Why Smart People Make Big Money Mistakes – Gary Belsky & Thomas Gilovich

Notes and Takeaways

- This is an optimistic book written by a pair of realists
- Mental Accounting (Treating same dollars differently)
    - Mental accounting (MA) is the tendency to value some dollars less than others and thus waste them
        - Inheritance, bonus, tax refund, etc.
    - Scenario MA 1;
        - A) Imagine you spent $150 to go to a football game with friends, then at the gate you realize you lost your ticket, do you spend another $150 to get in?
        - B) Now imagine you lost $150 in cash on the way to the gate to buy a ticket but still have plenty to buy a ticket, do you?
        - In both scenarios you are out $150, so why is it statistically more likely that people would not buy a ticket in the first scenario, but likely would in the second?
        - Treating essentially two equal $150 losses in very different ways because they occur in different manners is a classic example of mental accounting
    - Scenario MA 2;
        - A) Imagine going to the store to buy a lamp for $100. At the store you discover that four blocks away you could get the lamp for $75, do you go to the other store?
        - B) Now imagine that you are going to the same store to buy a dining room set for $1,775. At the store you discover that four blocks away you can get the same set for $1750, do you go to the other store?
        - In both scenarios the difference is $25 however in scenario A you are far more likely to go the 4 blocks
    - Another example of mental accounting is compartmentalizing money into different accounts, savings, investment, "safe"
        - They are all the same dollars, only mentally treated differently
    - "Reimbursements send people to the bank. Bonuses send people to the Bahamas."
    - How to get around this is to remind yourself that no matter what - a dollar is a dollar- and look at it from an ambivalent perspective
        - Break purchases up into parts especially when doing construction, buying a car, or spending more on something

- If it is all still hard, use mental accounting to your advantage by funneling money into "categories" that you feel less comfortable touching
  - Savings, investments, etc.

Prospect Theory (PT) (Loss aversion over gain)

- Framing a problem is important, see below
- Scenario PT 1;
  - A) A virus breaks out in a small town of 600, drug A saves 200, drug B has 1/3 chance that all are saved and 2/3 chance none will, which do you choose?
  - B) Same virus, same 600 people, drug A 400 people will die, drug B has 1/3 chance that all are saved and 2/3 chance none will, which do you choose?
  - Both scenarios are the same with same odds, but A) drug A says 200 will live, versus in B) drug A says 400 will die – framing is important
    - The study showed that people were likely to pick Drug A in the first case, and drug B in the second case
- If we apply the above scenario to financial matters, this phenomenon results in a willingness to take more risk if it means avoiding a sure loss and to be more conservative when given the chance to lock in a sure gain
- Scenario PT 2;
  - A) Imagine you have been given $1,000 and have two options
  - option 1) you are guaranteed to win $500
  - option 2) you flip a coin to win another $1000 or nothing more, what do you choose?
  - B) Imagine you have been given $2,000 and have two options, option 1 you are guaranteed to lose $500, option 2 you flip a coin if it's heads you lose $1,000 tails lose nothing, what do you choose?
  - Again mathematically both scenarios are the same
    - The study shows that most people choose option 1 in the first scenario and option 2 in the second
    - This shows a willingness to avoid losses
  - Traditional economics would say that you are indifferent between option 1 and option 2 in both scenarios
- A typical American family does not see a $5,000 loss or gain as a small percentage of their net worth, rather they see it as $5,000 they did or didn't have five minutes ago
- Framing is important – to save 20% is to lose that from your income, to live on 80% of your income is to do without what you would gain from that last 20%

- **People feel more strongly about the pain that comes with loss than they do about the pleasure than comes with an equal gain**
  - Better to care more about falling too far when climbing a tree in search of plumper fruit at the top
- Oversensitivity to loss can have catastrophic effects
  - Being especially sensitive to losses contributes to the panic selling that accompanies stock market crashes (2020)
- Pulling your money out of the market on the basis of facing too much pain leaves you vulnerable to a different sort of pain – the pain you feel when stocks rise while you are licking your wounds
- Although stocks would seem to rise steadily over time, in truth they actually do it in major fits and starts – a few big gains on a small number of days sprinkled throughout the year
  - By pulling your money out in reaction to short term drops, you run the risk of missing productive days
  - Missing the 90 best performing days of the market from 1963 to 2004 or LESS THAN 1% OF THE MARKET DAYS OPEN would take an 11% annual return to 3% OR 72% REDUCTION IN RETURN
- Being overly sensitive to pain of losing money can make us too quick to abandon investments and can be catastrophic to building long term wealth
- **The richer and older you are the more likely it is you will react strongly to prospect loss**
  - Mid sixty year olds need to remember it is very feasible that they would live for another 2-3 decades and need to have a long term view even in retirement
- People need to assume that they are more sensitive to loss aversion than they think
  - Something to help with this is writing down what you think you would be comfortable with and then have a professional analyze what needs to be done in order to meet that goal
- Need to continually ask yourself would you buy the same investment today at the existing price
- Surveys show that nearly 50% of investors check on their investments at least once a week – this tends to make the ups and downs much more felt and for the investor to be likely to have emotion get involved
  - Checking once a month or once a quarter can help with this

Regret Aversion(RA)

- People often will make decisions, or not make decisions if they link those choices to future regret
- Scenario RA1;
  - Mr. A waiting in line at the grocery to buy food. As he checks out he is told he is the 1 millionth customer and receives $100 dollars
  - Mr. B is in line at a different grocery, the person in front of him is the 1 millionth customer and he receives $1 million dollars, Mr. B wins $150
- Given the choice of both scenarios, most choose to be Mr. A even though they would end up with $50 dollars less
  - This is regret aversion – people will pay good money all the time to avoid the feeling of regret or to otherwise maintain the status quo
- Deciding not to decide is also a decision and with it can come regret
  - Postponement, delay, and procrastination may seem like the path of least resistance, but a passive approach to decision making can be as consequential as any other choice
- A good way to overcome decision paralysis is to set deadlines
  - An even better way is to give someone you trust the power to pick those deadlines for you
- A simple way to make decisions more easily is to change your frame of reference

Gambler's Fallacy

- This is the false notion that three heads in a row means a tails is "due"
- People move stats and probability to the side when emotion enters and sways decision making
- This can be seen regularly in stocks
  - It has gone down again, it is so cheap, it must be a good by at $XX price – until it goes bankrupt

Anchoring and The Power of Suggestion

- Anchoring is when a price or value is already planted in a person's mind prior to transacting
  - What this does is set a bias to be skewed around that number
- Countless studies have shown that people will glom on to meaningless numbers even after the numbers are shown to be irrelevant to the decision
  - Example: Kahneman asked students how many African nations in the UN, but before they answered he would spin a wheel of fortune wheel with numbers on it, and then they would have to respond if it was higher or lower than the number

    - The data showed that people's answers were strongly influenced by the number
  - Another example is when Uri Simonsohn was able to show with data that people were not able to shake previous real estate prices when moving to an entirely new state or area
    - Newcomers from more expensive areas rented or bought higher end
    - The opposite was also found
- Confirmation Bias
  - When a person seeks data or opinion that is in agreement with their opinion already set this is confirmation bias
  - It builds a false sense of confidence as it confirms what was already the assumption
  - Confirmation bias can affect almost any decision we make, which makes it one of the most dangerous
    - It can operate in the subconscious and not even bubble to the surface at times
    - Example: you own a business and are looking to hire someone, you love the Chicago Bears and golf, if one of the four applicants mentions how much of a fan they are of both, you will show more openness to that person and will tend to treat that person differently from the other three
  - When people start to develop preferences – even small ones – they tend to view new information that doesn't fit their preconceived notion as useless or uninformed and discount it
    - Think of politics on both sides or a close sports play, depending on what team you support you will see evidence to support what you want the outcome to be
  - People will reflectively try to prove a rule by looking for facts that would support it rather than looking for information that might contradict it
- The Ego Trap
  - You probably are not as smart as you think you are
  - Overconfidence is pervasive, even among people who presumably have good reason to think highly of themselves
  - Overconfidence is not always arrogance
    - It often appears as unrealistically high appraisals of our own qualities versus those of others
    - Example: survey in 1981 of Swedish drivers, 90% said they were above-average

- Being overconfident in other areas of life tends to flow over to finances where people tend to think they are in better shape than they really are
    - Average individual investor who invests in mutual funds consistently fares much worse than the average mutual fund performance
- With this excessive self-confidence,trait a little knowledge can lead to large overconfidence if not careful

Herd Mentality

- Conformity often results from uncertainty
    - We follow others because we don't know what to do
- As more and more people glom onto an idea it builds on itself
- The more people seem to buy into something the more viable the idea seems
    - Look to recognize when this is occurring and realize your views could be influenced
- The more one is on social media or watches the news, the more likely they are to be influenced by the herd
    - Example: not knowing where the Dow was could just as easily be a sign of investing intelligence as investing ignorance
- In the stock market there are daily reminders of herd mentality (simple fact markets are open every day)
    - Hot trends in investments that the media touts
- Long term investors need not concern themselves with yesterday's closing price or tomorrow's quarterly earnings
- Best way to avoid groupthink, is to establish rules of conduct for certain situations before encountering them

Emotional Baggage

- Emotions are partners in all decision making processes that we've been discussing
- How we feel affects how we act on any given day
    - How you feel can affect how you think (As a Man Thinketh)
- How often do "gut" feelings dictate some sort of action from us? The answer is generally very often
- Fear and anxiety are some of the biggest emotions that impact our decisions
    - When we have these feelings about one thing, it is easy to color your view of other things
- In a study by Delgado and Porcelli, it was discovered that stressed out students were more likely to take risk when facing the prospect of loss, and likelier to be more conservative when deciding between large and small gains
- Feelings of shame or guilt are also powerful

        - The example of the goalkeeper in penalty kicks, who statistically has a better chance of stopping the goal by not moving than jumping one way or the other
            - However due to the perceived in-action goalies choose the lower odds and pick a side because at least they tried
            - Now this is worth noting that if it was known a goalie never moved it would be easy to score on them
    - Durability bias is an important tendency
        - It is the tendency to assume that moods, especially negative ones, will last longer than they do