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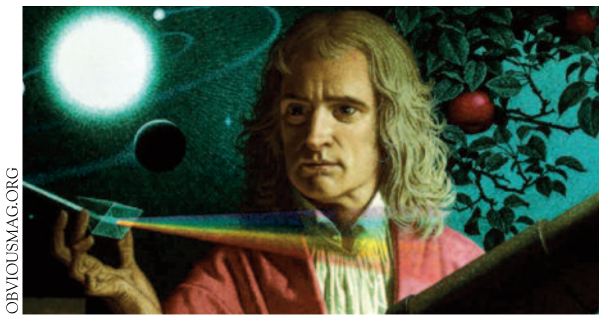
Financial Services

Sound Advice

Why Do Really Smart People Make Really Stupid Decisions About Money?

By Rod Tyler, CFP, R. F. P. , CLU


OBVIOUSMAG.ORG

Over the last few years I have developed a renewed interest in a part of finance called behavioural economics. Using words like this you might conclude that I'm just trying to impress you, or as some of us might say," blowing smoke." I promise you, I am not going to do that. What I am going to do is share with you, in a series of articles, some of the most amazing examples of how seemingly really smart people make really stupid decisions about money. Some of these really smart people you will readily recognize from the past, and some from the present. People such as Mark Twain and Isaac Newton from the past, and a pair of Nobel prize winning mathematicians from recent times. All of this is not intended to poke fun at long dead icons, or of recent examples of celebrities who made really dumb decisions about money. The real purpose is to remind ourselves how easy it is to be blinded by what we believe, and what we think we know, when the truth is that, we are either fooling ourselves or that we think we know more than we really do. Think of it as preventative maintenance against the risk of ruining your financial future.

However, before I begin telling you about some of the great stories of the financial misadventures of the rich and famous, I need to tell you about one of my own financial mistakes. It was a mistake that was obvious to everyone else, just not to me. As many of my friends know, I am a bit of a techie, sometimes a bit too fascinated by recently designed gadgets. In 1995, I became aware of the need to have some kind of computerized system that would take care of tracking all the important information about my client's investments, insurance and other financial planning data. At that point in time there was a limited number of software programs available to do this work. I decided to have a friend, a software engineer, begin writing a program to do just this job. If you have ever been involved with project management, you already know where this is going.

After about four months, and a lot of money paid out, I asked my software engineer to tell me how soon he would have a working model of my dream program. His answer floored me. He thought it would take another 6-12 months, but he couldn't be sure. I simultaneously felt stupid and embarrassed. I told him that I couldn't afford to keep funding this project, and so I wanted him to just junk it. He didn't seem too concerned. He just said that he would look for another programming job, probably with one of the many telecommunication companies working on telephone deregulation. Little did I realize that I was paying huge sums of money to a modern-day inventor, with no obvious working version anywhere in sight. I was simply blinded by my own belief that such a program could be written, without understanding the incalculable cost and time involved. An expensive, but ultimately valuable lesson. I will return to that in a later article.

So now that I have told you that I too, am vulnerable to

making really stupid decisions, albeit with my own money, I will share with you another example of this behavior from history. Then I will reveal how all of this can be so valuable to you, and how you can avoid a few of these really dumb ideas.

Sir Isaac Newton was born over 350 years ago in rural England. Newton's father died before he was born. When his mother remarried, she left Isaac in the care of his maternal grandmother. Isaac proved to be a gifted student, but was often bullied. He was accepted into Cambridge, paying his way by performing the duties of a valet. He subsequently was awarded a scholarship, which guaranteed him the income to complete his Master of Arts degree. Newton's academic career was interrupted in 1665 because of the threat of The Great Plague. That gave him two years to study at home, and he eventually returned in 1667. By then it became apparent that he was a truly gifted student.

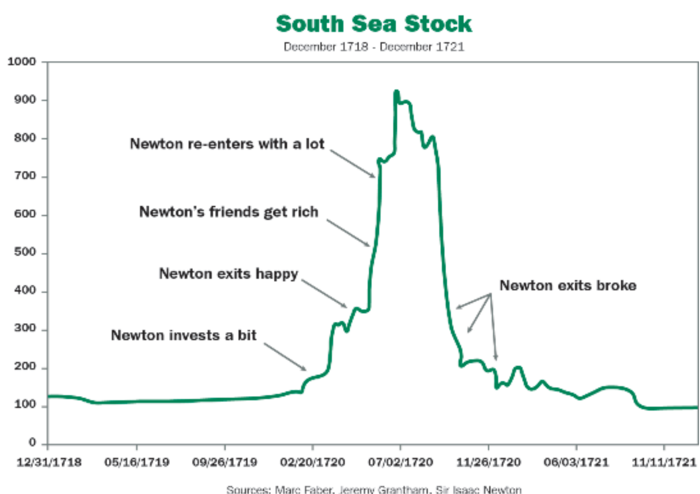
He would eventually be credited as one of the most influential scientists of all time, and came to dominate the study of physics, mathematics and astronomy. His list of accomplishments include the publication of the book entitled **Principia**, in which he formulated the laws of motion and universal gravitation, laws which dominated scientists view of the physical universe for the next 300 years. He was a key contributor to the development of calculus, of optics and built the first practical reflecting telescope. He refined the laws of motion, so that science could now comprehend the behavior of celestial bodies, such as stars, comets and planets. Indeed, Newton is widely credited with the advancement of the scientific revolution. Given such an impressive set of accomplishments, you might conclude that he was equally adept at investing money. Let's check the historical record.

The South Sea Company was established in London in 1711 and was granted a monopoly on trade with South America, in exchange for assuming England's war debts. Historically monopolies are a great way to ensure financial success. The Hudson Bay Company's monopoly of the fur trade in Canada is a good example. The problem was that Spain still dominated South American commerce and British trade with that continent was therefore limited. Nevertheless, Sir Issac Newton remembered his early childhood poverty very well. He really wanted to escape any connection to such a life experience, so he chose to invest in this speculative investment.

If you look at the attached illustration, you can see how his first decision in 1720 to invest money in the South Sea Company may have seemed reasonable. After all, the company possessed a monopoly on all trading with South America. His second decision was even more reasonable. He sold his shares, but not until after tripling his money. Then he watched as the share price of the South Sea company continued to rise. He saw his friends appearing to be making money, while he had chosen to sell out. Overwhelmed by his desire to become wealthy, he bought back his holding in the South Sea Company at even higher prices than before, literally with all his savings of some 20,000 pounds. For a while, it appeared that he was going to be rewarded. Then the South Seas Company share price began to collapse. Before long, his investment became virtually worthless. He eventually sold his shares, leaving him financially destitute. He had succumbed to the age-old emotions of greed and envy and the wish to become instantly rich.

He famously said, **"I can calculate the movement of the stars, but not the madness of men."** He lost 20,000 pounds, which if adjusted for today's monetary value, would be about 2,670,000 British pounds Sterling or $5,473,500 Canadian dollars. A very large sum any way you care to measure it.

However, in the words of Lord Overstone, **"No warning on earth can save people determined to grow suddenly rich."**



The lesson to be learned is that greed can cause you to make very bad investment decisions. Another equally, but unappreciated and important lesson is as follows: **Know what you own.** Sir Issac Newton only knew the people who were involved with the South Sea Company, not the inner workings of what was truly a highly speculative investment. **Compare that to the long term patient ownership of great businesses within your portfolio that supply us with goods and services we all want and need, and are willing to pay for. Think about Apple or Microsoft, Tim Horton's and Burger King, Johnson and Johnson and Nestle. Or a few of the large Canadian banks. The list is a long one, but you get the point.**

You don't need to gamble to become rich. Patience and a well diversified portfolio will do that for you. And finally, avoiding the behaviors of greed and fear will save you from the fate of Sir Issac Newton.

In the next issue of ***Sound Advice***, I will share with you how one of the greatest American humorists of all time described his own investment follies. Until then, I welcome your input. © 2016

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The Definition of Safety

- PART 2 -

By Rod Tyler, CFP, R. F. P. , CLU

In a previous article, *The Definition of Safety Part 1*, I described how each individual's perception of risk is highly influenced by their life experience and personality. I also said that when it comes to deciding on risk, the factor of time is critical. Money needed for short-term goals needs to be secure with regard to principal. That is a short-term concern. In the long term, the real risk shifts to the safety of purchasing power. In this segment, *The Definition of Safety, Part 2*, I want to explore this second form of risk. The risk that your investment income and growth will not keep up with the cost of living.

As many of you probably know, I'm a regular contributor to a newspaper series, *Family Finance*, as published in the *National Post, Leader Post*, and other Post Media newspapers. I also contribute articles to *Grain News*. The advantage of providing commentary for these articles is that I get to read a large number of requests for financial makeovers and advice from readers all across Canada. From reading and speaking with so many people from all walks of life, there are certain recurring themes that appear over and over. Here are two of them:

1. Very few individuals understand the real risk to their financial goals. It is not their fault. They are just regular human beings. More on that later.
2. Most people would benefit from the guidance of a trusted, experienced and dedicated financial advisor, in the same way most of us benefit by consulting with a trusted long-term friend, who has our best interest at heart.

So taken from these comments, here are two examples of how the popular definition of risk is simultaneously misleading, and may actually hurt us.

Let me begin by discussing the example of a young couple, around 35 years of age. If you were to ask that young couple how they would shop for a new home, look for a new restaurant, for a vacation or for a car, they would tell me that they looked it up and

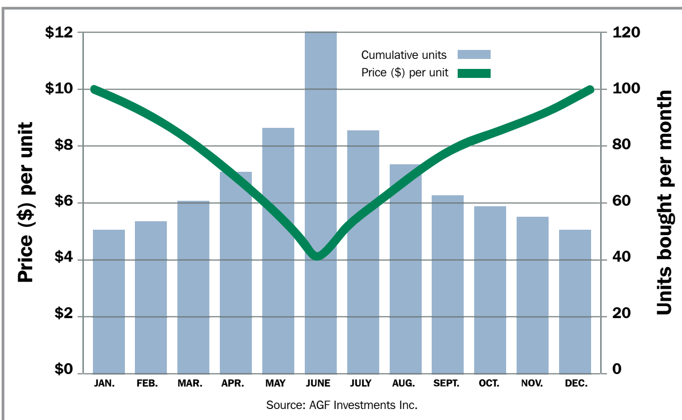
they checked the price on the Internet. They will have checked for what other people reported about a similar purchase or experience. **Translation - they are comparison shopping.** In this respect they know how to find a bargain. And chances are good that they will order things from Amazon, and have them delivered to their home in the next few days, or sooner! In that respect, they are just acting rationally. In another situation, they may buy at Walmart or Winners, or some other similar discount store. Regardless, they are looking for value for their money.

Now let's switch the situation. Instead of shopping for everyday items they want, need and are willing to pay for, they're trying to decide how to save for their child's education, or for their own ultimate retirement. Their target date for this money may be 10, 20 or 30 years or more from now. However, instead of looking for a bargain, they are overwhelmed by the bad news presented to them by the media on their television, IPad, cell phone or computer, and by everyone posing as an expert. They are being told that it is a dangerous world, so that they should put their

money in a safe investment. That safe investment may only earn 1 or 2%, but at least they won't lose their principal. That's the message they hear over and over, and young people are succumbing to this advice. To repeat, in the case of their retirement savings, they won't need these funds for 20 to 30 years. Using that so called safe investment advice and earning a 3% rate of return, they will need 26 years for their first investment dollars to double. What a shame!

Now let's look at the alternative choice, and what could happen if they would simply buy investments chosen by a professional manager of all of those same businesses from which they were buying goods and services.

Instead of putting money into savings accounts, why not own shares in several Canadian banks? Why not own the bank, instead of lending them money? And why not buy shares in lots of the great companies, the Walmarts, the Amazons, the Apples and the Microsoft's. Why not own the same companies from whom they are purchasing services and goods? Why not be an owner instead of a loaner?



Source: AGF Investments Inc.

Now here comes that big "What if?" question. What if the stock market on which companies are traded, for example the Toronto Stock Exchange, the Dow Jones or the S&P 500, go down? What if Korea does start a war, or the price of oil collapses, or rises? You get the idea. The great "What ifs?" begin to paralyze our 35-year-old couple and they just play it safe, or what they are told, and think is safe.

But what if they did something very different? What if they ignored all these negative and fear-based messages, and what if they regularly saved $500 a month towards their retirement goal, buying shares in all these wonderful companies, and others that will come to prominence? What if they also pay down their mortgage and other loans quickly, rather than spend the extra money saved on the current ultra low interest rates? What if this stock market drifted down for a year and then up for a year, to end at exactly the same place it is today? Let's consider what could and would happen.

As you can see, by the graph, compared to the person who was supposedly playing it safe, this approach to saving would produce a wonderful outcome, **despite the fact that the stock market never rose above its original starting level.** For the record, this investing technique is called dollar cost averaging. The message I'm conveying is simple.

If you're going to be a lifetime consumer of goods and services you want, need and must pay for, why not buy into the ownership of these great businesses. If the share prices decrease while you are in the process of buying, great! You get more shares for the same price.

And if you do this for a lifetime of saving, you will eliminate all the silly decisions based on the current **"What-if's?"** of temporary bad news. As a wonderful bonus, you will have had a lifetime of participating in the incredible growth of the world economies. You will be infinitely better prepared financially and emotionally to live in a world that is changing, but constantly improving. And you will have the money to enjoy all those advances in lifestyle options.

In a future article I will provide you the historical evidence for how this worked out so well for an older generation who, likewise, lived through a very long period of bad news. It worked out well for them, and it will work out well for the current generation of savers and investors.

As always, I welcome your comments and feedback! © 2016

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