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Behavioral Finance

Eskimos, Snow and Risk

Eskimos have many names for snow – they ought to, they live with it long enough. But for those who live in temperate climates, one word, snow, usually suffices.

It feels that way when I read financial press about Risk. All the complexities and nuances of financial markets are neatly boiled down to two concepts: Risk and Return. And some commentators even embellish them with adjectives: "Enormous Risk" or "Amazing returns".

Years ago I read Peter Bernstein's wonderful book: Against All Odds – the history of Risk. And over the years I have attended many insightful seminars on Risk. And as a professional investor I have learned that we need to look at "risk" in a more granular manner – like Eskimos look at "snow" in its different forms.

For example: There is risk, but there is also: uncertainty, there are probabilities, standard deviations, Sorrentino variance, asymmetrical outcomes, fat tails, drawdowns, Bankruptcy, Black Swans, etc. To my way of thinking these are different ways to look at Risk. And knowing these nuances helps to make better investment judgements and decisions.

Yes, like the word snow, the word risk is good enough for daily vernacular; but that's it. As I often quip: If an electrician confuses the terms "volts" with "watts" because they have to do with electricity and kind of sound the same, you likely have a very dead electrician.

Why Behavioral Finance is important

Professional investing, in my experience, needs three ingredients: Fundamentals analysis, good Judgement, and a dollop of luck. And, Behavioral Finance is a powerful judgement sharpener; therein lies its importance.

Nobel Prize winner Daniel Kahneman once quipped at a speech I attended that: "I won my Nobel Prize for one word. My thesis was that People are ***predictably*** irrational. If my thesis were: "People are irrational", there would be no news and no prize. But adding (and showing) that they are predictably so, won me the Nobel." Thus started the Behavioral Finance branch of financial theory.

For years his and other scholars' (Thaler, Ariely, Cialdini etc.) insights have served me well as an advisor. Over the years, I have distilled and internalized the key principles of behavioral finance and its related psychology into guideposts for informed decision making. So, I rely on fundamental analysis for researching an investment and let the behavioral finance principles guide my decisions about it.

And while investors are rational people for the most part, there invariably are times of extreme exuberance and extreme pessimism in financial markets and world events. At these times I observe that investors become “predictably irrational”. Warren Buffet picked up on this so many years ago when he wrote his essay about “Mr. Market” and how he has profited from this insight.

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Our Financial Planning Principles

Without a Purpose, accumulating money can become a soul-less task. A financial plan gives your savings a purpose.

It's OK to be broke when you are young - not so when you are old: Studies show that people typically tolerate risk and uncertainty better when they are younger.

Getting down from Mount Everest is as important as getting up: Pay as much attention to consuming your money after you retire as you do to accumulating it before you retire.

Planning is life-stage dependent: The principles of saving and investing money in your early years are very different from the techniques that you use in retirement to generate a reliable income stream.

Financial confidence comes from being on top of your taxes, protecting yourself from risks, having a clear picture of your investments and debt, and specific targets for saving and spending.

Achieving financial independence requires a careful balancing of Income, expenses, taxes, and savings. This balancing act (planning) is not intuitive, nor can it be done well on the back of an envelope, but effective plans do give more peace of mind.

Identify your true risks (in contrast to investment volatility, labelled as risk, or uncertainty) and take action to manage them using the correct risk management tools. Pick the right tools for the job - investments won't manage the risks you face, risk products (insurance) won't deliver the growth and flexibility you need.

Taxes remain important even after you retire. However, in retirement your investments become the principal source of your income and hence drive your taxes.

In matters of health: it's your body but your doctor knows better how your body works. So it is with your money: A partnership with an advisor will help you to reach your financial goals - you save, they help your savings grow. Together you can get there faster.