response, because 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. If I say, "There are a billion investors in the world. By sheer chance, would you expect 10 of them to become billionaires' predominantly off luck?" You would reply, "Of course." But then if I ask you to name those investors—to their face—you will likely back down. When judging others, attributing success to luck makes you look jealous and mean, even if we know it exists. And when judging yourself,

attributing success to luck can be too demoralizing to accept. Economist BhashkarMazumder has shown that incomes among brothers are more correlated than height or weight.

There are so many examples of this.
Countless fortunes (and failures) owe their outcome to leverage.
The best (and worst) managers drive their employees as hard as they can.
"The customer is always right" and "customers don't know what they want" are both accepted business wisdom.
The line between "inspiringly bold" and "foolishly reckless"
can be a millimeter thick and only visible with hindsight.
Risk and luck are doppelgangers.
This is not an easy problem to solve. The difficulty in identifying what is luck, what is skill, and what is risk is one of the biggest problems we face when trying to learn about the best way to manage money.
But two things can point you in a better direction.

Be careful who you praise and admire. Be careful who you look down upon and wish to avoid Becoming.
Therefore, focus less on specific individuals and case studies and more on broad patterns

3. Getting Wealthy vs. Staying Wealthy

1. 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. No one wants to hold cash during a bull market. They want to own assets that go up a lot. You look and feel conservative holding cash during a bull market, because you become acutely aware of how much return you're giving up by not owning the good stuff. Say cash earns 1% and stocks return 10% a year. That 9% gap will gnaw at you every day. But if that cash prevents you from having to sell your stocks during a bear market, the actual return you earned on that cash is not 1% a year—it could be many multiples of that, because preventing one desperate, ill-timed stock sale can do more for your lifetime returns than picking dozens of big-time winners. Compounding doesn't rely on earning big returns. Merely good returns sustained uninterrupted for the longest period of time—especially in times of chaos and havoc—will always win.

2. Planning is important, but the most important part of every plan is to plan on the plan not going according to plan.

What's the saying? You plan, God laughs. Financial and investment planning are critical, because they let you know whether your current actions are within the realm of reasonable. But few plans of any kind survive their first encounter with the real world. If you're projecting your income, savings rate, and market returns over the next 20years, think about all the big stuff that's happened in the last 20 years that no one could have foreseen: September 11th, a housing boom and bust that caused nearly 10 million Americans to lose their homes, a financial crisis that caused almost nine million to lose their jobs, a record-breaking stock-market rally that ensued, and a coronavirus that shakes the world as I write this. A plan is only useful if it can survive reality. And a future filled with unknowns is everyone's reality. A good plan doesn't pretend this weren't true; it embraces it and emphasizes room for error. The more you need specific elements of a plan to be true, the more fragile your financial life becomes. If there's enough room for error in your savings rate that you can say, "It'd be great if the market returns 8%a year over the next 30 years, but if it only does 4% a year, I'll still be OK," the more valuable your plan becomes. Many bets fail not because they were wrong, but because they were mostly right in a situation that required things to be exactly right. Room for error—often called margin of safety
—is one of the most underappreciated forces in finance. It comes in many forms: A frugal budget, flexible thinking, and loose timeline—anything that lets you live happily with a range of outcomes. It's different from being conservative. Conservative is avoiding a certain level of risk. Margin of safety is raising the odds of success at a given level of risk by increasing your chances of survival. Its magic is that the higher your margin of safety, the smaller your edge needs to be to have a favorable outcome.

3. A barreled personality—optimistic about the future, but paranoid about what will prevent you from getting to the future—is vital.

Optimism is usually defined as a belief that things will go well. But that's incomplete. Sensible optimism is a belief that the odds are in your favor, and over time things will balance out to a good outcome even if what happens in between is filled with misery. And in fact, you know it will be filled with misery. You can be optimistic that the long-term growth trajectory is up and to the right, but equally sure that the road between now

and then is filled with landmines, and always will be. Those two things are not mutually exclusive. The idea that something can gain over the long run while being a basket case in the short run is not intuitive, but it's how a lot of things work in life. By age 20 the average person can lose roughly half the synaptic connections they had in their brain at age two, as inefficient and redundant neural pathways are cleared out. But the average 20-year-old is much smarter than the average two-year-old. Destruction in the face of progress is not only possible, but an efficient way to get rid of excess.

4. Wealth is What You Don't See

Money has many ironies. Here's an important one: Wealth is what you don't see. 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. There are, of course, wealthy people who also spend a lot of money on stuff. But even in those cases what we see is their richness, not their wealth. We see the cars they chose to buy and perhaps the school they choose to send their kids to. We don't see the savings, retirement accounts, or investment portfolios. We see the homes they bought, not the homes they could have bought had they stretched themselves thin. The danger here is that I think most people, deep down, want to be wealthy. They want freedom and flexibility, which is what financial assets not yet spent can give you. But it is so ingrained in us that to have money is to spend money that we don't get to see the restraint it takes to actually be wealthy. And since we can't see it, it's hard to learn about it.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 cherished 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. Imagine how hard it would be to learn how to write if you couldn't read the works of great authors. Who would be your inspiration? Who would you admire? Whose nuanced tricks and tips would you follow? It would make something that is already hard even harder. It's difficult to learn from what you can't see. Which helps explain why it's so hard for many to build wealth. The world is filled with people who look modest but are actually wealthy and people who look rich who live at the razor's edge of insolvency. Keep this in mind when quickly judging others' success and setting your own goals.

It is excellent advice, but it may not go far enough. The only way to be wealthy is to not spend the money that you do have. It's not just the only way to accumulate wealth; it's the very definition of wealth. We should be careful to define the difference between wealthy and rich. It is more than semantics. Not knowing the difference is a source of countless poor money decisions.

5. Save Money

Let me convince you to save money.
It won't take long.
But it's an odd task, isn't it?
Do people need to be convinced to save money?
My observation is that, yes, many do.

The first idea—simple, but easy to overlook—is that building wealth has little to do with your income or investment returns, and lots to do with your savings rate.
Investment returns can make you rich. But whether an investing strategy will work, and how long it will work for, and whether markets will cooperate, is always in doubt. Results are shrouded in uncertainty. Personal savings and frugality—finance's conservation and efficiency—are parts of the money equation that are more in your control and have a 100% chance of being as effective in the future as they are today. If you view building wealth as something that will require more money or big investment returns, you may become as pessimistic as the energy dormers were in the 1970s. The path forward looks hard and out of your control. If you view it as powered by your own frugality and efficiency, the destiny is clearer. Wealth is just the accumulated leftovers after you spend what you take in. And since you can build wealth without a high income, but have no chance of building wealth without a high savings rate, it's clear which one matters more. More importantly, the value of wealth is relative to what you need.
Say you and I have the same net worth. And say you're a better investor than me. I can earn 8%annual returns and you can earn 12% annual returns. But I'm more efficient with my money. Let's say I need half as much money to be happy while your lifestyle compounds as fast as your assets. I'm better off than you are, despite being a worse investor. I'm getting more benefit from my investments despite lower returns. The same is true for incomes. Learning to be happy with less money creates a gap between what you have and what you want—similar to the gap you get from growing your paycheck, but easier and more in your control. A high-savings rate

means having lower expenses than you otherwise could, and having lower expenses means your savings go farther than they would if you spent more. Think about this in the context of how much time and effort goes into achieving 0.1% of annual investment outperformance—millions of hours of research, tens of billions of dollars of effort from professionals—and it's easy to see what's potentially more important or worth chasing. There are professional investors who grind 80 hours a week to add a tenth of a percentage point to their returns when there are two or three full percentage points of lifestyle bloat in their finances that can be exploited with less effort. Big investment returns and fat paychecks are amazing when they can be achieved, and some can achieve them. But the fact that there's so much effort put into one side of the finance equation and so little put into the other is an opportunity for most people. And you don't need a specific reason to save. Some people save money for a down payment on a house, or a new car, or for retirement. That's great, of course. But saving does not require a goal of purchasing something specific. You can save just for saving's sake. And indeed, you should. Everyone should. Only saving for a specific goal makes sense in a predictable world. But ours isn't. Saving is a hedge against life's inevitable ability to surprise the hell out of you at the worst possible moment. Another benefit of savings that isn't attached to a spending goal is what we discussed in chapter 7: gaining control over your time. 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. Savings without a spending goal gives you options and flexibility, the ability to wait and the opportunity to pounce. It gives you time to think. It lets you change course on your own terms. Every bit of savings is like taking a point in the future that would have been owned by someone else and giving it back to yourself.

REFERENCES:

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